

XL GROUP PLC
Form 10-Q
August 06, 2010

**UNITED STATES
SECURITIES AND EXCHANGE COMMISSION**
Washington, D.C. 20549

FORM 10-Q

QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF
THE SECURITIES EXCHANGE ACT OF 1934

For the quarterly period ended June 30, 2010

OR

TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF
THE SECURITIES EXCHANGE ACT OF 1934

For the transition period from ____ to ____

Commission file number 1-10804

XL GROUP

Public Limited Company

(Exact name of registrant as specified in its charter)

Ireland
(State or other jurisdiction of
incorporation or organization)

98-0665416
(I.R.S. Employer Identification No.)

No. 1 Hatch Street Upper, 4th Floor, Dublin 2, Ireland
(Address of principal executive offices and zip code)
+353 (1) 405-2033

(Registrant's telephone number, including area code)

Indicate by check mark whether the registrant: (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days.
Yes No

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes No

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, or a non-accelerated filer. See definition of accelerated filer and large accelerated filer in Rule 12b-2 of the Exchange Act. (Check one):

Large accelerated filer Accelerated filer Non-accelerated filer Smaller reporting company

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Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act).

Yes No

As of August 4, 2010, there were 342,010,919 outstanding Class A Ordinary Shares, \$0.01 par value per share, of the registrant.

XL GROUP PUBLIC LIMITED COMPANY

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PART I FINANCIAL INFORMATION

ITEM 1. FINANCIAL STATEMENTS

XL CAPITAL LTD

CONSOLIDATED BALANCE SHEETS

| | (Unaudited) June 30, 2010 | December 31, 2009 |
|--|---------------------------------|----------------------|
| <i>(U.S. dollars in thousands, except share amounts)</i> | | |
| ASSETS | | |
| Investments: | | |
| Fixed maturities, at fair value (amortized cost: 2010, \$27,995,736; 2009, \$28,798,504) | \$ 27,681,839 | \$ 27,512,032 |
| Equity securities, at fair value (cost: 2010, \$16,091; 2009, \$12,344) | 19,975 | 17,779 |
| Short-term investments, at fair value (amortized cost: 2010, \$1,544,344; 2009, \$1,767,197) | 1,552,301 | 1,777,360 |
| Total investments available for sale | 29,254,115 | 29,307,171 |
| Fixed maturities, held to maturity at amortized cost (fair value: 2010, \$504,726; 2009, \$530,319) | \$ 468,738 | \$ 546,067 |
| Investments in affiliates | 1,080,570 | 1,185,604 |
| Other investments | 858,636 | 783,189 |
| Total investments | 31,662,059 | 31,822,031 |
| Cash and cash equivalents | 3,801,194 | 3,643,697 |
| Accrued investment income | 326,297 | 350,055 |
| Deferred acquisition costs | 650,937 | 654,065 |
| Ceded unearned premiums | 783,132 | 711,875 |
| Premiums receivable | 2,756,348 | 2,597,602 |
| Reinsurance balances receivable | 236,054 | 374,844 |
| Unpaid losses and loss expenses recoverable | 3,454,004 | 3,584,028 |
| Net receivable from investments sold | | 84,617 |
| Goodwill and other intangible assets | 835,865 | 845,129 |
| Deferred tax asset | 169,590 | 240,425 |
| Other assets | 646,939 | 717,864 |
| Total assets | \$ 45,322,419 | \$ 45,626,232 |
| LIABILITIES AND SHAREHOLDERS EQUITY | | |
| Liabilities: | | |
| Unpaid losses and loss expenses | \$ 20,153,892 | \$ 20,823,524 |
| Deposit liabilities | 2,252,124 | 2,208,699 |
| Future policy benefit reserves | 4,892,612 | 5,490,119 |
| Unearned premiums | 3,842,364 | 3,651,310 |
| Notes payable and debt | 2,467,392 | 2,451,417 |
| Reinsurance balances payable | 327,064 | 378,887 |
| Net payable for investments purchased | 2,522 | 36,979 |
| Deferred tax liability | 82,748 | 46,557 |
| Other liabilities | 722,569 | 923,650 |
| Total liabilities | \$ 34,743,287 | \$ 36,011,142 |
| Commitments and Contingencies | | |
| Redeemable Series C preference ordinary shares, 20,000,000 authorized, par value \$0.01 Issued and outstanding: (2010, 2,876,000; 2009, 7,306,920) | \$ 71,900 | \$ 182,673 |

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| | | |
|---|----------------------|----------------------|
| Shareholders' Equity: | | |
| Noncontrolling interest in equity of consolidated subsidiaries | \$ 2,228 | \$ 2,305 |
| Series E preference ordinary shares, 1,000,000 authorized, par value \$0.01 Issued and outstanding: (2010, 1,000,000; 2009, 1,000,000) | 10 | 10 |
| Class A ordinary shares, 999,990,000 authorized, par value \$0.01 Issued and outstanding: (2010, 342,010,919; 2009, 342,118,986) | 3,421 | 3,421 |
| Additional paid in capital | 10,494,675 | 10,474,688 |
| Accumulated other comprehensive income (loss) | (338,733) | (1,142,467) |
| Retained earnings | 345,631 | 94,460 |
| | <hr/> | <hr/> |
| Total shareholders' equity | \$ 10,507,232 | \$ 9,432,417 |
| | <hr/> | <hr/> |
| Total liabilities, redeemable preference ordinary shares and shareholders' equity | \$ 45,322,419 | \$ 45,626,232 |
| | <hr/> | <hr/> |

See accompanying Notes to Unaudited Consolidated Financial Statements

XL CAPITAL LTD

CONSOLIDATED STATEMENTS OF INCOME

| | (Unaudited) Three Months Ended June 30, | | (Unaudited) Six Months Ended June 30, | |
|--|---|---------------------|---|---------------------|
| | 2010 | 2009 | 2010 | 2009 |
| <i>(U.S. dollars in thousands, except share amounts)</i> | | | | |
| Revenues: | | | | |
| Net premiums earned | \$ 1,302,761 | \$ 1,429,700 | \$ 2,671,246 | \$ 2,881,221 |
| Net investment income | 302,594 | 328,348 | 610,918 | 676,314 |
| Realized investment gains (losses): | | | | |
| Net realized gains (losses) on investments sold | (3,979) | 4,520 | 42 | 37,623 |
| Other-than-temporary impairments on investments | (26,736) | (115,620) | (87,250) | (400,660) |
| Other-than-temporary impairments on investments transferred to other comprehensive income | (30,671) | 30,670 | (10,354) | 30,670 |
| Total net realized gains (losses) on investments | (61,386) | (80,430) | (97,562) | (332,367) |
| Net realized and unrealized gains (losses) on derivative instruments | (19,896) | 969 | (40,376) | (438) |
| Net income (loss) from investment fund affiliates | 19,084 | 37,086 | 27,262 | 10,193 |
| Fee income and other | 9,535 | 9,824 | 17,953 | 21,982 |
| Total revenues | \$ 1,552,692 | \$ 1,725,497 | \$ 3,189,441 | \$ 3,256,905 |
| Expenses: | | | | |
| Net losses and loss expenses incurred | \$ 747,165 | \$ 779,628 | \$ 1,639,365 | \$ 1,569,911 |
| Claims and policy benefits | 123,375 | 174,588 | 247,118 | 332,547 |
| Acquisition costs | 180,560 | 223,272 | 381,697 | 441,491 |
| Operating expenses | 244,867 | 264,247 | 473,975 | 532,634 |
| Exchange (gains) losses | (32,276) | 145,221 | (53,359) | 120,597 |
| Interest expense | 49,149 | 54,198 | 98,219 | 115,539 |
| Loss on termination of guarantee | 23,500 | | 23,500 | |
| Amortization of intangible assets | 464 | 464 | 929 | 929 |
| Total expenses | \$ 1,336,804 | \$ 1,641,618 | \$ 2,811,444 | \$ 3,113,648 |
| Income (loss) before income tax and income (loss) from operating affiliates | \$ 215,888 | \$ 83,879 | \$ 377,997 | \$ 143,257 |
| Provision for income tax | 42,976 | 16,045 | 72,812 | 61,998 |
| Income (loss) from operating affiliates | 21,013 | 17,667 | 32,619 | 7,339 |
| Net income | \$ 193,925 | \$ 85,501 | \$ 337,804 | \$ 88,598 |
| Non-controlling interest in net (income) loss of subsidiary | 80 | 40 | 81 | 40 |
| Net income attributable to XL Capital Ltd | \$ 194,005 | \$ 85,541 | \$ 337,885 | \$ 88,638 |
| Preference share dividends | (2,194) | (5,592) | (34,694) | (42,126) |
| Gain on redemption of Series C Preference Ordinary Shares | | | 16,616 | 211,816 |
| Net income attributable to ordinary shareholders | \$ 191,811 | \$ 79,949 | \$ 319,807 | \$ 258,328 |
| Weighted average ordinary shares and ordinary share equivalents outstanding basic (in thousands) | 342,056 | 342,154 | 342,049 | 339,155 |
| Weighted average ordinary shares and ordinary share equivalents outstanding diluted (in thousands) | 342,878 | 342,468 | 342,781 | 339,262 |

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| | | | | |
|---|---------|---------|---------|---------|
| Earnings per ordinary share and ordinary share equivalent - basic | \$ 0.56 | \$ 0.23 | \$ 0.93 | \$ 0.76 |
| Earnings per ordinary share and ordinary share equivalent - diluted | \$ 0.56 | \$ 0.23 | \$ 0.93 | \$ 0.76 |

See accompanying Notes to Unaudited Consolidated Financial Statements

XL CAPITAL LTD

CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME

| | (Unaudited) Three Months Ended June 30, | | (Unaudited) Six Months Ended June 30, | |
|--|---|---------------------|---|-------------------|
| | 2010 | 2009 | 2010 | 2009 |
| <i>(U.S. dollars in thousands)</i> | | | | |
| Net income attributable to XL Capital Ltd | \$ 194,005 | \$ 85,541 | \$ 337,885 | \$ 88,638 |
| Impact of adoption of new authoritative other-than-temporary (OTTI) guidance, net of tax | | (229,670) | | (229,670) |
| Change in net unrealized gains (losses) on investments, net of tax | 324,308 | 1,115,165 | 880,332 | 326,480 |
| Change in other-than-temporary impairment losses recognized in other comprehensive income, net of tax | 48,095 | (25,595) | 31,637 | (25,595) |
| Change in underfunded pension liability | 85 | (250) | 3,567 | (316) |
| Change in value of cash flow hedge | 110 | 110 | 220 | 218 |
| Foreign currency translation adjustments, net | (75,823) | 184,893 | (108,308) | 89,639 |
| Change in net unrealized gain (loss) on future policy benefit reserves | (962) | (5,487) | (3,714) | 2,007 |
| Comprehensive income (loss) | \$ 489,818 | \$ 1,124,707 | \$ 1,141,619 | \$ 251,401 |

See accompanying Notes to Unaudited Consolidated Financial Statements

XL CAPITAL LTD

CONSOLIDATED STATEMENTS OF SHAREHOLDERS EQUITY

| | (Unaudited) Six Months Ended June 30, | |
|---|---|-----------------------|
| | 2010 | 2009 |
| <i>(U.S. dollars in thousands)</i> | | |
| Noncontrolling Interest in Equity of Consolidated Subsidiaries: | | |
| Balance beginning of year | \$ 2,305 | \$ 1,598 |
| Non-controlling interest share in net income (loss) of subsidiary | (81) | \$ (40) |
| Non-controlling interest share in change in accumulated other comprehensive (income) loss | 4 | 816 |
| Balance end of period | \$ 2,228 | \$ 2,374 |
| Series E Preference Ordinary Shares: | | |
| Balance beginning of year | \$ 10 | \$ 10 |
| Balance end of period | \$ 10 | \$ 10 |
| Class A Ordinary Shares: | | |
| Balance beginning of year | \$ 3,421 | \$ 3,308 |
| Issuance of Class A ordinary shares | | 115 |
| Exercise of stock options | 1 | 1 |
| Repurchase of shares | (1) | (2) |
| Balance end of period | \$ 3,421 | \$ 3,422 |
| Additional Paid in Capital: | | |
| Balance beginning of year | \$ 10,474,688 | \$ 9,792,371 |
| Issuance of Class A ordinary shares | 1,095 | 742,258 |
| Repurchase of Class A ordinary shares | (1,840) | |
| Dividends on Class A ordinary shares | | (68,390) |
| Dividends on preference ordinary shares | | (42,126) |
| Exercise of stock options, net of tax benefit | 104 | |
| Share based compensation expense | 20,628 | 30,869 |
| Balance end of period | \$ 10,494,675 | \$ 10,454,982 |
| Accumulated Other Comprehensive Income (Loss): | | |
| Balance beginning of year | \$ (1,142,467) | \$ (3,364,927) |
| Impact of adoption of new authoritative OTTI guidance, net of taxes | | (229,670) |
| Change in net unrealized (losses) on investment portfolio, net of tax | 863,940 | 319,960 |
| Change in net unrealized (losses) gains on affiliate and other investments, net of tax | 16,392 | 6,520 |
| Change in OTTI losses recognized in other comprehensive income, net of tax | 31,637 | (25,595) |
| Change in underfunded pension liability | 3,567 | (316) |
| Change in value of cash flow hedge | 220 | 218 |
| Foreign currency translation adjustments | (108,308) | 89,639 |
| Change in net unrealized gain (loss) on future policy benefit reserves | (3,714) | 2,007 |
| Balance end of period | \$ (338,733) | \$ (3,202,164) |
| Retained Earnings (Deficit): | | |
| Balance beginning of year | \$ 94,460 | \$ (315,529) |
| Impact of adoption of new authoritative OTTI guidance, net of taxes | | 229,670 |

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| | | |
|---|-------------------|-------------------|
| Net income attributable to XL Capital Ltd | 337,885 | 88,638 |
| Dividends on Series E preference ordinary shares | (34,694) | |
| Dividends on Class A ordinary shares | (68,636) | |
| Gain on redemption of Series C preference ordinary shares | 16,616 | 211,816 |
| | <u> </u> | <u> </u> |
| Balance end of period | \$ 345,631 | \$ 214,595 |
| | <u> </u> | <u> </u> |
| Total Shareholders Equity | \$ 10,507,232 | \$ 7,473,219 |
| | <u> </u> | <u> </u> |

See accompanying Notes to Unaudited Consolidated Financial Statements

XL CAPITAL LTD

CONSOLIDATED STATEMENTS OF CASH FLOWS

| | (Unaudited) Six Months Ended June 30, | |
|--|---|---------------------|
| | 2010 | 2009 |
| <i>(U.S. dollars in thousands)</i> | | |
| Cash flows (used in) provided by operating activities: | | |
| Net income attributable to XL Capital Ltd | \$ 337,885 | \$ 88,638 |
| Adjustments to reconcile net income to net cash (used in) provided by operating activities: | | |
| Net realized losses on sales of investments | 97,562 | 332,367 |
| Net realized and unrealized losses on derivative instruments | 40,376 | 438 |
| Amortization of premiums (discounts) on fixed maturities | 20,396 | (18,267) |
| (Income) loss from investment and operating affiliates | (59,881) | (17,532) |
| Amortization of deferred compensation | 15,586 | 19,713 |
| Accretion of convertible debt | 500 | 496 |
| Accretion of deposit liabilities | 51,229 | 23,306 |
| Unpaid losses and loss expenses | (139,971) | (328,569) |
| Future policy benefit reserves | (124,805) | (45,102) |
| Unearned premiums | 321,433 | (13,572) |
| Premiums receivable | (300,119) | (154,816) |
| Unpaid losses and loss expenses recoverable | 61,732 | 121,547 |
| Ceded unearned premiums | (95,083) | (51,718) |
| Reinsurance balances receivable | 132,088 | 165,926 |
| Deferred acquisition costs | (21,706) | (21,422) |
| Reinsurance balances payable | (34,782) | (252,006) |
| Deferred tax asset | 51,008 | (26,375) |
| Other assets | 55,262 | (42,857) |
| Other liabilities | (155,048) | (253,383) |
| Other | 117,365 | (47,780) |
| Total adjustments | \$ 33,142 | \$ (609,606) |
| Net cash provided by (used in) operating activities | \$ 371,027 | \$ (520,968) |
| Cash flows provided by (used in) investing activities: | | |
| Proceeds from sale of fixed maturities and short-term investments | \$ 2,386,683 | \$ 5,140,997 |
| Proceeds from redemption of fixed maturities and short-term investments | 1,438,725 | 2,119,654 |
| Proceeds from sale of equity securities | 37,344 | 353,600 |
| Purchases of fixed maturities and short-term investments | (3,850,644) | (7,467,848) |
| Purchases of equity securities | (41,026) | (18,339) |
| Net dispositions of investment affiliates | 174,179 | 597,852 |
| Other investments, net | (8,728) | (25,014) |
| Net cash provided by (used in) investing activities | \$ 136,533 | \$ 700,902 |
| Cash flows (used in) financing activities: | | |
| Proceeds from issuance of Class A ordinary shares | \$ | \$ 745,000 |
| Repurchase of Class A ordinary shares | (1,840) | (541) |
| Redemption of Series C preference ordinary shares | (94,157) | (104,718) |
| Dividends paid on Class A ordinary shares | (68,398) | (68,372) |
| Dividends paid on preference ordinary shares | (38,073) | (50,178) |
| Deposit liabilities | (64,120) | (138,976) |
| Repayment of debt | | (745,000) |
| Collateral received on securities lending | | 108,906 |
| Collateral returned on securities lending | | (351,568) |

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| | | |
|---|---------------------|---------------------|
| Net cash (used in) financing activities | \$ (266,588) | \$ (605,447) |
| Effects of exchange rate changes on foreign currency cash | (83,475) | 61,059 |
| Increase (decrease) in cash and cash equivalents | 157,497 | (364,454) |
| Cash and cash equivalents beginning of period | 3,643,697 | 4,353,826 |
| Cash and cash equivalents end of period | \$ 3,801,194 | \$ 3,989,372 |

See accompanying Notes to Unaudited Consolidated Financial Statements

XL CAPITAL LTD

NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS

1. Basis of Preparation and Consolidation

Unless the context otherwise indicates, references herein to the Company include XL Capital Ltd and its consolidated subsidiaries.

These unaudited consolidated financial statements include the accounts of the Company and all of its subsidiaries and have been prepared in accordance with accounting principles generally accepted in the United States of America (GAAP) for interim financial information and with the instructions to Form 10-Q and Article 10 of Regulation S-X. Accordingly, they do not include all of the information and footnotes required by GAAP for complete financial statements. In addition, the year-end balance sheet data was derived from audited financial statements but does not include all disclosures required by GAAP. In the opinion of management, these unaudited financial statements reflect all adjustments (consisting of normal recurring accruals) considered necessary for a fair statement of financial position and results of operations as at the end of and for the periods presented. The results of operations for any interim period are not necessarily indicative of the results for a full year. All significant inter-company accounts and transactions have been eliminated. The preparation of financial statements in conformity with GAAP requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ materially from these estimates.

To facilitate period-to-period comparisons, certain reclassifications have been made to prior period consolidated financial statement amounts to conform to current period presentation. There was no effect on net income from this change in presentation.

On July 1, 2010, XL Capital Ltd changed its name to XL Group Ltd.

In addition, on July 1, 2010, XL Group plc, an Irish public limited company (XL Ireland), and XL Group plc (formerly, XL Capital Ltd), a Cayman Islands exempted company (XL-Cayman), completed a redomestication transaction in which all of the ordinary shares of XL-Cayman were exchanged for all of the ordinary shares of XL-Ireland (the Redomestication). As a result, XL-Cayman became a wholly owned subsidiary of XL-Ireland. On July 23, 2010, the Irish High Court approved XL Group plc s creation of distributable reserves, subject to the completion of certain formalities under Irish Company law. These formalities are expected to be completed in early August 2010. For further detailed information on this transaction and its impacts on shareholder rights, shareholders equity, debt and notes outstanding and employee stock plan awards, see the Company s Report on Form 8-K filed with the U.S. Securities and Exchange Commission on July 2, 2010.

2. Significant Accounting Policies

(a) Recent Accounting Pronouncements

In June 2009, the FASB issued final authoritative guidance over accounting for transfers of financial assets which removes the concept of a qualifying special-purpose entity from existing accounting guidance over transfers of financial assets and also removes the exception from applying guidance surrounding consolidation of variable interest entities to qualifying special-purpose entities. This new guidance was applied by the Company from January 1, 2010, however, it did not have an impact on the Company s financial condition or results of operations.

In June 2009, the FASB issued final authoritative accounting guidance in an effort to improve financial reporting by enterprises involved with variable interest entities. This guidance retains the scope of the previous standard covering variable interest entities except, as noted above, with the addition of entities previously considered qualifying special-purpose entities. The new guidance requires an enterprise to perform an analysis to determine whether the enterprise s variable interest or interests give it a controlling financial interest in a variable interest entity under revised guidelines that are more qualitative than under previous guidance and amends previous guidance to require ongoing reassessments of whether an enterprise is the primary beneficiary of a variable interest entity. Before this update, previous guidance required reconsideration of whether an enterprise is the primary beneficiary of a variable interest entity only when specific events occurred. The new guidance also amends previous guidance to require enhanced disclosures that provide users of financial statements with more transparent information about an enterprise s involvement with a variable interest entity. The enhanced disclosures are required for any enterprise that holds a variable interest in a variable interest entity. The content of the enhanced disclosures required by this new guidance is generally consistent with that required by the previous standards. The Company applied this new guidance from January 1, 2010, however, it did not have an impact on the Company s financial condition and results of operations. See Note 10, Variable Interest Entities , for the disclosures required by this guidance.

XL CAPITAL LTD

NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

2. Significant Accounting Policies (Continued)

(a) Recent Accounting Pronouncements (Continued)

In January 2010, the FASB issued an accounting standards update on Improving Disclosures about Fair Value Measurements. The provisions of this authoritative guidance require new disclosures about recurring and nonrecurring fair value measurements including significant transfers into and out of Level 1 and Level 2 fair value measurements and information on purchases, sales, issuances, and settlements on a gross basis in the reconciliation of Level 3 fair value measurements. This guidance was effective for the Company from January 1, 2010, except for the Level 3 reconciliation disclosures which are effective for annual periods beginning after December 15, 2010. This standard affects disclosures only and accordingly did not have an impact on the Company's financial condition or results of operations.

In March 2010, the FASB issued authoritative guidance relating to derivative accounting. Under this guidance, all entities that enter into contracts containing an embedded credit derivative feature related to the transfer of credit risk that is not in the form of subordination of one financial instrument to another will be affected. The guidance clarifies that the embedded credit derivative scope exception found in existing derivative guidance does not apply to such contracts. As a result, entities that have contracts containing an embedded credit derivative feature in a form other than such subordination may need to separately account for the embedded credit derivative feature. This guidance will be effective and applied as of July 1, 2010. The Company has investments in senior tranches of Synthetic Collateralized Debt Obligations (CDO) as well as certain CDOs of CDO structures that hold credit default swap contracts rather than direct credit exposures. The derivative instruments held within these structures are impacted by this new guidance. The Company holds Synthetic CDOs and CDOs of CDO structures with an amortized cost of \$75.3 million and net unrealized losses of \$32.1 million as of June 30, 2010. Upon initial adoption of this guidance the Company will elect to apply the fair value option for impacted securities. This is expected to result in a decrease to opening retained earnings of approximately \$32.1 million. Subsequent to July 1, 2010, the changes in fair value of these securities will be recorded in earnings.

3. Fair Value Measurements

Fair value is defined as the exchange price that would be received for an asset or paid to transfer a liability (an exit price), in the principal or most advantageous market for the asset or liability in an orderly transaction between market participants as of the measurement date. Applicable accounting guidance provides an established hierarchy for inputs used in measuring fair value that maximizes the use of observable inputs and minimizes the use of unobservable inputs by requiring that the most observable inputs be used when available. Observable inputs are inputs that market participants would use in valuing the asset or liability and are developed based on market data obtained from sources independent of the Company. Unobservable inputs are inputs that reflect the Company's assumptions about the factors that market participants would use in valuing the asset or liability. Assets and liabilities are classified based on the lowest level of input that is significant to the fair value measurements. The Company reviews the fair value hierarchy classification on a quarterly basis. Changes in the observability of valuation inputs may result in a reclassification of levels for certain securities within the fair value hierarchy.

XL CAPITAL LTD

NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

3. Fair Value Measurements (Continued)

The following tables set forth the Company's assets and liabilities that were accounted for at fair value as of June 30, 2010 and December 31, 2009 by level within the fair value hierarchy (for further information, see Item 8, Note 2 to the Consolidated Financial Statements, Significant Accounting Policies in the Company's Annual Report on Form 10-K for the year ended December 31, 2009):

| June 30, 2010 <i>(U.S. dollars in thousands)</i> <i>(Unaudited)</i> | Quoted Prices in Active Markets for Identical Assets (Level 1) | Significant Other Observable Inputs (Level 2) | Significant Unobservable Inputs (Level 3) | Collateral and Counterparty Netting | Balance as of June 30, 2010 |
|---|---|---|--|---|--------------------------------------|
| Assets | | | | | |
| U.S. Government and Government-Related/Supported Corporate (1) | \$ | \$ 2,491,906 | \$ | \$ | \$ 2,491,906 |
| Residential mortgage-backed securities Agency | | 10,663,540 | 39,676 | | 10,703,216 |
| Residential mortgage-backed securities Non-Agency | | 5,935,953 | 1,226 | | 5,937,179 |
| Commercial mortgage-backed securities Collateralized debt obligations | | 1,321,593 | 10,008 | | 1,331,601 |
| Other asset-backed securities | | 1,259,407 | 427 | | 1,259,834 |
| U.S. States and political subdivisions of the States | | 12,678 | 686,767 | | 699,445 |
| Non-U.S. Sovereign Government, Supranational and Government-Related | | 1,165,261 | 22,521 | | 1,187,782 |
| | | 1,140,876 | | | 1,140,876 |
| | | 2,926,818 | 3,182 | | 2,930,000 |
| Total fixed maturities, at fair value | \$ | \$ 26,918,032 | \$ 763,807 | \$ | \$ 27,681,839 |
| Equity securities, at fair value | 8,042 | 11,933 | | | 19,975 |
| Short-term investments, at fair value (2) | | 1,547,220 | 5,081 | | 1,552,301 |
| Total investments available for sale | \$ 8,042 | \$ 28,477,185 | \$ 768,888 | \$ | \$ 29,254,115 |
| Cash equivalents (3) | 1,979,540 | 726,341 | | | 2,705,881 |
| Other investments (4) | | 402,916 | 92,857 | | 495,773 |
| Other assets (5)(6) | | 156,701 | 252,921 | (305,253) | 104,369 |
| Total assets accounted for at fair value | \$ 1,987,582 | \$ 29,763,143 | \$ 1,114,666 | \$ (305,253) | \$ 32,560,138 |
| Liabilities | | | | | |
| Financial instruments sold, but not yet purchased (7) | \$ | \$ 29,008 | \$ | \$ | \$ 29,008 |
| Other liabilities (5)(6) | | 17,993 | 90,010 | (56,976) | 51,027 |
| Total liabilities accounted for at fair value | \$ | \$ 47,001 | \$ 90,010 | \$ (56,976) | \$ 80,035 |

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NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

3. Fair Value Measurements (Continued)

| December 31, 2009 <i>(U.S. dollars in thousands)</i> | Quoted Prices in Active Markets for Identical Assets (Level 1) | Significant Other Observable Inputs (Level 2) | Significant Unobservable Inputs (Level 3) | Collateral and Counterparty Netting | Balance as of December 31, 2009 |
|--|---|---|--|---|--|
| Assets | | | | | |
| U.S. Government and Government-Related/Supported Corporate (1) | \$ | \$ 2,664,625 | \$ | \$ | \$ 2,664,625 |
| Residential mortgage-backed securities Agency | | 9,788,689 | 10,311 | | 9,799,000 |
| Residential mortgage-backed securities Non-Agency | | 6,220,607 | 7,894 | | 6,228,501 |
| Commercial mortgage-backed securities Collateralized debt obligations | | 1,379,125 | 42,190 | | 1,421,315 |
| Other asset-backed securities | | 1,214,044 | 2,755 | | 1,216,799 |
| U.S. States and political subdivisions of the States | | 507,898 | 190,663 | | 698,561 |
| Non-U.S. Sovereign Government, Supranational and Government-Related | | 1,129,806 | 38,179 | | 1,167,985 |
| | | 913,473 | | | 913,473 |
| | | 3,398,556 | 3,217 | | 3,401,773 |
| Total fixed maturities, at fair value | \$ | \$ 27,216,823 | \$ 295,209 | \$ | \$ 27,512,032 |
| Equity securities, at fair value | 5,621 | 12,158 | | | 17,779 |
| Short-term investments, at fair value (2) | | 1,770,874 | 6,486 | | 1,777,360 |
| Total investments available for sale | \$ 5,621 | \$ 28,999,855 | \$ 301,695 | \$ | \$ 29,307,171 |
| Cash equivalents (3) | 1,496,938 | 1,136,268 | | | 2,633,206 |
| Other investments (4) | | 342,005 | 75,584 | | 417,589 |
| Other assets (5)(6) | | 117,401 | 185,455 | (218,409) | 84,447 |
| Total assets accounted for at fair value | \$ 1,502,559 | \$ 30,595,529 | \$ 562,734 | \$ (218,409) | \$ 32,442,413 |
| Liabilities | | | | | |
| Financial instruments sold, but not yet purchased (7) | \$ | \$ 36,979 | \$ | \$ | \$ 36,979 |
| Other liabilities (5)(6) | | 24,337 | 84,940 | (49,319) | 59,958 |
| Total liabilities accounted for at fair value | \$ | \$ 61,316 | \$ 84,940 | \$ (49,319) | \$ 96,937 |

(1) Included within Corporate are certain floating rate medium term notes supported primarily by pools of European credit with varying degrees of leverage. The notes have a fair value of \$552.6 million and \$587.7 million and an amortized cost of \$620.2 million and \$707.9 million at June 30, 2010 and December 31, 2009, respectively. These notes allow the investor to participate in cash flows of the underlying bonds including certain residual values, which could serve to either decrease or increase the ultimate values of these notes.

(2) Short-term investments consist primarily of Corporate, U.S. Government and Government-Related/Supported securities and Non-U.S. Sovereign Government, Supranational and Government-Related securities.

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- (3) Cash equivalents balances subject to fair value measurement include certificates of deposit and money market funds. Operating cash balances are not subject to fair value measurement guidance.
- (4) The Other investments balance excludes certain structured transactions including certain investments in project finance transactions, a payment obligation and liquidity financing provided to a structured credit vehicle as a part of a third party medium term note facility. These investments are carried at amortized cost that totaled \$362.9 million at June 30, 2010 and \$365.6 million at December 31, 2009.
- (5) Other assets and other liabilities include derivative instruments.

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NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

3. Fair Value Measurements (Continued)

- (6) The derivative balances included in each category above are reported on a gross basis by level with a netting adjustment presented separately in the Collateral and Counterparty Netting column. The Company often enters into different types of derivative contracts with a single counterparty and these contracts are covered under a netting agreement. In addition, the Company held net cash collateral related to derivative assets of approximately \$254.2 million and \$169.1 million at June 30, 2010 and December 31, 2009, respectively. This balance is included within cash and cash equivalents and the corresponding liability to return the collateral has been offset against the derivative asset within the balance sheet as appropriate under the netting agreement. The fair value of the individual derivative contracts are reported gross in their respective levels based on the fair value hierarchy.
- (7) Financial instruments sold, but not yet purchased represent short sales and are included within Net payable for investments purchased on the balance sheet. *Level 3 Gains and Losses*

The tables below present additional information about assets and liabilities measured at fair value on a recurring basis and for which Level 3 inputs were utilized to determine fair value. The table reflects gains and losses for the three and six month periods ended June 30, 2010 and June 30, 2009 for all financial assets and liabilities categorized as Level 3 as of June 30, 2010 and June 30, 2009, respectively. The tables do not include gains or losses that were reported in Level 3 in prior periods for assets that were transferred out of Level 3 prior to June 30, 2010 and June 30, 2009. Gains and losses for assets and liabilities classified within Level 3 in the table below may include changes in fair value that are attributable to both observable inputs (Levels 1 and 2) and unobservable inputs (Level 3). Further, it should be noted that the following tables do not take into consideration the effect of offsetting Level 1 and 2 financial instruments entered into by the Company that are either economically hedged by certain exposures to the Level 3 positions or that hedge the exposures in Level 3 positions.

In general, Level 3 assets include securities for which the values were obtained from brokers where either significant inputs were utilized in determining the value that were difficult to corroborate with observable market data, or sufficient information regarding the specific inputs utilized by the broker was not available to support a Level 2 classification. Level 3 assets also include securities for which the Company determined that current market trades represent distressed transactions, and accordingly, the Company determined fair value using certain inputs that are not observable to market participants. Transfers into or out of Level 3 primarily arise as a result of the valuations utilized by the Company changing between those provided by independent pricing services that do not contain significant unobservable inputs, and other valuations sourced from either brokers or in limited instances from internal models for certain assets, which are considered Level 3.

There were no transfers between Level 1 and Level 2 during the six month periods ending June 30, 2010 and 2009.

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NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

3. Fair Value Measurements (Continued)

Level 3 Gains and Losses (continued)

| (U.S. dollars in thousands) (Unaudited) | Level 3 Assets and Liabilities Three Months Ended June 30, 2010 | | | | |
|---|--|--|--|---|------------------------------------|
| | Corporate | Residential mortgage-backed securities Agency | Residential mortgage-backed securities Agency | Commercial mortgage-backed securities | Collateralized debt obligations |
| Balance, beginning of period | \$ 9,493 | \$ | \$ 30,000 | \$ 41,655 | \$ 711,749 |
| Realized gains (losses) | 117 | | (2,681) | (286) | (7,930) |
| Movement in unrealized gains (losses) | 33 | | 474 | (60) | (13,889) |
| Purchases, sales issuances and settlements, net | 22,687 | 1,226 | (1,748) | | (467) |
| Transfers into Level 3 | 12,146 | | 7,201 | | |
| Transfers out of Level 3 | (4,800) | | (23,238) | (40,882) | (1,280) |
| Fixed maturities to short-term investments classification change | | | | | (1,416) |
| Balance, end of period | \$ 39,676 | \$ 1,226 | \$ 10,008 | \$ 427 | \$ 686,767 |
| Movement in total gains (losses) above relating to instruments still held at the reporting date | \$ 316 | \$ | \$ 340 | \$ (54) | \$ (15,385) |

| (U.S. dollars in thousands) (Unaudited) | Level 3 Assets and Liabilities Three Months Ended June 30, 2010 (Continued) | | | | |
|---|--|--|---------------------------|----------------------|-------------------------------|
| | Other asset backed securities | Non-U.S. Sovereign Government and Supranationals and Government Related | Short-term Investments | Other investments | Derivative Contracts - Net |
| Balance, beginning of period | \$ 52,082 | \$ 3,242 | \$ 6,566 | \$ 83,088 | \$ 104,474 |
| Realized gains (losses) | (7,742) | | (1,146) | 2,565 | |
| Movement in unrealized gains (losses) | 5,490 | (60) | (160) | 1,567 | 53,027 |
| Purchases, sales issuances and settlements, net | (75) | | (717) | 5,637 | 5,410 |
| Transfers into Level 3 | | | | | |
| Transfers out of Level 3 | (27,234) | | (878) | | |
| Fixed maturities to short-term investments classification change | | | 1,416 | | |
| Balance, end of period | \$ 22,521 | \$ 3,182 | \$ 5,081 | \$ 92,857 | \$ 162,911 |
| | \$ (3,221) | \$ (60) | \$ (58) | \$ 1,567 | \$ 53,027 |

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NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

3. Fair Value Measurements (Continued)

Level 3 Gains and Losses (continued)

| (U.S. dollars in thousands) (Unaudited) | Level 3 Assets and Liabilities Six Months Ended June 30, 2010 | | | | |
|--|--|--|---|---|---------------------------------------|
| | Corporate | Residential mortgage-backed securities Agency | Residential mortgage-backed securities Non Agency | Commercial mortgage-backed securities | Collateralized debt obligations |
| Balance, beginning of period | \$ 10,311 | \$ 7,894 | \$ 42,190 | \$ 2,755 | \$ 190,663 |
| Realized gains (losses) | (4,438) | | (5,674) | (209) | (13,174) |
| Movement in unrealized gains (losses) | 480 | | 706 | 16 | 16,636 |
| Purchases, sales issuances and settlements, net | 22,140 | 1,226 | (844) | (706) | (14) |
| Transfers into Level 3 | 14,951 | | 8,433 | | 495,734 |
| Transfers out of Level 3 | (3,768) | (7,894) | (34,803) | (1,429) | (1,356) |
| Fixed maturities to short-term investments classification change | | | | | (1,722) |
| Balance, end of period | \$ 39,676 | \$ 1,226 | \$ 10,008 | \$ 427 | \$ 686,767 |
| Movement in total gains (losses) above relating to instruments still held at the reporting date | \$ 599 | \$ | \$ 405 | \$ (151) | \$ 15,574 |

| (U.S. dollars in thousands) (Unaudited) | Level 3 Assets and Liabilities Six Months Ended June 30, 2010 (Continued) | | | | |
|--|--|--|---------------------------|----------------------|----------------------------------|
| | Other asset backed securities | Non-U.S. Sovereign Government and Supranationals and Government Related | Short-term Investments | Other investments | Derivative Contracts - Net |
| Balance, beginning of period | \$ 38,179 | \$ 3,217 | \$ 6,486 | \$ 75,584 | \$ 100,515 |
| Realized gains (losses) | (14,082) | | (4,502) | 2,565 | |
| Movement in unrealized gains (losses) | 9,236 | (102) | 2,512 | 5,552 | 51,637 |
| Purchases, sales issuances and settlements, net | 4,437 | | (2,124) | 9,156 | 10,759 |
| Transfers into Level 3 | 204 | 67 | 987 | | |
| Transfers out of Level 3 | (15,453) | | | | |
| Fixed maturities to short-term investments classification change | | | 1,722 | | |
| Balance, end of period | \$ 22,521 | \$ 3,182 | \$ 5,081 | \$ 92,857 | \$ 162,911 |
| Movement in total gains (losses) above relating to instruments still held at the reporting date | \$ (1,168) | \$ (102) | \$ 2,193 | \$ 5,552 | \$ 51,637 |

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NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

3. Fair Value Measurements (Continued)

Level 3 Gains and Losses (continued)

| | Level 3 Assets and Liabilities Three Months Ended June 30, 2009 | | | | |
|---|--|--|---|---------------------------------------|-------------------------------------|
| | Corporate | Residential mortgage-backed securities Agency | Commercial mortgage-backed securities | Collateralized debt obligations | Other asset backed securities |
| <i>(U.S. dollars in thousands)</i> <i>(Unaudited)</i> | | | | | |
| Balance, beginning of period | \$ 31,146 | \$ 19,270 | \$ 34,933 | \$ 429,460 | \$ 61,794 |
| Realized gains (losses) | (1,224) | (749) | (1,069) | (8,916) | 507 |
| Movement in unrealized gains (losses) | 3,545 | 2,631 | (670) | 102,377 | (4,509) |
| Purchases, sales issuances and settlements, net | (2,223) | | (57) | (915) | |
| Transfers into Level 3 | 1,974 | 174 | 166 | 993 | 7 |
| Transfers out of Level 3 | (11,716) | (2,388) | (14) | (19,831) | (14,458) |
| Fixed maturities to short-term investments classification change | (40) | | | | |
| Balance, end of period | \$ 21,462 | \$ 18,938 | \$ 33,289 | \$ 503,168 | \$ 43,341 |
| Movement in total gains (losses) above relating to instruments still held at the reporting date | \$ 2,425 | \$ 2,091 | \$ (734) | \$ 89,027 | \$ (4,886) |

| | Level 3 Assets and Liabilities Three Months Ended June 30, 2009 (continued) | | | |
|---|--|---------------------------|----------------------|----------------------------------|
| | Non-U.S. Sovereign Government | Short-term Investments | Other investments | Derivative Contracts - Net |
| <i>(U.S. dollars in thousands)</i> <i>(Unaudited)</i> | | | | |
| Balance, beginning of period | \$ 45,719 | \$ 13,830 | \$ 64,391 | \$ 186,448 |
| Realized gains (losses) | 912 | (4,167) | | 2,823 |
| Movement in unrealized gains (losses) | 847 | 7,348 | 1,720 | (73,454) |
| Purchases, sales issuances and settlements, net | 15,975 | 471 | (977) | 4,918 |
| Transfers into Level 3 | | 188 | | |
| Transfers out of Level 3 | (17,960) | (4) | | |
| Fixed maturities to short-term investments classification change | (2,908) | 2,948 | | |
| Balance, end of period | \$ 42,585 | \$ 20,614 | \$ 65,134 | \$ 120,735 |
| Movement in total gains (losses) above relating to instruments still held at the reporting date | \$ (775) | \$ 5,485 | \$ 1,720 | \$ (73,454) |

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NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

3. Fair Value Measurements (Continued)

Level 3 Gains and Losses (continued)

| (U.S. dollars in thousands) (Unaudited) | Level 3 Assets and Liabilities Six Months Ended June 30, 2009 | | | | |
|--|--|--|---|---------------------------------------|-------------------------------------|
| | Corporate | Residential mortgage-backed securities Agency | Commercial mortgage-backed securities | Collateralized debt obligations | Other asset backed securities |
| Balance, beginning of period | \$ 62,506 | \$ 37,150 | \$ 43,811 | \$ 598,110 | \$ 121,150 |
| Realized gains (losses) | (5,514) | (2,621) | (4,294) | (29,518) | (2,570) |
| Movement in unrealized gains (losses) | 6,042 | 2,116 | 7,551 | (19,525) | (6,789) |
| Purchases, sales issuances and settlements, net | (4,071) | 641 | (5,260) | (11,826) | (5,481) |
| Transfers into Level 3 | 1,455 | 200 | 3,082 | 1,044 | 2 |
| Transfers out of Level 3 | (38,256) | (18,548) | (11,601) | (35,117) | (62,971) |
| Fixed maturities to short-term investments classification change | (700) | | | | |
| Balance, end of period | \$ 21,462 | \$ 18,938 | \$ 33,289 | \$ 503,168 | \$ 43,341 |
| Movement in total gains (losses) above relating to instruments still held at the reporting date | \$ 4,073 | \$ 1,970 | \$ 5,741 | \$ (36,681) | \$ (9,476) |

| (U.S. dollars in thousands) (Unaudited) | Level 3 Assets and Liabilities Six Months Ended June 30, 2009 (continued) | | | |
|--|--|---------------------------|----------------------|----------------------------------|
| | Non-U.S. Sovereign Government | Short-term Investments | Other investments | Derivative Contracts - Net |
| Balance, beginning of period | \$ 89,152 | \$ 20,746 | \$ 65,354 | \$ 226,818 |
| Realized gains (losses) | | (2,827) | | 2,823 |
| Movement in unrealized gains (losses) | (1,192) | 3,684 | (5,898) | (118,803) |
| Purchases, sales issuances and settlements, net | 16,395 | (5,073) | 5,678 | 9,897 |
| Transfers into Level 3 | | 418 | | |
| Transfers out of Level 3 | (58,804) | | | |
| Fixed maturities to short-term investments classification change | (2,966) | 3,666 | | |
| Balance, end of period | \$ 42,585 | \$ 20,614 | \$ 65,134 | \$ 120,735 |
| Movement in total gains (losses) above relating to instruments still held at the reporting date | \$ (1,026) | \$ 2,700 | \$ (5,898) | \$ (118,803) |

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NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

3. Fair Value Measurements (Continued)

Fixed maturities and short-term investments

During the six months ended June 30, 2010, certain CDOs that were previously classified as Level 2 due to sufficient market data being available to allow a price to be determined and provided by third party pricing vendors, were transferred to Level 3 because third party vendor prices were no longer believed to be the most appropriate pricing source, therefore, broker quotes are the primary source of the valuations for these CDOs.

In addition, at each of June 30, 2010 and 2009, certain fixed maturity securities that were previously classified as Level 3, due to a lack of available third party vendor pricing, were transferred to Level 2 as prices for these securities were provided by third party pricing vendors.

The remainder of the Level 3 assets relate to private equity investments where the nature of the underlying assets held by the investee include positions such as private business ventures and are such that significant Level 3 inputs are utilized in the valuation.

Other investments

Included within the Other Investments component of the Company's Level 3 valuations are private investments and alternatives where the Company is not deemed to have significant influence over the investee. The fair value of these investments is based upon net asset values received from the investment manager or general partner of the respective entity. The nature of the underlying investments held by the investee which form the basis of the net asset value include assets such as private business ventures and are such that significant Level 3 inputs are utilized in the determination of the individual underlying holding values and accordingly the fair value of the Company's investment in each entity is classified within Level 3. The Company also incorporates factors such as the most recent financial information received, the values at which capital transactions with the investee take place, and management's judgment regarding whether any adjustments should be made to the net asset value in recording the fair value of each position. Investments in private equity and alternative funds included in Other investments utilize strategies including Arbitrage, Directional, Event Driven and Multi-style. These funds potentially have lockup and gate provisions which may limit redemption liquidity. For further details regarding the nature of Other investments and related features see Item 8, Note 11, Other Investments to the Consolidated Financial Statements included in the Company's Annual Report on Form 10-K for the year ended December 31, 2009.

Derivative instruments

Derivative instruments classified within Level 3 include: (i) certain interest rate swaps where the duration of the contract the Company holds exceeds that of the longest term on a market observable input, (ii) GMIB benefits embedded within a certain reinsurance contract, (iii) a put option included within the Company's remaining contingent capital facility and (iv) credit derivatives sold providing protection on senior tranches of structured finance transactions where the value is obtained directly from the investment bank counterparty for which sufficient information regarding the inputs utilized in the valuation was not obtained to support a Level 2 classification. The majority of inputs utilized in the valuations of these types of derivative contracts are considered Level 1 or Level 2; however, each valuation includes at least one Level 3 input that was significant to the valuation and accordingly the values are disclosed within Level 3.

In addition, see Item 8, Note 2 to the Consolidated Financial Statements, Significant Accounting Policies in the Company's Annual Report on Form 10-K for the year ended December 31, 2009 for a general discussion of types of assets and liabilities that are classified within Level 3 of the fair value hierarchy as well as the Company's valuation policies for such instruments.

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NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

3. Fair Value Measurements (Continued)

Financial Instruments Not Carried at Fair Value

Authoritative guidance over disclosures about fair value of financial instruments requires additional disclosure of fair value information for financial instruments not carried at fair value in both interim and annual reporting periods. Certain financial instruments, particularly insurance contracts, are excluded from these fair value disclosure requirements. The carrying values of cash and cash equivalents, accrued investment income, net receivable from investments sold, other assets, net payable for investments purchased, other liabilities and other financial instruments not included below approximated their fair values. The following table includes financial instruments for which the carrying amount differs from the estimated fair values:

| <i>(U.S. dollars in thousands)</i> <i>(Unaudited)</i> | As of June 30, 2010 | | As of December 31, 2009 | |
|--|----------------------------|---------------------|--------------------------------|---------------------|
| | Carrying Value | Fair Value | Carrying Value | Fair Value |
| Fixed maturities, held to maturity | \$ 468,738 | \$ 504,726 | \$ 546,067 | \$ 530,319 |
| Other investments structured transactions | \$ 362,862 | \$ 345,095 | \$ 365,600 | \$ 341,352 |
| Financial Assets | \$ 831,600 | \$ 849,821 | \$ 911,667 | \$ 871,671 |
| Deposit liabilities | \$ 2,252,124 | \$ 2,233,725 | \$ 2,208,699 | \$ 2,245,961 |
| Notes payable and debt | 2,467,392 | 2,469,786 | 2,451,417 | 2,504,386 |
| Financial Liabilities | \$ 4,719,516 | \$ 4,703,511 | \$ 4,660,116 | \$ 4,750,347 |
| Redeemable series C preference ordinary shares | \$ 71,900 | \$ 49,611 | \$ 182,673 | \$ 137,918 |

The Company historically participated in structured transactions which include cash loans supporting project finance transactions, providing liquidity facility financing to structured project deals and an investment in a payment obligation with an insurance company. These transactions are carried at amortized cost. The fair value of these investments held by the Company is determined through use of internal models utilizing reported trades, benchmark yields, broker/dealer quotes, issuer spreads, two-sided markets, benchmark securities, bids, offers and reference data.

Deposit liabilities include obligations under structured insurance and reinsurance transactions as well as funding agreements issued. For purposes of fair value disclosures, the Company determines the fair value of the deposit liabilities by assuming a discount rate equal to the appropriate U.S. Treasury rate plus 223.8 basis points and the appropriate U.S. Treasury Rate plus 108.3 basis points at June 30, 2010 and December 31, 2009, respectively, to determine the present value of projected contractual liability payments through final maturity. The discount rate incorporates the Company's own credit risk into the determination of estimated fair value.

The fair values of the Company's notes payable and debt outstanding are determined based on quoted market prices.

The fair value of the Company's redeemable series C preference ordinary shares outstanding is determined based on indicative quotes provided by brokers.

There are no significant concentrations of credit risk within the Company's financial instruments as defined in the authoritative guidance over disclosures of fair value of financial instruments not carried at fair value.

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NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

4. Segment Information

Following a streamlining of the Company's operating segments in the first quarter of 2009, the Company is organized into three operating segments: Insurance, Reinsurance and Life operations. The Company's general investment and financing operations are reflected in Corporate.

The Company evaluates the performance for both the Insurance and Reinsurance segments based on underwriting profit and contribution from its Life operations segment. Other items of revenue and expenditure of the Company are not evaluated at the segment level for reporting purposes. In addition, the Company does not allocate investment assets by segment for its Property and Casualty (P&C) operations. Investment assets related to the Company's Life operations and certain structured products included in the Insurance and Reinsurance segments and Corporate are held in separately identified portfolios. As such, net investment income from these assets is included in the contribution from each of these segments.

Three months ended June 30, 2010:

(U.S. dollars in thousands, except ratios)

(Unaudited)

| | Insurance | Reinsurance | Total P&C | Life Operations | Corporate | Total |
|--|--------------|-------------|----------------|--------------------|--------------|-------------------|
| Gross premiums written | \$ 1,085,740 | \$ 421,340 | \$ 1,507,080 | \$ 92,838 | \$ | \$ 1,599,918 |
| Net premiums written | 757,424 | 357,180 | 1,114,604 | 86,094 | | 1,200,698 |
| Net premiums earned | 868,666 | 347,647 | 1,216,313 | 86,448 | | 1,302,761 |
| Net losses and loss expenses | 592,184 | 154,981 | 747,165 | 123,375 | | 870,540 |
| Acquisition costs | 92,236 | 75,572 | 167,808 | 12,752 | | 180,560 |
| Operating expenses (1) | 163,005 | 43,662 | 206,667 | 2,765 | | 209,432 |
| Underwriting profit (loss) | \$ 21,241 | 73,432 | 94,673 | (52,444) | | 42,229 |
| Net investment income | | | 205,346 | 75,389 | | 280,735 |
| Net results from structured products (2) | 2,940 | 5,776 | 8,716 | | 3,086 | 11,802 |
| Net fee income and other (3) | (4,337) | 575 | (3,762) | 114 | | (3,648) |
| Net realized gains (losses) on investments | | | (55,876) | (5,445) | (65) | (61,386) |
| Contribution from P&C, Life Operations and Corporate | | | 249,097 | 17,614 | 3,021 | 269,732 |
| Corporate & other: | | | | | | |
| Net realized & unrealized gains (losses) on derivative instruments | | | | | (19,896) | (19,896) |
| Net income (loss) from financial, investments and other operating affiliates | | | | | 40,097 | 40,097 |
| Exchange (gains) losses | | | | | (32,276) | (32,276) |
| Corporate operating expenses | | | | | 22,793 | 22,793 |
| Interest expense (4) | | | | | 38,551 | 38,551 |
| Non-controlling interest in net (income) loss of subsidiary | | | | | 80 | 80 |
| Loss on termination of guarantee | | | | | 23,500 | 23,500 |
| Income taxes & other | | | | | 43,440 | 43,440 |
| Net income attributable to XL Capital Ltd | | | | | | \$ 194,005 |
| Ratios P&C operations: (5) | | | | | | |
| Loss and loss expense ratio | 68.2% | 44.6% | 61.4% | | | |
| Underwriting expense ratio | 29.4% | 34.3% | 30.8% | | | |

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| | | | |
|----------------|-------|-------|-------|
| Combined ratio | 97.6% | 78.9% | 92.2% |
|----------------|-------|-------|-------|

Notes:

- (1) Operating expenses exclude Corporate operating expenses, shown separately.
- (2) The net results from P&C and Corporate structured products include net investment income, interest expense and operating expenses of \$17.2 million, \$9.9 million and \$1.4 million (credit) and \$4.7 million, \$0.7 million and \$0.9 million, respectively.
- (3) Net fee income and other includes operating expenses from the Company's loss prevention consulting services business and expenses related to the cost of an endorsement facility with National Indemnity Company.
- (4) Interest expense excludes interest expense related to deposit liabilities recorded in the Insurance and Reinsurance segments and Corporate.
- (5) Ratios are based on net premiums earned from P&C operations.

XL CAPITAL LTD

NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

4. Segment Information (Continued)

Three months ended June 30, 2009:

(U.S. dollars in thousands, except ratios)

(Unaudited)

| | Insurance | Reinsurance | Total P&C | Life Operations | Corporate (6) | Total |
|--|--------------|-------------|----------------|--------------------|---------------|------------------|
| Gross premiums written | \$ 1,124,220 | \$ 376,970 | \$ 1,501,190 | \$ 150,711 | \$ | \$ 1,651,901 |
| Net premiums written | 766,606 | 311,672 | 1,078,278 | 140,674 | | 1,218,952 |
| Net premiums earned | 881,490 | 400,259 | 1,281,749 | 147,951 | | 1,429,700 |
| Net losses and loss expenses | 598,784 | 180,844 | 779,628 | 174,588 | | 954,216 |
| Acquisition costs | 112,430 | 85,302 | 197,732 | 25,540 | | 223,272 |
| Operating expenses (1) | 167,931 | 47,019 | 214,950 | 4,269 | | 219,219 |
| Underwriting profit (loss) | \$ 2,345 | 87,094 | 89,439 | (56,446) | | 32,993 |
| Net investment income | | | 218,490 | 82,855 | | 301,345 |
| Net results from structured products (2) | 4,093 | 6,172 | 10,265 | | 5,019 | 15,284 |
| Net fee income and other (3) | (3,220) | 545 | (2,675) | 123 | | (2,552) |
| Net realized gains (losses) on investments | | | (34,570) | (51,663) | 5,803 | (80,430) |
| Contribution from P&C, Life Operations and Corporate | | | 280,949 | (25,131) | 10,822 | 266,640 |
| Corporate & other: | | | | | | |
| Net realized & unrealized gains (losses) on derivative instruments | | | | | 969 | 969 |
| Net income (loss) from financial, investments and other operating affiliates | | | | | 54,753 | 54,753 |
| Exchange (gains) losses | | | | | 145,221 | 145,221 |
| Corporate operating expenses | | | | | 32,219 | 32,219 |
| Interest expense (4) | | | | | 42,912 | 42,912 |
| Non-controlling interest in net (income) loss of subsidiary | | | | | 40 | 40 |
| Income taxes & other | | | | | 16,509 | 16,509 |
| Net income attributable to XL Capital Ltd | | | | | | \$ 85,541 |

Ratios P&C operations: (5)

| | | | |
|-----------------------------|-------|-------|-------|
| Loss and loss expense ratio | 67.9% | 45.2% | 60.8% |
| Underwriting expense ratio | 31.8% | 33.0% | 32.2% |
| Combined ratio | 99.7% | 78.2% | 93.0% |

Notes:

(1) Operating expenses exclude Corporate operating expenses, shown separately.

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- (2) The net results from P&C and Corporate structured products include net investment income, interest expense and operating expenses of \$19.4 million, \$9.1 million and nil and \$7.6 million, \$2.2 million and \$0.4 million, respectively.
- (3) Net fee income and other includes operating expenses from the Company's loss prevention consulting services business and expenses related to the cost of an endorsement facility with National Indemnity Company.
- (4) Interest expense excludes interest expense related to deposit liabilities recorded in the Insurance and Reinsurance segments and Corporate.
- (5) Ratios are based on net premiums earned from P&C operations.

XL CAPITAL LTD

NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

4. Segment Information (Continued)

Six months ended June 30, 2010:

(U.S. dollars in thousands, except ratios)

(Unaudited)

| | Insurance | Reinsurance | Total P&C | Life Operations | Corporate (6) | Total |
|--|--------------|--------------|--------------|--------------------|---------------|-------------------|
| Gross premiums written | \$ 2,217,630 | \$ 1,211,763 | \$ 3,429,393 | \$ 205,739 | \$ | \$ 3,635,132 |
| Net premiums written | 1,658,688 | 1,052,441 | 2,711,129 | 190,760 | | 2,901,889 |
| Net premiums earned | 1,765,677 | 714,237 | 2,479,914 | 191,332 | | 2,671,246 |
| Net losses and loss expenses | 1,240,503 | 398,862 | 1,639,365 | 247,118 | | 1,886,483 |
| Acquisition costs | 202,378 | 148,177 | 350,555 | 31,142 | | 381,697 |
| Operating expenses (1) | 316,241 | 85,690 | 401,931 | 5,773 | | 407,704 |
| Underwriting profit (loss) | \$ 6,555 | 81,508 | 88,063 | (92,701) | | (4,638) |
| Net investment income | | | 409,260 | 155,733 | | 564,993 |
| Net results from structured products (2) | 8,579 | 8,252 | 16,831 | | 6,739 | 23,570 |
| Net fee income and other (3) | (8,123) | 894 | (7,229) | 154 | | (7,075) |
| Net realized gains (losses) on investments | | | (84,453) | (9,858) | (3,251) | (97,562) |
| Contribution from P&C, Life Operations and Corporate | | | 422,472 | 53,328 | 3,488 | 479,288 |
| Corporate & other: | | | | | | |
| Net realized & unrealized gains (losses) on derivative instruments | | | | | (40,376) | (40,376) |
| Net income (loss) from financial, investments and other operating affiliates | | | | | 59,881 | 59,881 |
| Exchange (gains) losses | | | | | (53,359) | (53,359) |
| Corporate operating expenses | | | | | 41,656 | 41,656 |
| Interest expense (4) | | | | | 75,451 | 75,451 |
| Non-controlling interest in net (income) loss of subsidiary | | | | | 81 | 81 |
| Loss on termination of guarantee | | | | | 23,500 | 23,500 |
| Income taxes & other | | | | | 73,741 | 73,741 |
| Net income attributable to XL Capital Ltd | | | | | | \$ 337,885 |

Ratios P&C operations: (5)

| | | | |
|-----------------------------|-------|-------|-------|
| Loss and loss expense ratio | 70.3% | 55.8% | 66.1% |
| Underwriting expense ratio | 29.3% | 32.8% | 30.3% |
| Combined ratio | 99.6% | 88.6% | 96.4% |

Notes:

(1) Operating expenses exclude Corporate operating expenses, shown separately.

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- (2) The net results from P&C and Corporate structured products include net investment income, interest expense and operating expenses of \$36.9 million, \$21.4 million and \$1.3 million (credit) and \$9.0 million, \$1.3 million and \$0.9 million, respectively.
- (3) Net fee income and other includes operating expenses from the Company's loss prevention consulting services business and expenses related to the cost of an endorsement facility with National Indemnity Company.
- (4) Interest expense excludes interest expense related to deposit liabilities recorded in the Insurance and Reinsurance segments and Corporate.
- (5) Ratios are based on net premiums earned from P&C operations.

XL CAPITAL LTD

NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

4. Segment Information (Continued)

Six months ended June 30, 2009:

(U.S. dollars in thousands, except ratios)

(Unaudited)

| | <u>Insurance</u> | <u>Reinsurance</u> | <u>Total P&C</u> | <u>Life Operations</u> | <u>Corporate (6)</u> | <u>Total</u> |
|--|------------------|--------------------|----------------------|----------------------------|----------------------|------------------|
| Gross premiums written | \$ 2,215,465 | \$ 1,163,953 | \$ 3,379,418 | \$ 285,823 | \$ | \$ 3,665,241 |
| Net premiums written | 1,598,774 | 984,815 | 2,583,589 | 262,259 | | 2,845,848 |
| Net premiums earned | 1,791,601 | 811,835 | 2,603,436 | 277,785 | | 2,881,221 |
| Net losses and loss expenses | 1,213,998 | 355,913 | 1,569,911 | 332,547 | | 1,902,458 |
| Acquisition costs | 217,842 | 181,026 | 398,868 | 42,623 | | 441,491 |
| Operating expenses (1) | 347,259 | 94,107 | 441,366 | 8,110 | | 449,476 |
| Underwriting profit (loss) | \$ 12,502 | 180,789 | 193,291 | (105,495) | | 87,796 |
| Net investment income | | | 460,656 | 160,377 | | 621,033 |
| Net results from structured products (2) | 7,214 | 14,596 | 21,810 | | 9,664 | 31,474 |
| Net fee income and other (3) | (4,220) | 2,596 | (1,624) | 174 | | (1,450) |
| Net realized gains (losses) on investments | | | (197,383) | (126,313) | (8,671) | (332,367) |
| Contribution from P&C, Life Operations and Corporate | | | 476,750 | (71,257) | 993 | 406,486 |
| Corporate & other: | | | | | | |
| Net realized & unrealized gains (losses) on derivative instruments | | | | | (438) | (438) |
| Net income (loss) from financial, investments and other operating affiliates | | | | | 17,532 | 17,532 |
| Exchange (gains) losses | | | | | 120,597 | 120,597 |
| Corporate operating expenses | | | | | 58,931 | 58,931 |
| Interest expense (4) | | | | | 92,527 | 92,527 |
| Non-controlling interest in net (income) loss of subsidiary | | | | | 40 | 40 |
| Income taxes & other | | | | | 62,927 | 62,927 |
| Net income attributable to XL Capital Ltd | | | | | | \$ 88,638 |

Ratios P&C operations: (5)

| | | | |
|-----------------------------|-------|-------|-------|
| Loss and loss expense ratio | 67.8% | 43.8% | 60.3% |
| Underwriting expense ratio | 31.5% | 33.9% | 32.3% |
| Combined ratio | 99.3% | 77.7% | 92.6% |

Notes:

(1) Operating expenses exclude Corporate operating expenses, shown separately.

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- (2) The net results from P&C and Corporate structured products include net investment income, interest expense and operating expenses of \$39.7 million, \$17.9 million and nil and \$15.6 million, \$5.1 million and \$0.8 million, respectively.
- (3) Net fee income and other includes operating expenses from the Company's loss prevention consulting services business and expenses related to the cost of an endorsement facility with National Indemnity Company.
- (4) Interest expense excludes interest expense related to deposit liabilities recorded in the Insurance and Reinsurance segments and Corporate.
- (5) Ratios are based on net premiums earned from P&C operations.

XL CAPITAL LTD

NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

4. Segment Information (Continued)

The following tables summarize the Company's net premiums earned by line of business:

Three months ended June 30, 2010

(U.S. dollars in thousands)

(Unaudited)

| | Insurance | Reinsurance | Life Operations | Total |
|--|-------------------|-------------------|--------------------|---------------------|
| P&C Operations: | | | | |
| Casualty – professional lines | \$ 328,068 | \$ 51,665 | \$ | \$ 379,733 |
| Casualty – other lines | 147,001 | 51,320 | \$ | 198,321 |
| Property catastrophe | (1) | 80,877 | \$ | 80,876 |
| Other property | 108,016 | 115,425 | \$ | 223,441 |
| Marine, energy, aviation and satellite | 133,720 | 22,451 | \$ | 156,171 |
| Other specialty lines (1) | 153,949 | \$ | \$ | 153,949 |
| Other (2) | (4,555) | 25,847 | \$ | 21,292 |
| Structured indemnity | 2,468 | 62 | \$ | 2,530 |
| Total P&C Operations | \$ 868,666 | \$ 347,647 | \$ | \$ 1,216,313 |
| Life Operations: | | | | |
| Other Life | \$ | \$ | \$ 55,879 | \$ 55,879 |
| Annuity | \$ | \$ | 30,569 | 30,569 |
| Total Life Operations | \$ | \$ | \$ 86,448 | \$ 86,448 |
| Total | \$ 868,666 | \$ 347,647 | \$ 86,448 | \$ 1,302,761 |

Three months ended June 30, 2009:

(U.S. dollars in thousands)

(Unaudited)

| | Insurance | Reinsurance | Life Operations | Total |
|--|-------------------|-------------------|--------------------|---------------------|
| P&C Operations: | | | | |
| Casualty – professional lines | \$ 310,985 | \$ 62,135 | \$ | \$ 373,120 |
| Casualty – other lines | 160,653 | 60,660 | \$ | 221,313 |
| Property catastrophe | 1,760 | 75,478 | \$ | 77,238 |
| Other property | 104,636 | 140,336 | \$ | 244,972 |
| Marine, energy, aviation and satellite | 139,835 | 20,333 | \$ | 160,168 |
| Other specialty lines (1) | 153,990 | \$ | \$ | 153,990 |
| Other (2) | 4,563 | 39,944 | \$ | 44,507 |
| Structured indemnity | 5,068 | 1,373 | \$ | 6,441 |
| Total P&C Operations | \$ 881,490 | \$ 400,259 | \$ | \$ 1,281,749 |
| Life Operations: | | | | |
| Other Life | \$ | \$ | \$ 114,560 | \$ 114,560 |
| Annuity | \$ | \$ | 33,391 | 33,391 |
| Total Life Operations | \$ | \$ | \$ 147,951 | \$ 147,951 |
| Total | \$ 881,490 | \$ 400,259 | \$ 147,951 | \$ 1,429,700 |

-
- (1) Other specialty lines within the Insurance segment includes: environmental, programs, equine, warranty, specie, middle markets and excess and surplus lines.
 - (2) Other includes credit and surety, whole account contracts and other lines.

XL CAPITAL LTD

NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

4. Segment Information (Continued)

The following tables summarize the Company's net premiums earned by line of business:

Six months ended June 30, 2010

(U.S. dollars in thousands)

(Unaudited)

| | <u>Insurance</u> | <u>Reinsurance</u> | <u>Life Operations</u> | <u>Total</u> |
|--|---------------------|--------------------|----------------------------|---------------------|
| P&C Operations: | | | | |
| Casualty – professional lines | \$ 665,126 | \$ 107,385 | \$ | \$ 772,511 |
| Casualty – other lines | 309,549 | 115,453 | | 425,002 |
| Property catastrophe | 115 | 165,511 | | 165,626 |
| Other property | 205,555 | 228,688 | | 434,243 |
| Marine, energy, aviation and satellite | 274,490 | 42,641 | | 317,131 |
| Other specialty lines (1) | 306,457 | | | 306,457 |
| Other (2) | (609) | 54,844 | | 54,235 |
| Structured indemnity | 4,994 | (285) | | 4,709 |
| | <u>\$ 1,765,677</u> | <u>714,237</u> | <u>\$</u> | <u>\$ 2,479,914</u> |
| Life Operations: | | | | |
| Other Life | \$ | \$ | \$ 129,332 | \$ 129,332 |
| Annuity | | | 62,000 | 62,000 |
| | <u>\$</u> | <u>\$</u> | <u>\$ 191,332</u> | <u>\$ 191,332</u> |
| Total | <u>\$ 1,765,677</u> | <u>\$ 714,237</u> | <u>\$ 191,332</u> | <u>\$ 2,671,246</u> |

Six months ended June 30, 2009:

(U.S. dollars in thousands)

(Unaudited)

| | <u>Insurance</u> | <u>Reinsurance</u> | <u>Life Operations</u> | <u>Total</u> |
|--|---------------------|--------------------|----------------------------|---------------------|
| P&C Operations: | | | | |
| Casualty – professional lines | \$ 626,601 | \$ 124,129 | \$ | \$ 750,730 |
| Casualty – other lines | 315,158 | 123,443 | | 438,601 |
| Property catastrophe | 1,762 | 146,174 | | 147,936 |
| Other property | 214,072 | 283,096 | | 497,168 |
| Marine, energy, aviation and satellite | 287,483 | 41,614 | | 329,097 |
| Other specialty lines (1) | 324,087 | | | 324,087 |
| Other (2) | 12,508 | 92,037 | | 104,545 |
| Structured indemnity | 9,930 | 1,342 | | 11,272 |
| | <u>\$ 1,791,601</u> | <u>\$ 811,835</u> | <u>\$</u> | <u>\$ 2,603,436</u> |
| Life Operations: | | | | |
| Other Life | \$ | \$ | \$ 214,967 | \$ 214,967 |
| Annuity | | | 62,818 | 62,818 |
| | <u>\$</u> | <u>\$</u> | <u>\$ 277,785</u> | <u>\$ 277,785</u> |

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| | | | | |
|--------------|--------------|------------|------------|--------------|
| Total | \$ 1,791,601 | \$ 811,835 | \$ 277,785 | \$ 2,881,221 |
|--------------|--------------|------------|------------|--------------|

-
- (1) Other specialty lines within the Insurance segment includes: environmental, programs, equine, warranty, specie, middle markets and excess and surplus lines.
- (2) Other includes credit and surety, whole account contracts and other lines.

XL CAPITAL LTD

NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

5. Investments

The cost (amortized cost for fixed maturities and short-term investments), fair value, gross unrealized gains, gross unrealized (losses), and other-than-temporary impairments (OTTI) recorded in accumulated other comprehensive income (AOCI) of the Company s available for sale investments at June 30, 2010 and December 31, 2009 were as follows:

| June 30, 2010 (U.S. dollars in thousands) (Unaudited) | Cost or Amortized Cost | Included in Accumulated Other Comprehensive Income (AOCI) | | | Fair Value |
|--|------------------------------|---|---|--|----------------------|
| | | Gross Unrealized Gains | Gross Unrealized Losses | | |
| | | | Related to changes in estimated fair value | OTTI included in other comprehensive income (Loss)(1) | |
| Fixed maturities | | | | | |
| U.S. Government and Government-Related/Supported (2) | \$ 2,375,159 | \$ 126,505 | \$ (9,758) | \$ | \$ 2,491,906 |
| Corporate (3) (4) | 10,659,732 | 457,586 | (336,992) | (77,110) | 10,703,216 |
| Residential mortgage-backed securities Agency | 5,733,573 | 204,831 | (1,225) | | 5,937,179 |
| Residential mortgage-backed securities Non-Agency | 1,772,876 | 18,943 | (252,550) | (207,668) | 1,331,601 |
| Commercial mortgage-backed securities | 1,237,784 | 47,254 | (10,502) | (14,702) | 1,259,834 |
| Collateralized debt obligations | 1,013,097 | 9,762 | (314,234) | (9,180) | 699,445 |
| Other asset-backed securities | 1,204,176 | 26,764 | (29,516) | (13,642) | 1,187,782 |
| U.S. States and political subdivisions of the States | 1,120,582 | 28,257 | (7,963) | | 1,140,876 |
| Non-U.S. Sovereign Government, Supranational and Government-Related/Supported (2) | 2,878,757 | 106,489 | (55,246) | | 2,930,000 |
| Total fixed maturities | \$ 27,995,736 | \$ 1,026,391 | \$ (1,017,986) | \$ (322,302) | \$ 27,681,839 |
| Total short-term investments | \$ 1,544,344 | \$ 15,337 | \$ (7,380) | \$ | \$ 1,552,301 |
| Total equity securities | \$ 16,091 | \$ 4,391 | \$ (507) | \$ | \$ 19,975 |

- (1) Represents the amount of OTTI losses in AOCI, which from April 1, 2009 was not included in earnings under authoritative accounting guidance.
- (2) U.S. Government and Government-Related/Supported and Non-U.S. Sovereign Government, Supranationals and Government-Related/Supported includes government-related securities with an amortized cost of \$1,880.8 million and fair value of \$1,928.7 million and U.S. Agencies with an amortized cost of \$1,020.9 million and fair value of \$1,093.6 million.
- (3) Included within Corporate are certain medium term notes supported primarily by pools of European credit with varying degrees of leverage. The notes have a fair value of \$552.6 million and an amortized cost of \$620.2 million. These notes allow the investor to participate in cash flows of the underlying bonds including certain residual values, which could serve to either decrease or increase the ultimate values of these notes.
- (4) Included in the table above are Tier One and Upper Tier Two securities, representing committed term debt and hybrid instruments senior to the common and preferred equities of the financial institutions. These securities have a fair value of \$753.4 million and an amortized cost of \$915.2 million as at June 30, 2010.

XL CAPITAL LTD

NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

5. Investments (Continued)

| December 31, 2009 <i>(U.S. dollars in thousands)</i> | Cost or Amortized Cost | Gross Unrealized Gains | Included in Accumulated Other Comprehensive Income (AOCI) | | Fair Value |
|--|------------------------------|------------------------------|---|---|----------------------|
| | | | Related to changes in estimated fair value | Gross Unrealized Losses OTTI included in other comprehensive income (Loss)(1) | |
| Fixed maturities | | | | | |
| U.S. Government and Government-Related/Supported (2) | \$ 2,619,731 | \$ 73,611 | \$ (28,717) | \$ | \$ 2,664,625 |
| Corporate (3) (4) | 10,121,973 | 260,451 | (472,170) | (111,254) | 9,799,000 |
| Residential mortgage-backed securities Agency | 6,169,707 | 96,715 | (37,921) | | 6,228,501 |
| Residential mortgage-backed securities Non-Agency | 2,015,593 | 13,958 | (397,696) | (210,540) | 1,421,315 |
| Commercial mortgage-backed securities | 1,276,602 | 8,107 | (54,095) | (13,815) | 1,216,799 |
| Collateralized debt obligations | 1,030,245 | 9,783 | (332,403) | (9,064) | 698,561 |
| Other asset-backed securities | 1,247,822 | 13,046 | (82,438) | (10,445) | 1,167,985 |
| U.S. States and political subdivisions of the States | 909,609 | 18,465 | (14,601) | | 913,473 |
| Non-U.S. Sovereign Government, Supranational and Government-Related/Supported (2) | 3,407,222 | 60,506 | (65,955) | | 3,401,773 |
| Total fixed maturities | \$ 28,798,504 | \$ 554,642 | \$ (1,485,996) | \$ (355,118) | \$ 27,512,032 |
| Total short-term investments | \$ 1,767,197 | \$ 16,899 | \$ (6,736) | \$ | \$ 1,777,360 |
| Total equity securities | \$ 12,344 | \$ 5,793 | \$ (358) | \$ | \$ 17,779 |

- (1) Represents the amount of OTTI losses in AOCI, which from April 1, 2009 was not included in earnings under authoritative accounting guidance.
- (2) U.S. Government and Government-Related/Supported and Non U.S. Sovereign Government, Supranationals and Government-Related/Supported includes government-related securities with an amortized cost of \$2,325.4 million and fair value of \$2,326.6 million and U.S. Agencies with an amortized cost of \$1,361.6 million and fair value of \$1,395.0 million.
- (3) Included within Corporate are certain medium term notes supported primarily by pools of European credit with varying degrees of leverage. The notes have a fair value of \$587.7 million and an amortized cost of \$707.9 million. These notes allow the investor to participate in cash flows of the underlying bonds including certain residual values, which could serve to either decrease or increase the ultimate values of these notes.
- (4) Included in the table above are Tier One and Upper Tier Two securities, representing committed term debt and hybrid instruments senior to the common and preferred equities of the financial institutions. These securities have a fair value of \$904.3 million and an amortized cost of \$1,104.6 million as at December 31, 2009.

The Company had gross unrealized losses totaling \$1.3 billion at June 30, 2010 on its available for sale portfolio, which it considers to be temporarily impaired. Individual security positions comprising this balance have been evaluated by management, based on specified criteria, to determine if these impairments should be considered other-than-temporary. These criteria include an assessment of the severity of impairment along with management's assessment as to whether it is likely to sell these securities, among other factors included below.

XL CAPITAL LTD

NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

5. Investments (Continued)

At June 30, 2010 and December 31, 2009, approximately 3.7% and 3.6%, respectively, of the Company's fixed income investment portfolio at fair value was invested in securities which were below investment grade or not rated. Approximately 36.7% and 30.1% of the gross unrealized losses in the Company's fixed income securities portfolio at June 30, 2010 and December 31, 2009, respectively, related to securities that were below investment grade or not rated.

The following is an analysis of how long the available for sale securities at June 30, 2010 had been in a continual unrealized loss position:

| June 30, 2010 <i>(U.S. dollars in thousands)</i> <i>(Unaudited)</i> | Less than 12 months | | Equal to or greater than 12 months | |
|---|---------------------|-----------------------------|------------------------------------|-----------------------------|
| | Fair Value | Gross Unrealized Losses (1) | Fair Value | Gross Unrealized Losses (1) |
| Fixed maturities and short-term investments: | | | | |
| U.S. Government and Government Related/Supported Corporate (2) (3) | \$ 105,343 | \$ 4,065 | \$ 161,540 | \$ 6,489 |
| Residential mortgage-backed securities Agency | 775,557 | 42,043 | 2,111,010 | 374,390 |
| Residential mortgage-backed securities Non-Agency | 42,644 | 315 | 14,524 | 912 |
| Commercial mortgage-backed securities | 85,588 | 22,405 | 1,086,479 | 438,337 |
| Collateralized debt obligations | 13,520 | 410 | 181,773 | 24,823 |
| Other asset-backed securities | 89,024 | 25,557 | 600,126 | 298,409 |
| U.S. States and political subdivisions of the States | 27,522 | 170 | 348,623 | 43,640 |
| Non-U.S. Sovereign Government, Supranational and Government-Related | 258,451 | 3,295 | 29,685 | 4,677 |
| | 407,078 | 17,380 | 366,787 | 40,351 |
| Total fixed maturities and short-term investments | \$ 1,804,727 | \$ 115,640 | \$ 4,900,547 | \$ 1,232,028 |
| Total equity securities | \$ 5,002 | \$ 507 | \$ | \$ |

- (1) On securities impacted by the April 1, 2009 changes to OTTI authoritative guidance, length of time of impairment is measured from the point at which securities returned to a net unrealized loss position (i.e. from April 1, 2009).
- (2) Included within Corporate are certain medium term notes supported primarily by pools of European credit with varying degrees of leverage. The notes have a fair value of \$374.3 million and an amortized cost of \$443.6 million. These notes allow the investor to participate in cash flows of the underlying bonds including certain residual values, which could serve to either decrease or increase the ultimate values of these notes.
- (3) Included in the table above are Tier One and Upper Tier Two securities, representing committed term debt and hybrid instruments senior to the common and preferred equities of the financial institutions. These securities have a fair value of \$753.4 million and an amortized cost of \$915.2 million as at June 30, 2010.

XL CAPITAL LTD

NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

5. Investments (Continued)

The following is an analysis of how long each of those available for sale securities at December 31, 2009 had been in a continual unrealized loss position:

| December 31, 2009 <i>(U.S. dollars in thousands)</i> | Less than 12 months | | Equal to or greater than 12 months | |
|---|---------------------|-----------------------------|------------------------------------|-----------------------------|
| | Fair Value | Gross Unrealized Losses (1) | Fair Value | Gross Unrealized Losses (1) |
| Fixed maturities and short-term investments: | | | | |
| U.S. Government and Government-Related/Supported Corporate (2) (3) | \$ 792,605 | \$ 15,527 | \$ 84,105 | \$ 13,691 |
| Residential mortgage-backed securities Agency | 1,892,737 | 55,538 | 2,900,332 | 527,963 |
| Residential mortgage-backed securities Non-Agency | 2,948,912 | 37,592 | 2,342 | 329 |
| Commercial mortgage-backed securities | 208,914 | 71,999 | 1,140,549 | 536,237 |
| Collateralized debt obligations | 231,230 | 9,347 | 558,551 | 58,563 |
| Other asset-backed securities | 127,171 | 36,144 | 563,340 | 306,058 |
| U.S. States and political subdivisions of the States | 273,034 | 4,555 | 553,286 | 88,677 |
| Non-U.S. Sovereign Government, Supranational and Government-Related | 326,392 | 5,586 | 55,278 | 9,015 |
| | 944,204 | 17,499 | 514,058 | 53,530 |
| Total fixed maturities and short-term investments | \$ 7,745,199 | \$ 253,787 | \$ 6,371,841 | \$ 1,594,063 |
| Total equity securities | \$ 1,660 | \$ 358 | \$ | \$ |

(1) On securities impacted by the April 1, 2009 changes to OTTI values, length of time of impairment is measured from the point at which securities returned to a net unrealized loss position (i.e. from April 1, 2009).

(2) Included within Corporate are certain medium term notes supported primarily by pools of European credit with varying degrees of leverage. The notes have a fair value of \$587.7 million and an amortized cost of \$707.9 million. These notes allow the investor to participate in cash flows of the underlying bonds including certain residual values, which could serve to either decrease or increase the ultimate values of these notes.

(3) Included in the table above are Tier One and Upper Tier Two securities, representing committed term debt and hybrid instruments senior to the common and preferred equities of the financial institutions. These securities have a fair value of \$904.3 million and an amortized cost of \$1,104.6 million as at December 31, 2009.

The contractual maturities of available for sale fixed income securities are shown below. Actual maturities may differ from contractual maturities because borrowers may have the right to call or prepay obligations with or without call or prepayment penalties.

| <i>(U.S. dollars in thousands)</i> <i>(Unaudited)</i> | June 30, 2010 (1) | | December 31, 2009 (1) | |
|--|-------------------|--------------|-----------------------|--------------|
| | Amortized Cost | Fair Value | Amortized Cost | Fair Value |
| Due after 1 through 5 years | \$ 8,339,377 | \$ 8,501,119 | \$ 7,969,186 | \$ 8,010,078 |
| Due after 5 through 10 years | 3,860,698 | 4,026,417 | 3,936,489 | 3,962,993 |
| Due after 10 years | 4,834,155 | 4,738,462 | 5,152,860 | 4,805,800 |

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| | | | | |
|---|----------------------|----------------------|----------------------|----------------------|
| | 17,034,230 | 17,265,998 | 17,058,535 | 16,778,871 |
| Residential mortgage-backed securities Agency | 5,733,573 | 5,937,179 | 6,169,707 | 6,228,501 |
| Residential mortgage-backed securities Non-Agency | 1,772,876 | 1,331,601 | 2,015,593 | 1,421,315 |
| Commercial mortgage-backed securities | 1,237,784 | 1,259,834 | 1,276,602 | 1,216,799 |
| Collateralized debt obligations | 1,013,097 | 699,445 | 1,030,245 | 698,561 |
| Other asset-backed securities | 1,204,176 | 1,187,782 | 1,247,822 | 1,167,985 |
| | <u>10,961,506</u> | <u>10,415,841</u> | <u>11,739,969</u> | <u>10,733,161</u> |
| Total | <u>\$ 27,995,736</u> | <u>\$ 27,681,839</u> | <u>\$ 28,798,504</u> | <u>\$ 27,512,032</u> |

-
- (1) Included in the table above are Tier One and Upper Tier Two securities, representing committed term debt and hybrid instruments senior to the common and preferred equities of the financial institutions, at their fair value of \$753.4 million and \$904.3 million as at June 30, 2010 and December 31, 2009, respectively. These securities have been distributed in the table based on their call date and have net unrealized losses of \$185.2 million and \$225.2 million as at June 30, 2010 and December 31, 2009, respectively.

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NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

5. Investments (Continued)

Gross unrealized losses of \$1.3 billion on available for sale assets at June 30, 2010 can be attributed to the following significant drivers:

§ gross unrealized losses of \$272.6 million related to the Company's Life operations investment portfolio, which had a fair value of \$6.1 billion as at June 30, 2010. Of this, \$204.8 million of gross unrealized losses related to \$1.6 billion of exposures to corporate financial institutions including \$145.8 million of losses on \$613.2 million of Tier One and Upper Tier Two securities. In addition, \$42.9 million of gross unrealized losses are foreign exchange losses related to the corporate holdings within the Company's Life operations investment portfolio. At June 30, 2010, this portfolio had an average interest rate duration of 8.6 years, primarily denominated in U.K. Sterling and Euros. As a result of the long duration, significant gross losses have arisen as the fair values of these securities are more sensitive to prevailing government interest rates and credit spreads. This portfolio is matched to corresponding long duration liabilities. A hypothetical parallel increase in interest rates and credit spreads of 50 basis points, respectively, would increase the unrealized losses related to this portfolio at June 30, 2010 by approximately \$261.2 million and \$198.9 million, respectively on both the available for sale and held to maturity portfolios. Given the long term nature of this portfolio, and the level of credit spreads as at June 30, 2010 relative to historical averages within the U.K. and Euro-zone as well as the Company's liquidity needs at June 30, 2010, the Company believes that these assets will continue to be held until such time as they mature, or credit spreads revert to levels more consistent with historical averages.

§ gross unrealized losses of \$184.4 million related to the corporate holdings within the Company's non-life fixed income portfolios, which had a fair value of \$8.0 billion as at June 30, 2010. Of this, \$51.2 million of gross unrealized losses related to foreign exchange losses. During the quarter ended June 30, 2010, as a result of widening credit spreads particularly in European financial markets, the gross unrealized losses on these holdings has increased.

Of the gross unrealized losses noted above, \$66.5 million relate to medium term notes primarily supported by pools of investment grade European credit with varying degrees of leverage. These had a fair value of \$513.7 million at June 30, 2010. Management believes that expected cash flows over the expected holding period from these bonds are sufficient to support the remaining reported amortized cost.

§ gross unrealized losses of \$446.5 million related to non-Agency residential mortgage backed securities (RMBS) portfolio (which consists of the Company's holdings of sub-prime non-agency securities, second liens, ABS CDOs with sub-prime collateral, Alt-A mortgage exposures and Prime RMBS), which had a fair value of \$1,148.4 million as at June 30, 2010. The Company undertook a security level review in conjunction with its investment manager service providers of these securities and recognized charges to the extent it believed the discounted cash flow value (or fair value in certain cases) of any security was below its amortized cost. The Company has recognized realized losses, consisting of charges for OTTI and realized losses from sales, of approximately \$1.2 billion since the beginning of 2007 and through June 30, 2010 on these asset classes.

The Company purchased a number of these assets to support the previously written guaranteed investment contract (GIC) and funding agreement contracts and has reduced its exposure to this asset class as part of its strategic portfolio realignment. The Company believes that, based on market conditions and liquidity needs at June 30, 2010, this reduction will be realized through natural cash flows of the portfolio, and limited selective sales, rather than selling these assets into markets which continue to not be reflective of the intrinsic value of these assets. The weighted average life of the sub-prime and Alt-A residential holdings within this portfolio at June 30, 2010 were 4.6 years and 4.0 years, respectively. The Company, based on current market conditions and liquidity needs as well as its assessment of the holdings, believes it will continue to hold these securities until either maturity or a return of liquidity and valuations more reflective of intrinsic value of these holdings.

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NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

5. Investments (Continued)

§ gross unrealized losses of \$321.6 million related to the non-Life portfolio of Core CDO holdings (defined by the Company as investments in non-subprime collateralized debt obligations), which consists primarily of CDOs and had a fair value of \$701.9 million as of June 30, 2010. The Company undertook a security level review in conjunction with its investment manager service providers of these securities and recognized charges to the extent it believed the discounted cash flow value of the security was below the amortized cost. The Company believes that the level of impairment is primarily a function of continuing wide spreads in the CDO market during the period, driven by the level of illiquidity in this market. The Company purchased a number of these assets to support the previously written GIC and funding agreement contracts and has announced its intention to reduce its exposure to this asset class over time as a part of its strategic portfolio realignment. The Company, based on current market conditions and liquidity needs as well as its assessment of the holdings, believes it is likely that the Company will continue to hold these securities until either maturity or a recovery of value, following which the Company intends to reduce its exposure to this asset class.

Management, in its assessment of whether securities in a gross unrealized loss position are temporarily impaired, considers the significance of the impairments. The Company had structured credit securities with gross unrealized losses of \$243.1 million, with a fair value of \$135.5 million, which at June 30, 2010 were impaired by greater than 50% of amortized costs. All of these are asset-backed or non-Agency mortgage backed securities. Of these gross unrealized losses, \$52.2 million are rated investment grade. The Company has evaluated each of these securities in conjunction with its investment manager service providers and believes it is more likely than not that the issuer will be able to fund sufficient principal and interest payments to support the current amortized cost and the Company does not have the intent to sell. These securities include gross unrealized losses of \$139.3 million on non-Agency RMBS, \$85.8 million on Core CDOs and \$7.7 million on commercial mortgage backed securities (CMBS) holdings.

Included in the gross unrealized losses associated with the Company's corporate portfolio as of June 30, 2010 are gross unrealized losses of \$7.8 million related to Tier One and Upper Tier Two securities that have been rated below investment grade by at least one major rating agency. Of this total, none have gross unrealized losses representing greater than 50% of amortized cost. The Company has completed its review of this portfolio and believes, at this time, that these impairments remain temporary in nature. The primary basis for this conclusion was the analysis of the fundamentals of these securities using a debt-based impairment model, which indicated that these securities continue to meet their obligations, and the issuer has the ability to call these obligations at their call date. In addition, as these securities are below investment grade, the Company considered these securities using an equity impairment model. Factors that were considered and supported that these impairments were temporary included that the vast majority of these securities had been rated below investment grade beginning in first quarter of 2009, in certain cases alternative ratings were available that indicated these securities remained investment grade, or the securities were only slightly below investment grade and recent improvement in the prices of these securities. At June 30, 2010, the Company believes that it is likely that the fair values of these securities will ultimately increase to equal the cost basis over a reasonable period of time. However, there is a high degree of judgment in reaching this conclusion, including an assessment of how various governments will treat these securities in the event of governmental intervention in these institutions' operations or management's decision to defer calls or coupons. Management will closely monitor the developments related to these securities.

The Company recorded net impairment charges of \$57.4 million for the quarter ended June 30, 2010. The significant assumptions and inputs associated with these securities consist of:

- § For structured credit securities, the Company recorded net impairments of \$25.0 million for the quarter ended June 30, 2010. The Company determined that the likely recovery on these securities was below the amortized cost, and accordingly impaired the securities to the discounted value of the cash flows of these securities.
- § For corporate securities, excluding medium term notes backed primarily by investment grade European credit, the Company recorded negligible net impairments for the quarter ended June 30, 2010. The impairment charges consisted of below investment grade securities, with respect to which the Company considered impairment factors consistent with an equity impairment model, along with a debt impairment model, and accordingly recorded impairment charges to fair value, or determined that the securities in an unrealized loss position would be sold.

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NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

5. Investments (Continued)

§ For equities, the Company recorded impairments of \$0.4 million for the quarter ended June 30, 2010 because the security was impaired for more than 11 months.

§ The Company recorded impairments of \$6.7 million related to currency losses for the quarter ended June 30, 2010.

§ The Company recorded impairments totaling \$25.3 million in relation to medium term notes backed primarily by investment grade European credit that are securities for which management has the intent to sell.

As discussed in Note 2, a portion of certain OTTI losses on fixed income securities and short-term investments is recognized in Other comprehensive income (loss) (OCI). Under final authoritative accounting guidance effective April 1, 2009, other than in a situation in which the Company has the intent to sell a security or more likely than not will be required to sell a security, the amount of the OTTI related to a credit loss is recognized in earnings, and the amount of the OTTI related to other factors (i.e., interest rates, market conditions, etc.) is recorded as a component of OCI. The net amount recognized in earnings (credit loss impairments) represents the difference between the amortized cost of the security and the net present value of its projected future cash flows discounted at the effective interest rate implicit in the debt security prior to impairment. Any remaining difference between the fair value and amortized cost is recognized in OCI. The following table sets forth the amount of credit loss impairments on fixed income securities held by the Company as of the dates indicated, for which a portion of the OTTI loss was recognized in OCI, and the corresponding changes in such amounts.

OTTI related to Credit Losses recognized in earnings

(U.S. dollars in thousands)
(Unaudited)

| | Three Months Ended June 30, | | Six Months Ended June 30, | |
|--|-----------------------------|------------|---------------------------|------------|
| | 2010 | 2009 | 2010 | 2009 |
| Opening balance | 551,748 | | 537,121 | |
| Credit losses remaining in retained earnings related to adoption of new authoritative guidance | | 187,773 | | 187,773 |
| Credit loss impairment recognized in the current period on securities not previously impaired | 9,384 | 13,594 | 19,458 | 13,594 |
| Credit loss impairments previously recognized on securities which matured, paid down, prepaid or were sold during the period | (22,003) | (4,177) | (37,978) | (4,177) |
| Credit loss impairments previously recognized on securities impaired to fair value during the period | (130,891) | | (130,891) | |
| Additional credit loss impairments recognized in the current period on securities previously impaired | 22,591 | 27,988 | 50,218 | 27,988 |
| Accretion of credit loss impairments previously recognized due to an increase in cash flows expected to be collected | (7,788) | | (14,887) | |
| Balance, June 30, 2010 | \$ 423,041 | \$ 225,178 | \$ 423,041 | \$ 225,178 |

The determination of credit losses is based on detailed analyses of underlying cash flows. Such analyses require the use of certain assumption in developing the estimated performance of underlying collateral. Key assumptions used include, but are not limited to, items such as, RMBS default rates based on collateral duration in arrears, severity of losses on default by collateral class, collateral reinvestment rates and expected future general corporate default rates.

The following represents an analysis of net realized gains (losses) on investments:

| Three Months Ended June 30, | Six Months Ended June 30, |
|-----------------------------|---------------------------|
|-----------------------------|---------------------------|

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(U.S. dollars in thousands)
(Unaudited)

| | <u>2010</u> | <u>2009</u> | <u>2010</u> | <u>2009</u> |
|--------------------------------------|-------------|-------------|-------------|--------------|
| Gross realized gains | 28,969 | 97,579 | 63,142 | 285,254 |
| Gross realized losses | (90,355) | (178,009) | (160,704) | (617,621) |
| Net realized (losses) on investments | \$ (61,386) | \$ (80,430) | \$ (97,562) | \$ (332,367) |

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NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

5. Investments (Continued)

Transfer of Available for Sale Securities to Held to Maturity

In November 2009, the Company formalized its intention to hold certain fixed income securities to maturity. Consistent with this intention, the Company has reclassified these securities from available for sale to held to maturity in the consolidated financial statements. As a result of this classification, these fixed income securities are reflected in the held to maturity portfolio and recorded at amortized cost in the consolidated balance sheet and not fair value. The held to maturity portfolio is comprised of long duration non-U.S. sovereign government and government-related securities which are primarily Euro denominated. The Company believes this held to maturity strategy is achievable due to the relatively stable and predictable cash flows of the Company's long-term liabilities within its Life operations along with its ability to substitute other assets at a future date in the event that liquidity was required due to changes in expected cash flows or other transactions entered into related to the long-term liabilities supported by the held to maturity portfolio. The unrealized appreciation at the date of the transfer continues to be reported as a separate component of shareholders' equity and is being amortized over the remaining lives of the securities as an adjustment to yield in a manner consistent with the amortization of any premium or discount. The unrealized U.S. dollar equivalent appreciation on the date of transfer was \$51.2 million and \$41.9 million of this balance remains unamortized at June 30, 2010.

On August 1, 2010 the Company reclassified an additional \$2.1 billion in fixed income securities as held to maturity. The unrealized U.S. dollar equivalent appreciation on the date of transfer was approximately \$71.0 million.

Fixed Maturities Held to Maturity

The fair values and amortized cost of held to maturity fixed maturities at June 30, 2010 and December 31, 2009 were:

| June 30, 2010 <i>(U.S. dollars in thousands)</i> <i>(Unaudited)</i> | Cost or Amortized Cost | Gross Unrealized Gains | Gross Unrealized Losses | Fair Value |
|--|---------------------------------------|---------------------------------------|--|-----------------------|
| Fixed maturities | | | | |
| Non-U.S. Sovereign Government, Supranational and Government-Related | \$ 468,738 | \$ 35,988 | \$ | \$ 504,726 |
| Total fixed maturities held to maturity | \$ 468,738 | \$ 35,988 | \$ | \$ 504,726 |
| | | | | |
| December 31, 2009 <i>(U.S. dollars in thousands)</i> | Cost or Amortized Cost | Gross Unrealized Gains | Gross Unrealized Losses | Fair Value |
| Fixed maturities | | | | |
| Non-U.S. Sovereign Government, Supranational and Government-Related | \$ 546,067 | \$ | \$ (15,748) | \$ 530,319 |
| Total fixed maturities held to maturity | \$ 546,067 | \$ | \$ (15,748) | \$ 530,319 |

The Company had gross unrealized gains totaling \$36.0 million at June 30, 2010 and gross unrealized losses totaling \$15.7 million at December 31, 2009, respectively, which it considers to be temporarily impaired. As at June 30, 2010, the Company's held to maturity portfolio consists entirely of Non-U.S. sovereign holdings and all held to maturity fixed maturity securities have a maturity distribution of due after 10 years at each of June 30, 2010 and December 31, 2009.

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NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

6. Derivative Instruments

The Company enters into derivative instruments for both risk management and investment purposes. The Company is exposed to potential loss from various market risks, and manages its market risks based on guidelines established by management. The Company recognizes all derivatives as either assets or liabilities in the balance sheet and measures those instruments at fair value with the changes in fair value of derivatives shown in the consolidated statement of income as net realized and unrealized gains and losses on derivative instruments unless the derivatives are designated as hedging instruments. The accounting for derivatives that are designated as hedging instruments is described in Item 8, Note 2(h) to the Consolidated Financial Statements, Significant Accounting Policies Derivative Instruments, in the Company's Annual Report on Form 10-K for the year ended December 31, 2009.

The following table summarizes information on the location and gross amounts of derivative fair values contained in the consolidated balance sheet as at June 30, 2010 and December 31, 2009:

| (U.S. dollars in thousands) (Unaudited) | June 30, 2010 | | | | December 31, 2009 | | | |
|--|---|--|---|--|---|--|---|--|
| | Asset Derivative Notional Amount | Asset Derivative Fair Value (1) | Liability Derivative Notional Amount | Liability Derivative Fair Value (1) | Asset Derivative Notional Amount | Asset Derivative Fair Value (1) | Liability Derivative Notional Amount | Liability Derivative Fair Value (1) |
| Derivatives designated as hedging instruments: | | | | | | | | |
| Interest rate contracts (2) | \$ 957,793 | \$ 329,170 | \$ 95,648 | \$ (10,235) | \$ 2,169,642 | \$ 238,639 | \$ 95,948 | \$ (8,225) |
| Foreign exchange contracts | 1,097,616 | 32,007 | | | 1,014,063 | 15,019 | | |
| Total derivatives designated as hedging instruments | \$ 2,055,409 | \$ 361,177 | \$ 95,948 | \$ (10,235) | \$ 3,183,705 | \$ 253,658 | \$ 95,948 | \$ (8,225) |
| Derivatives not designated as hedging instruments: | | | | | | | | |
| <i>Investment Related Derivatives:</i> | | | | | | | | |
| Interest rate exposure | \$ 150,312 | \$ 239 | \$ | \$ | \$ 111,875 | \$ 1,248 | \$ 1,800 | \$ (6) |
| Foreign exchange exposure | 73,655 | 2,105 | 283,809 | (9,701) | 127,329 | 1,577 | 314,361 | (8,226) |
| Credit exposure | 284,650 | 11,480 | 352,000 | (2,940) | 214,650 | 13,244 | 741,388 | (18,198) |
| Financial market exposure | 244,160 | 1,290 | 400 | (31) | 306,464 | 1,983 | | |
| <i>Financial Operations Derivatives: (3)</i> | | | | | | | | |
| Credit exposure | | | 254,456 | (25,887) | | | 271,704 | (18,386) |
| <i>Other Non-Investment Derivatives:</i> | | | | | | | | |
| Contingent capital facility | 350,000 | | | | 350,000 | | | |
| Guaranteed minimum income benefit contract | | | 84,369 | (23,984) | | | 86,250 | (22,909) |
| Modified coinsurance funds withheld contract | | | 68,731 | | | | 71,695 | (266) |
| Foreign exchange exposure | | | | | | | | |

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**Total derivatives not
designated as hedging
instruments**

| | | | | | | | |
|--------------|-----------|--------------|-------------|--------------|-----------|--------------|-------------|
| \$ 1,102,777 | \$ 15,114 | \$ 1,043,765 | \$ (62,543) | \$ 1,110,318 | \$ 18,052 | \$ 1,487,198 | \$ (67,991) |
|--------------|-----------|--------------|-------------|--------------|-----------|--------------|-------------|

-
- (1) Derivative instruments in an asset or liability position are included within Other Assets or Other Liabilities, respectively, in the Balance Sheet.
 - (2) At June 30, 2010 and December 31, 2009, the Company held net cash collateral related to these derivative assets of \$254.2 million and \$169.1 million. The collateral balance is included within cash and cash equivalents and the corresponding liability to return the collateral has been offset against the derivative asset within the balance sheet as appropriate under the netting agreement.
 - (3) Financial operations derivatives represent interests in variable interest entities as described in Note 10, Variable Interest Entities.

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NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

6. Derivative Instruments (Continued)

(a) Derivative Instruments Designated as Fair Value Hedges

The Company designates certain of its derivative instruments as fair value hedges or cash flow hedges 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 or cash flows of the linked hedged item.

At June 30, 2010, a portion of the Company's liabilities are hedged against changes in the applicable designated benchmark interest rate. Interest rate swaps are also used to hedge the changes in fair value of certain fixed rate liabilities and fixed income securities due to changes in the designated benchmark interest rate. In addition, the Company utilizes foreign exchange contracts to hedge the fair value of certain fixed income securities as well as to hedge certain net investments in foreign operations.

On June 7, 2010, the Company settled the interest rate contracts designated as fair value hedges of certain issues of the Company's notes payable and debt. The derivative contracts were settled for a gain of \$21.6 million. The cumulative increase recorded to the carrying value of the hedged notes payable and debt, representing the effective portion of the hedging relationship, will be amortized through interest expense over the remaining term of the debt. From the date of settlement through June 30, 2010, \$0.5 million of the balance was recorded as a reduction of interest expense. The remaining balance of \$21.2 million will be amortized over the weighted average period remaining to maturity of the debt of 3.6 years.

The following table provides the total impact on earnings relating to derivative instruments formally designated as fair value hedges along with the impacts of the related hedged items for the three and six month periods ended June 30, 2010 and 2009:

Three months ended June 30, 2010

(U.S. dollars in thousands)

(Unaudited)

| | Gain/(Loss) Recognized in Income on Derivative | Hedged Items Amount of Gain/(Loss) Recognized in Income Attributable to Risk | | | Ineffective Portion of Hedging Relationship Gain/ (Loss) |
|---|--|---|----------------------------------|------------------------------|--|
| | | Deposit Liabilities | Fixed Maturity Investments | Notes Payable and Debt | |
| Derivatives Designated as Fair Value Hedges: | | | | | |
| Interest rate exposure | \$ 85,900 | | | | |
| Foreign exchange exposure | 13,312 | | | | |
| Total | \$ 99,212 | \$ (85,918) | \$ (11,668) | \$ (6,209) | \$ (4,583) |

Three months ended June 30, 2009

(U.S. dollars in thousands)

(Unaudited)

| | Gain/(Loss) Recognized in Income on Derivative | Hedged Items Amount of Gain/(Loss) Recognized in Income Attributable to Risk | | | Ineffective Portion of Hedging Relationship Gain/ (Loss) |
|---|--|---|----------------------------------|------------------------------|--|
| | | Deposit Liabilities | Fixed Maturity Investments | Notes Payable and Debt | |
| Derivatives Designated as Fair Value Hedges: | | | | | |
| Interest rate exposure | \$ (126,914) | | | | |

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Foreign exchange exposure

| | | | | | |
|-------|---------------------|-------------------|------------------|-----------|-----------------|
| Total | <u>\$ (126,914)</u> | <u>\$ 117,831</u> | <u>\$ 10,613</u> | <u>\$</u> | <u>\$ 1,530</u> |
|-------|---------------------|-------------------|------------------|-----------|-----------------|

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NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

6. Derivative Instruments (Continued)

(a) Derivative Instruments Designated as Fair Value Hedges (Continued)

Six months ended June 30, 2010

(U.S. dollars in thousands)

(Unaudited)

| | Gain/(Loss) Recognized in Income on Derivative | Hedged Items Amount of Gain/(Loss) Recognized in Income Attributable to Risk | | | Ineffective Portion of Hedging Relationship Gain/ (Loss) |
|---|---|---|----------------------------------|---------------------------------|--|
| | | Deposit Liabilities | Fixed Maturity Investments | Notes Payable and Debt | |
| Derivatives Designated as Fair Value Hedges: | | | | | |
| Interest rate exposure | \$ 92,036 | | | | |
| Foreign exchange exposure | 48,556 | | | | |
| Total | \$ 140,592 | \$ (86,742) | \$ (46,334) | \$ (15,940) | \$ (8,424) |

Six months ended June 30, 2009

(U.S. dollars in thousands)

(Unaudited)

| | Gain/(Loss) Recognized in Income on Derivative | Hedged Items Amount of Gain/(Loss) Recognized in Income Attributable to Risk | | | Ineffective Portion of Hedging Relationship Gain/ (Loss) |
|---|--|---|----------------------------------|---------------------------------|--|
| | | Deposit Liabilities | Fixed Maturity Investments | Notes Payable and Debt | |
| Derivatives Designated as Fair Value Hedges: | | | | | |
| Interest rate exposure | \$ (189,553) | | | | |
| Foreign exchange exposure | | | | | |
| Total | \$ (189,553) | \$ 182,635 | \$ 9,759 | \$ | \$ 2,841 |

The gains (losses) recorded on both the derivatives instruments and specific items designated as being hedged as part of the fair value hedging relationships outlined above are recorded through net realized and unrealized gains (losses) on derivative instruments in the income statement along with any associated ineffectiveness in the relationships. In addition, the periodic coupon settlements relating to the interest rate swaps are recorded as adjustments to net investment income for the hedges of fixed maturity investments and as adjustments to interest expense for the hedges of deposit liabilities and notes payable and debt.

The periodic coupon settlements resulted in decreases to net investment income of \$1.0 million and \$2.0 million for the three and six months ended June 30, 2010, respectively and increases to net investment income of \$3.1 million and \$5.5 million for the three and six months ended June 30, 2009, respectively.

The periodic coupon settlements also resulted in decreases to interest expense of \$20.5 million and \$34.5 million for the three and six months ended June 30, 2010, respectively, and decreases to interest expense of \$6.9 million and \$13.1 million for the three and six months ended June 30, 2009, respectively.

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NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

6. Derivative Instruments (Continued)

(b) Derivative Instruments Designated as Cash Flow Hedges

During March 2007, the Company entered into an interest rate swap agreement in connection with the issuance of the 2027 Senior Notes, as described in Item 8, Note 16 to the Consolidated Financial Statements, Notes Payable and Debt and Financing Arrangements, of the Company's Annual Report on Form 10-K for the year ended December 31, 2009. This transaction, which met the requirements of accounting guidance applicable to a cash flow hedge of a forecasted transaction, was entered into to mitigate the interest rate risk associated with the subsequent issuance of the 2027 Senior Notes. The gain on the settlement of the swap transaction on May 2, 2007 of \$3.8 million was credited to AOCI and is being amortized to interest expense over the 20-year term of the related debt. In addition, the Company entered into a treasury rate guarantee agreement in anticipation of the issuance of \$300.0 million of 5.25% Senior Notes due September 15, 2014 during 2004. The loss on the settlement of the treasury rate guarantee transaction on August 18, 2004 of \$6.3 million was charged to AOCI and is being amortized to interest expense over the 10-year term of the related debt. The impact on earnings relating to these derivative instruments formally designated as cash flow hedges were increases to interest expense of \$0.1 million and \$0.2 million for each of the three and six months periods ended June 30, 2010 and 2009, respectively.

(c) Derivative Instruments Designated as Hedges of the Net Investment in a Foreign Operation

The Company utilizes foreign exchange contracts to hedge the fair value of certain net investments in foreign operations. During the three and six months ended June 30, 2010, the Company entered into foreign exchange contracts that were formally designated as hedges of the investment in foreign subsidiaries with functional currencies of U.K. Sterling and the Euro. The U.S. Dollar equivalent of foreign denominated net assets of \$505.4 million and \$372.7 million was hedged during the three and six months ended June 30, 2010, respectively, which resulted in a derivative gain of \$19.9 million and \$22.6 million being recorded in the cumulative translation adjustment account within AOCI for each period, respectively. There was no ineffectiveness resulting from these transactions. The Company did not have any hedges of net investments in foreign operations in place during the quarter or six months ended June 30, 2009.

(d) Derivative Instruments Not Formally Designated As Hedging Instruments

The following table provides the total impact on earnings relating to derivative instruments not formally designated as hedging instruments under authoritative accounting guidance. The impacts are all recorded through Net realized and unrealized gains (losses) on derivatives in the income statement.

| | Amount of Gain (Loss) Recognized in Income on Derivative | | | |
|---|--|----------|---------------------------|----------|
| | Three Months Ended June 30, | | Six Months Ended June 30, | |
| | 2010 | 2009 | 2010 | 2009 |
| <i>(U.S. dollars in thousands)</i> | | | | |
| <i>(Unaudited)</i> | | | | |
| Derivatives not designated as hedging instruments: | | | | |
| <i>Investment Related Derivatives:</i> | | | | |
| Interest rate exposure | 2,909 | 4,751 | 4,906 | 5,624 |
| Foreign exchange exposure | (14,574) | 14,930 | (28,011) | 8,514 |
| Credit exposure | 2,414 | (28,280) | 1,143 | (27,244) |
| Financial market exposure | (376) | 367 | 135 | 2,327 |
| <i>Financial Operations Derivatives:</i> | | | | |
| Credit exposure | (3,340) | 3,669 | (7,342) | 9,254 |
| <i>Other Non-Investment Derivatives:</i> | | | | |
| Contingent capital facility | (2,053) | (2,053) | (4,083) | (4,083) |
| Guaranteed minimum income benefit contract | (2,688) | 3,355 | (1,075) | (608) |
| Modified coinsurance funds withheld contract | 2,395 | (213) | 2,375 | 24 |
| <i>Weather and Energy Derivatives:</i> | | | | |
| Structured weather risk management products | | 2,913 | | 2,913 |
| Total derivatives not designated as hedging instruments | (15,313) | (561) | (31,952) | (3,279) |

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| | | | | |
|--|-------------------|-------------------|-------------------|-------------------|
| Amount of gain (loss) recognized in income from ineffective portion of fair value hedges | (4,583) | 1,530 | (8,424) | 2,841 |
| | <u> </u> | <u> </u> | <u> </u> | <u> </u> |
| Net realized and unrealized gains (losses) on derivative instruments | \$ (19,896) | \$ 969 | \$ (40,376) | \$ (438) |
| | <u> </u> | <u> </u> | <u> </u> | <u> </u> |

The Company's objectives in using these derivatives are explained in sections (d) and (e) of this note below.

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NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

6. Derivative Instruments (Continued)

(d)(i) Investment Related Derivatives

The Company, either directly or through its investment managers, may use derivative instruments within its investment portfolio, including interest rate swaps, inflation swaps, credit derivatives (single name and index credit default swaps), options, forward contracts and financial futures (foreign exchange, bond and stock index futures), primarily as a means of economically hedging exposures to interest rate, credit spread, equity price changes and foreign currency risk or in limited instances for investment purposes. The Company is exposed to credit risk in the event of non-performance by the counterparties under any swap contracts although the Company generally seeks to use credit support arrangements with counterparties to help manage this risk.

Investment Related Derivatives Interest Rate Exposure

The Company utilizes risk management and overlay strategies that incorporate the use of derivative financial instruments, primarily to manage its fixed income portfolio duration and exposure to interest rate risks associated with certain of its assets and liabilities primarily in relation to certain legacy other financial lines and structured indemnity transactions. The Company uses interest rate swaps to convert certain liabilities from a fixed rate to a variable rate of interest and may also use them to convert a variable rate of interest from one basis to another.

Investment Related Derivatives Foreign Exchange Exposure

The Company uses foreign exchange contracts to manage its exposure to the effects of fluctuating foreign currencies on the value of certain of its foreign currency fixed maturities primarily within its Life operations portfolio. These contracts are not designated as specific hedges for financial reporting purposes and, therefore, realized and unrealized gains and losses on these contracts are recorded in income in the period in which they occur. These contracts generally have maturities of twelve months or less.

In addition, certain of the Company's investment managers may, subject to investment guidelines, enter into forward contracts where potential gains may exist. The Company has exposure to foreign currency exchange rate fluctuations through its operations and in its investment portfolio.

Investment Related Derivatives Credit Exposure

Credit derivatives are purchased within the Company's investment portfolio in the form of single name and basket credit default swaps, which are used to mitigate credit exposure through a reduction in credit spread duration (i.e. macro credit strategies rather than single-name credit hedging) or exposure to selected issuers, including issuers that are not held in the underlying bond portfolio.

Investment Related Derivatives Financial Market Exposure

Stock index futures may be purchased within the Company's investment portfolio in order to create synthetic equity exposure and to add value to the portfolio with overlay strategies where market inefficiencies are believed to exist. The Company previously wrote a number of resettable strike swaps contracts relating to an absolute return index and diversified baskets of funds. Finally, from time to time, the Company may enter into other financial market exposure derivative contracts on various indices including, but not limited to, inflation and commodity contracts.

(d)(ii) Financial Operations Derivatives Credit Exposure

The Company held credit derivative exposures through a limited number of contracts written as part of the Company's previous financial lines businesses, and through the Company's prior reinsurance agreements with Syncora, as described below. Following the secondary market sale of Syncora common shares, the Company retained some credit derivative exposures written by Syncora and certain of its subsidiaries through reinsurance agreements that had certain derivatives exposures embedded within them. The change in value of the derivative portion of the financial guarantee reinsurance agreements the Company had with Syncora was included in Net (loss) income from operating affiliates. Following the closing of the Master Agreement during August 2008, as described in Item 8, Note 4 to the Consolidated Financial Statements, Syncora Holdings Ltd., in the Company's Annual Report on Form 10-K for the year ended December 31, 2009, which terminated certain reinsurance and other agreements, these credit derivative exposures were eliminated by virtue of the commutation of the relevant reinsurance agreements.

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NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

6. Derivative Instruments (Continued)

(d)(ii) Financial Operations Derivatives Credit Exposure (Continued)

As of June 30, 2010 and December 31, 2009 the remaining credit derivative exposures outside of the Company's investment portfolio consisted of two contracts written by the Company, one, that provides credit protection on the senior tranches of a structured finance transaction and the other, a European project finance loan participation. The aggregate outstanding exposure for the two contracts is \$254.5 million (\$233.2 million principal and \$21.2 million interest), and \$271.7 million (\$244.9 million principal and \$26.8 million interest), weighted average contractual term to maturity of 5.5 years and 6.0 years, a total liability recorded of \$25.9 million and \$18.4 million, respectively.

The credit protection related to the structured finance transaction is a credit default swap executed in 2000. The underlying collateral is predominantly securitized pools of leveraged loans and bonds. The transaction is in compliance with most of the coverage tests except the mezzanine overcollateralization test. As a result, both interest and principal proceeds are currently redirected to amortize the senior most notes which reduces the Company's exposure sooner than originally anticipated. Management continues to monitor its underlying performance and is comfortable with the collateral coverage. The European project finance loan participation benefits from an 80% deficiency guarantee from the German state and federal governments.

As of June 30, 2010, there were no reported events of default on these obligations. Credit derivatives are recorded at fair values, which are determined using either models developed by the Company or third party prices and are dependent upon a number of factors, including changes in interest rates, future default rates, credit spreads, changes in credit quality, future expected recovery rates and other market factors. The change resulting from movements in credit and credit quality spreads is unrealized as the credit derivatives are not traded to realize this resultant value.

(d)(iii) Other Non-Investment Derivatives

The Company entered into derivatives as part of its contingent capital facility including put options, interest rate swaps, and asset return swaps. These derivatives are recorded at fair value with changes in fair value recognized in earnings.

The Company also has derivatives embedded in certain reinsurance contracts. For a particular life reinsurance contract, the Company pays the ceding company a fixed amount equal to the estimated present value of the excess of guaranteed benefit GMIB over the account balance upon the policyholder's election to take the income benefit. The fair value of this derivative is determined based on the present value of expected cash flows. In addition, the Company has modified coinsurance and funds withheld reinsurance agreements that provide for a return based on a portfolio of fixed income securities. As such, the agreements contain embedded derivatives. The embedded derivative is bifurcated from the funds withheld balance and recorded at fair value with changes in fair value recognized in earnings through net realized and unrealized gains and losses on derivative instruments.

(e) Contingent Credit Features

Certain derivatives agreements entered into by the Company or its subsidiaries contain rating downgrade provisions that permit early termination of the agreement by the counterparty if collateral is not posted following failure to maintain certain credit ratings from one or more of the principal credit rating agencies. If the Company were required to early terminate such agreements due to rating downgrade, it could potentially be in a net liability position at time of settlement. The aggregate fair value of all derivatives agreements containing such rating downgrade provisions that were in a liability position on June 30, 2010 and December 31, 2009 was \$28.6 million and \$30.8 million, respectively. The Company has not been required to post collateral under any of these agreements as of June 30, 2010.

7. Share Capital

(a) Authorized and Issued

As described in further detail within Item 8, Note 21 to the Consolidated Financial Statements, Share Capital, in the Company's Annual Report of Form 10-K for the year ended December 31, 2009, on February 15, 2009 following the maturity of the purchase contracts associated with the 7.0% equity security units, the Company issued 11,461,080 shares for net proceeds of approximately \$745.0 million, which was used to retire the senior notes previously due February 2011, which had a fixed coupon of 5.25%.

(b) Redeemable Series C Preference Ordinary Shares

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On February 12, 2010, the Company repurchased a portion of its outstanding Series C Preference Ordinary Shares which resulted in approximately 4.4 million Series C Preference Ordinary Shares with a liquidation value of \$110.8 million being purchased by the Company for approximately \$94.2 million. As a result, a book value gain of approximately \$16.6 million was recorded in the first quarter of 2010 to common shareholders.

On March 26, 2009, the Company completed a cash tender offer for a portion of its outstanding Series C Preference Ordinary Shares that resulted in approximately 12.7 million Series C Preference Ordinary Shares with a liquidation value of \$317.3 million being purchased by the Company for approximately \$104.7 million plus accrued and unpaid dividends, combined with professional fees totaling \$0.8 million. As a result, a book value gain of approximately \$211.8 million was recorded in the first quarter of 2009 to common shareholders.

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NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

7. Share Capital (Continued)

(c) Stock Plans

The Company's performance incentive programs provide for grants of stock options, restricted stock, restricted stock units and performance units and stock appreciation rights. Share based compensation granted by the Company generally contains a vesting period of three or four years and certain awards will also contain performance conditions. The Company records compensation expense related to each award over its vesting period incorporating the best estimate of the expected outcome of performance conditions where applicable. Compensation expense is generally recorded on a straight line basis over the vesting period of an award. See Item 8, Note 21 to the Consolidated Financial Statements, Share Capital, in the Company's Annual Report on Form 10-K for the year ended December 31, 2009 for further information on the Company's performance incentive programs and associated accounting.

During the six months ended June 30, 2010, the Company granted approximately 0.9 million stock options with a weighted-average grant date fair value of \$9.32 per option. The fair value of the options issued was estimated on the date of grant using the Black-Scholes option pricing model using the following weighted average assumptions:

| | |
|-------------------------|-----------|
| Dividend yield | 3.25% |
| Risk free interest rate | 2.73% |
| Volatility | 72.5% |
| Expected lives | 6.0 years |

During the six months ended June 30, 2010, the Company granted approximately 1.1 million restricted stock units to officers of the Company and its subsidiaries with an aggregate grant date fair value of approximately \$20.2 million. Each restricted stock unit represents the Company's obligation to deliver to the holder one Class A Ordinary Share upon satisfaction of the three year vesting term. Restricted stock units are granted at the closing market price on the day of grant and entitle the holder to receive dividends declared and paid in the form of additional Class A Ordinary Shares contingent upon vesting.

During the six months ended June 30, 2010, the Company granted approximately 1.5 million performance units (representing a potential maximum share payout of approximately 3.1 million Class A Ordinary Shares) to certain employees with an aggregate grant date fair value of approximately \$26.3 million. The performance units vest after three years and entitle the holder to shares of the Company's stock. There are no dividend rights associated with the performance units. Each grant of performance units has a target number of shares, with final payouts ranging from 0% to 200% of the grant amount depending upon a combination of corporate and business segment performance along with each employee's continued service through the vest date. Performance targets are based on relative and absolute financial performance metrics.

In connection with, and effective upon, the completion of the Redomestication, XL-Ireland assumed the existing liabilities, obligations and duties of XL-Cayman under the NAC Re Corp. 1989 Stock Option Plan (the 1989 Plan), the XL Capital Amended and Restated 1991 Performance Incentive Program (the 1991 Program), the XL Capital 1999 Performance Incentive Program for Employees (the 1999 Program), the XL Capital Ltd Directors Stock & Option Plan (the Directors Plan), the XL Capital Ltd 2009 Cash Long-term Program (the 2009 Program), the XL Capital Supplemental Deferred Compensation Plan (the DC Plan, and together with the 1989 Plan, 1991 Program, the 1999 Program, the Directors Plan and the 2009 Program, the Programs). Furthermore, in connection with, and effective upon, the completion of the Redomestication, the Programs have been amended by XL-Cayman, among other things, (i) to provide that XL-Ireland and its Board of Directors will succeed to all powers, authorities and obligations of XL-Cayman and its Board of Directors under each Program, (ii) to provide that the securities to be issued pursuant to each Program will consist of ordinary shares of XL-Ireland and (iii) otherwise to reflect the completion of the Redomestication.

8. XL Capital Finance (Europe) plc

XL Capital Finance (Europe) plc (XLCFE) is a wholly owned finance subsidiary of the Company. In January 2002, XLCFE issued \$600.0 million par value 6.5% Guaranteed Senior Notes due January 2012. These Notes are fully and unconditionally guaranteed by the Company. XL Capital Ltd's ability to obtain funds from its subsidiaries is subject to certain contractual restrictions, applicable laws and statutory requirements of the various countries in which the Company operates including Bermuda, the U.S. and the U.K., among others. Required statutory capital and surplus for the principal operating subsidiaries of the Company was \$7.0 billion as of December 31, 2009.

On June 30, 2010, XL-Cayman entered into the Supplemental Indenture (the XLCFE Supplemental Indenture) to the Indenture (the XLCFE Indenture), dated as of January 10, 2002, by and among XLCFE, XL-Cayman and State Street Bank and Trust Company. The XLCFE

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Supplemental Indenture provides for, among other things, the assumption of XL-Cayman's obligations under the guarantee of obligations under the XLCFE Indenture and the securities issued pursuant thereto by XL Company Switzerland GmbH.

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NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

9. Related Party Transactions

At June 30, 2010 and December 31, 2009, the Company owned non-controlling stakes in eight and nine independent investment management companies (Investment Manager Affiliates) totaling \$160.1 million and \$210.7 million, respectively. The Company seeks to develop relationships with specialty investment management organizations, generally acquiring an equity interest in the business. The Company also invests in certain of the funds and limited partnerships and other legal entities managed by these affiliates and through these funds and partnerships pays management and performance fees to the Company's Investment Manager Affiliates.

In the normal course of business, the Company enters into certain quota share reinsurance contracts with a subsidiary of one of its other strategic affiliates, ARX Holding Corporation. During the quarter ended June 30, 2010, these contracts resulted in reported net premiums of \$8.2 million, net paid claims of \$5.2 million and reported acquisition costs of \$6.0 million. During the same period in 2009, these contracts resulted in reported net premiums of \$15.9 million, net paid claims of \$5.4 million and reported acquisition costs of \$6.1 million. Management believes that these transactions are conducted at market rates consistent with negotiated arms-length contracts.

In the normal course of business, the Company enters into cost sharing and service level agreement transactions with certain other strategic affiliates, which management believes to be conducted consistent with arms-length rates. Such transactions, individually and in the aggregate, are not material to the Company's financial condition, results of operations and cash flows.

10. Variable Interest Entities

At times, the Company has utilized variable interest entities both indirectly and directly in the ordinary course of the Company's business.

The Company invests in CDOs, and other structured investment vehicles that are issued through variable interest entities as part of the Company's investment portfolio. The activities of these variable interest entities are generally limited to holding the underlying collateral used to service investments therein. Management has evaluated the nature of the Company's involvement in such entities and has concluded that the Company is not the primary beneficiary of these variable interest entities as contemplated in current authoritative accounting guidance. The Company's involvement in these entities is passive in nature and management was not involved in either the establishment or arrangement of these entities. Management does not believe that the Company has the power to direct activities, such as asset selection and collateral management, which most significantly impact the entity's economic performance. The Company's financial results are impacted by the changes in fair value of the variable interest entities consistent with the accounting policies applied to invested assets. For further details on the nature of the Company's investment portfolio, in particular mortgage and asset backed securities which typically represent interests in variable interest entities, see Item 8, Note 9 to the Consolidated Financial Statements, Investments, in the Company's Annual Report on Form 10-K for the year ended December 31, 2009.

The Company has utilized variable interest entities in certain instances as a means of accessing contingent capital. The Company has utilized unconsolidated entities in the formation of contingent capital facilities. The Company's interest in Stoneheath Re (Stoneheath) represents an interest in a variable interest entity; however, the Company is not the primary beneficiary as contemplated in that guidance. The Company's interest in such entities is as a contributor of variability and not an absorber of losses and, as such, the Company would not be considered the primary beneficiary. Given that there are no contractual requirements or intentions to enter into additional variable interests in this entity, management considers the likelihood of consolidating Stoneheath in the future to be remote. For further details regarding Stoneheath, see Item 8, Note 18 to the Consolidated Financial Statements, Off-Balance Sheet Arrangements, in the Company's Annual Report on Form 10-K for the year ended December 31, 2009.

The Company has a limited number of remaining outstanding credit enhancement exposures including written financial guarantee and credit default swap contracts. The obligations related to these transactions are often securitized through variable interest entities. The Company is not the primary beneficiary of these variable interest entities as contemplated in current authoritative accounting guidance on the basis that management does not believe that the Company has the power to direct the activities, such as asset selection and collateral management, which most significantly impact each entity's economic performance. For further details on the nature of the obligations and the size of the Company's maximum exposure see Item 8, Note 2(r), Recent Accounting Pronouncements, and Note 17, Derivative Instruments, to the Consolidated Financial Statements in the Company's Annual Report on Form 10-K for the year ended December 31, 2009.

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NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

10. Variable Interest Entities (Continued)

The credit exposures represent the most significant risks associated with the Company's involvement with variable interest entities and there have been no significant changes in the nature of the Company's involvement with variable interest entities during the six months ended June 30, 2010.

11. Computation of Earnings Per Ordinary Share and Ordinary Share Equivalent

| | (Unaudited) Three Months Ended June 30, | | (Unaudited) Six Months Ended June 30, | |
|--|---|----------------|---|----------------|
| | 2010 | 2009 | 2010 | 2009 |
| <i>(U.S. dollars and shares in thousands, except per share amounts)</i> | | | | |
| <i>(Unaudited)</i> | | | | |
| Basic earnings per ordinary share and ordinary share equivalents: | | | | |
| Net income attributable to XL Capital Ltd | \$ 194,005 | \$ 85,541 | \$ 337,885 | \$ 88,638 |
| Less: preference share dividends | (2,194) | (5,592) | (34,694) | (42,126) |
| Plus: gain on redemption of Series C Preference Ordinary shares | | | 16,616 | 211,816 |
| Net income available to ordinary shareholders | \$ 191,811 | \$ 79,949 | \$ 319,807 | \$ 258,328 |
| Weighted average ordinary shares outstanding | 342,056 | 342,154 | 342,049 | 339,155 |
| Basic earnings per ordinary share & ordinary share equivalents outstanding | \$ 0.56 | \$ 0.23 | \$ 0.93 | \$ 0.76 |
| Diluted earnings per ordinary share and ordinary share equivalents: | | | | |
| Net income attributable to XL Capital Ltd | \$ 194,005 | \$ 85,541 | \$ 337,885 | \$ 88,638 |
| Less: preference share dividends | (2,194) | (5,592) | (34,694) | (42,126) |
| Plus: gain on redemption of Series C Preference Ordinary shares | | | 16,616 | 211,816 |
| Net income available to ordinary shareholders | \$ 191,811 | \$ 79,949 | \$ 319,807 | \$ 258,328 |
| Weighted average ordinary shares outstanding - basic | 342,056 | 342,154 | 342,049 | 339,155 |
| Impact of share based compensation and certain conversion features | 822 | 314 | 732 | 107 |
| Weighted average ordinary shares outstanding - diluted | 342,878 | 342,468 | 342,781 | 339,262 |
| Diluted earnings per ordinary share & ordinary share equivalents outstanding | \$ 0.56 | \$ 0.23 | \$ 0.93 | \$ 0.76 |
| Dividends per ordinary share | \$ 0.10 | \$ 0.10 | \$ 0.20 | \$ 0.20 |

XL CAPITAL LTD

NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

12. Commitments and Contingencies*Financial and Other Guarantee Exposures*

As part of the Company's legacy financial guarantee business, the Company's outstanding financial guarantee contracts as of June 30, 2010 included the reinsurance of 38 financial guarantee contracts with total insured contractual payments outstanding of \$619.1 million (\$493.4 million of principal and \$125.7 million of interest) and having a remaining weighted-average contract period of 11.6 years. These contracts provide credit support for a variety of collateral types. The largest exposures are comprised of (i) \$386.5 million of notional financial guarantee (including principal and interest) on a Chilean toll road structure where the Issuer has decided to prepay the debt and, therefore, the exposure has been eliminated in the third quarter of 2010; (ii) \$70.6 million of notional financial guarantee on a collateralized fund obligation which is currently being wound-up in an orderly manner and where collateral cushion exceeds 60%; and (iii) the remaining \$162.0 million of financial guarantees is comprised of 36 separate transactions with varying forms of underlying collateral, including pre-2000 vintage asset backed securities and municipal government bonds. The underlying financial guarantees are diversified and individually small.

The total gross claim liability and unearned premiums recorded at June 30, 2010 associated with the 38 contracts were \$14.5 million and \$0.6 million, respectively. Of the contractual exposure existing at June 30, 2010, the Company has reinsured the above mentioned Chilean toll road exposure with subsidiaries of Syncora, however, as of June 30, 2010 there are no gross claim liabilities or recoverables recorded relating to this exposure. Of the 38 contracts noted above, 3 contracts with total insured contractual payments outstanding of \$13.1 million had experienced an event of default and were considered by the Company to be non-performing at June 30, 2010, while the remaining 35 contracts were considered to be performing at such date.

As of December 31, 2009, the Company's outstanding financial guarantee contracts included the reinsurance of 41 financial guarantee contracts with total insured contractual payments outstanding of \$713.6 million (\$568.2 million of principal and \$145.4 million of interest) and having a remaining weighted-average contract period of 11.5 years. The total gross claim liability and unearned premiums recorded at December 31, 2009 were \$14.5 million and \$1.5 million, respectively. Of the contractual exposure existing at December 31, 2009, the Company had reinsured \$423.8 million with subsidiaries of Syncora, however, as at December 31, 2009 there were no gross claims liabilities or recoverables recorded. Of the 41 contracts noted above, 3 contracts with total insured contractual payments outstanding of \$16.1 million had experienced an event of default and were considered by the Company to be non-performing at December 31, 2009, while the remaining 38 contracts were considered to be performing at such date.

Surveillance procedures to track and monitor credit deteriorations in the insured financial obligations are performed by the primary obligors for each transaction on the Company's behalf. Information regarding the performance status and updated exposure values is provided to the Company on a quarterly basis and evaluated by management in recording claims reserves.

On June 28, 2010, the Company's subsidiary XL Insurance (Bermuda) Ltd (XLI) completed a commutation, termination and release agreement (the Termination Agreement) with European Investment Bank (EIB) which fully extinguishes and terminates all of the guarantees issued to EIB by XLI in connection with financial guaranty policies between certain subsidiaries of Syncora Holdings Ltd. (formerly Security Capital Assurance Ltd, Syncora Holdings) and EIB. These guarantees were provided for the benefit of EIB relating to project finance transactions comprised of transportation, school and hospital projects with an average rating of BBB, written between 2001 and 2006 with anticipated maturities ranging between 2027 and 2038. The guarantees had been accounted for under Accounting Standards Codification (ASC) section 460-10, *Guarantees* (previously FIN 45, *Guarantor's Accounting and Disclosure Requirements for Guarantees, Including Indirect Guarantees of Indebtedness of Others.*)

Under the Termination Agreement, XLI paid \$38 million to EIB, and all of XLI's exposures under the EIB guarantees, with aggregate par outstanding of approximately \$900 million, were eliminated. In addition, a further \$0.5 million was paid to EIB for expenses in relation to the termination. Pursuant to the obligations of Syncora Holdings and its affiliates (collectively Syncora) under the Master Commutation, Release and Restructuring Agreement (the Master Agreement), dated as of July 28, 2008, as amended, among XLI and affiliates, Syncora, and certain of Syncora's credit default swap counterparties, Syncora paid XLI \$15 million subsequent to June 30, 2010 (of the total \$38 million payment). The net cost of this transaction is reflected in the Company's Consolidated Statement of Income as Loss on Termination of Guarantee . For further historical information regarding the above-mentioned EIB guarantees and the Master Agreement, refer to Note 4 to the Consolidated Financial Statements, included in the Company's Annual Report on Form 10-K for the year ended December 31, 2009.

13. Taxation

During the first six months of 2010, the Company revised its capital strategy such that it is no longer able to positively assert that all earnings arising within the United States will be permanently reinvested in that jurisdiction. As a result, the effective tax rate for the period

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includes a provision for withholding tax on certain earnings arising in the United States. The impact of this change on the estimated effective rate for the six months ended is an increase of approximately 0.5%.

ITEM 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

General

On July 1, 2010, XL Group plc, an Irish public limited company ("XL Ireland"), and XL Group plc (formerly, XL Capital Ltd), a Cayman Islands exempted company ("XL-Cayman"), completed a redomestication transaction in which all of the ordinary shares of XL-Cayman were exchanged for all of the ordinary shares of XL-Ireland. As a result, XL-Cayman became a wholly owned subsidiary of XL-Ireland. Unless the context otherwise indicates, references in this Management's Discussion and Analysis of Financial Condition and Results of Operations to "XL Group" include XL-Ireland and its consolidated subsidiaries; references to the "Company" include XL-Cayman and its consolidated subsidiaries prior to July 1, 2010.

The following is a discussion of XL Group's financial condition and liquidity and results of operations. Certain aspects of XL Group's business have loss experience characterized as low frequency and high severity. This may result in volatility in both XL Group's and an individual segment's results of operations and financial condition.

This Management's Discussion and Analysis of Financial Condition and Results of Operations contains forward-looking statements that involve inherent risks and uncertainties. Statements that are not historical facts, including statements about the Company's beliefs and expectations, are forward-looking statements. These statements are based upon current plans, estimates and projections. Actual results may differ materially from those included in such forward-looking statements, and therefore undue reliance should not be placed on them. See

Cautionary Note Regarding Forward-Looking Statements below for a list of factors that could cause actual results to differ materially from those contained in any forward-looking statement.

This discussion and analysis should be read in conjunction with the Management's Discussion and Analysis of Financial Condition and Results of Operations and the audited Consolidated Financial Statements and notes thereto, presented under Item 7 and Item 8, respectively, of the Company's Annual Report on Form 10-K for the year ended December 31, 2009.

Executive Overview

See Executive Overview in Item 7 of the Company's Annual Report on Form 10-K for the year ended December 31, 2009.

Results of Operations and Key Financial Measures

The following table presents an analysis of the Company's net income available to ordinary shareholders and other financial measures (described below) for the three and six months ended June 30, 2010 and 2009:

| | (Unaudited) Three Months Ended June 30, | | (Unaudited) Six Months Ended June 30, | |
|---|---|-----------|---|------------|
| | 2010 | 2009 | 2010 | 2009 |
| <i>(U.S. dollars and shares in thousands, except per share amounts)</i> <i>(Unaudited)</i> | | | | |
| Net income attributable to ordinary shareholders | \$ 191,811 | \$ 79,949 | \$ 319,807 | \$ 258,328 |
| Earnings per ordinary share - basic | \$ 0.56 | \$ 0.23 | \$ 0.93 | \$ 0.76 |
| Earnings per ordinary share - diluted | \$ 0.56 | \$ 0.23 | \$ 0.93 | \$ 0.76 |
| Weighted average number of ordinary shares and ordinary share equivalents - basic | 342,056 | 342,154 | 342,049 | 339,155 |
| Weighted average number of ordinary shares and ordinary share equivalents - diluted | 342,878 | 342,468 | 342,781 | 339,262 |
| Change in fully diluted book value per ordinary share | 1.36 | 3.87 | 3.14 | 3.43 |

The following are some of the financial measures management considers important in evaluating the Company's operating performance:

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(U.S. dollars and shares in thousands, except per share amounts)
(Unaudited)

| | (Unaudited) Three Months Ended June 30, | | (Unaudited) Six Months Ended June 30, | |
|--|---|------------|---|------------|
| | 2010 | 2009 | 2010 | 2009 |
| Underwriting profit (loss) P&C operations | \$ 94,673 | \$ 89,439 | \$ 88,063 | \$ 193,291 |
| Combined ratio P&C operations | 92.2% | 93.0% | 96.4% | 92.6% |
| Net investment income P&C operations | \$ 222,544 | \$ 237,887 | \$ 446,183 | \$ 500,347 |
| Annualized return on average shareholders equity | 8.3% | 5.5% | 7.1% | 8.9% |

| | (Unaudited) June 30, 2010 | December 31, 2009 |
|---|---------------------------------|----------------------|
| Book value per ordinary share | \$ 27.79 | \$ 24.64 |
| Fully diluted book value per ordinary share (1) | \$ 27.74 | \$ 24.60 |

- (1) Fully diluted book value per ordinary share is a non-GAAP measure and represents book value per ordinary share combined with the impact from dilution of share based compensation including in-the-money stock options and certain conversion features at any period end. The Company believes that fully diluted book value per ordinary share is a financial measure important to investors and other interested parties who benefit from having a consistent basis for comparison with other companies within the industry. However, this measure may not be comparable to similarly titled measures used by companies either outside or inside of the insurance industry.

Key Financial Measures

Underwriting profit property and casualty (P&C) operations

One way that the Company evaluates the performance of its insurance and reinsurance operations is the underwriting profit or loss. The Company does not measure performance based on the amount of gross premiums written. Underwriting profit or loss is calculated from premiums earned less net losses incurred and expenses related to underwriting activities. The Company's underwriting profit for the three month period ended June 30, 2010 was primarily reflective of the combined ratio discussed below.

Combined ratio P&C operations

The combined ratio for P&C operations is used by the Company and many other insurance and reinsurance companies as another measure of underwriting profitability. The combined ratio is calculated from the net losses incurred and underwriting expenses as a ratio of the net premiums earned for the Company's insurance and reinsurance operations. A combined ratio of less than 100% indicates an underwriting profit and greater than 100% reflects an underwriting loss. The Company's combined ratio for the six months ended June 30, 2010, is higher than the same period in the previous year, primarily as a result of an increase in the loss and loss expense ratio, partially offset by a decrease in the underwriting expense ratio. The loss and loss expense ratio has increased as a result of higher levels of catastrophe losses in both the insurance and reinsurance segments. The decreased underwriting expense ratio is reflective of the additional costs incurred in 2009 associated with the Company's restructuring activities.

Net investment income P&C operations

Net investment income related to P&C operations is an important measure that affects the Company's overall profitability. The largest liability of the Company relates to its unpaid loss reserves, and the Company's investment portfolio provides liquidity for claims settlements of these reserves as they become due. Thus, a significant part of the investment portfolio is invested in fixed income securities. Net investment income is influenced by a number of factors, including the amounts and timing of inward and outward cash flows, the level of interest rates and credit spreads and changes in overall asset allocation. Net investment income related to P&C operations decreased by \$54.2 million during the first half of 2010 as compared to the same period in the prior year. Overall, portfolio yields have decreased as a result of the impact of declines in U.S. interest rates, and particularly the impact of decreased U.S. Dollar Libor on the Company's floating rate securities previously supporting

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the GIC and funding agreement business. In addition, the Company increased its holdings in lower-yielding cash, government and agency RMBS securities in connection with its investment portfolio de-risking efforts as the Company re-aligned its portfolio to one more typical of a P&C portfolio.

Book value per ordinary share

Management also views the change in the Company's book value per ordinary share as an additional measure of the Company's performance. Book value per ordinary share is calculated by dividing ordinary shareholders' equity by the number of outstanding ordinary shares at any period end. Book value per ordinary share is affected primarily by the Company's net income (loss), by any changes in the net unrealized gains and losses on its investment portfolio and currency translation adjustments and also the impact of any share repurchase or issuance activity.

Book value per ordinary share increased by \$3.15 in the six months ended June 30, 2010 as compared to an increase of \$3.45 during the first six months of 2009. During the first half of 2010, there was a decrease in net unrealized losses of \$1.0 billion, net of tax. The increasing investment fair values was due in large part to declining interest rates during the first half of 2010, which was partially offset by the impact of modest year-to-date widening of credit spreads in certain asset classes. In addition, book value per ordinary share increased as a result of net income attributable to ordinary shareholders increasing by \$61.5 million during the first half of 2010 compared to the first half of 2009. This increase was comprised of an increase in Net Income attributable to XL Capital Ltd of \$249.2 million offset by decrease of \$195.2 million in the gains associated with the two separate purchases of portions of the Company's Redeemable Series C Preference Ordinary Shares that were completed during the first half of each of 2010 and 2009.

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As noted above, fully diluted book value per ordinary share represents book value per ordinary share combined with the impact from dilution of share based compensation including in-the-money stock options and certain other share based compensation units and certain conversion features at any period end. Fully diluted book value per ordinary share increased by \$3.14 and increased by \$3.43 during the six months ended June 30, 2010 and 2009, respectively, as a result of the factors noted above.

Annualized return on average ordinary shareholders' equity

Return on average ordinary shareholder's equity (ROE) is another financial measure that management considers important in evaluating the Company's operating performance. ROE is calculated by dividing the net income for any period by the average of the opening and closing ordinary shareholders' equity. The Company establishes minimum target ROEs for its total operations, segments and lines of business. If the Company's minimum ROE targets over the longer term are not met with respect to any line of business, the Company seeks to modify and/or exit these lines. In the first half of 2010, ROE was 7.1%, 1.8 percentage points lower than the same period in the prior year when it was 8.9%, mainly as a result of significantly higher equity levels during 2010 following the increase in value of the Company's investment portfolio.

Significant Items Affecting the Results of Operations

The Company's net income and other financial measures as shown above for the three and six months ended June 30, 2010 have been affected by, among other things, the following significant items:

- 1) The impact of natural catastrophes and large loss events in 2010;
- 2) Market movement impacts on the Company's investment portfolio; and
- 3) Continuing competitive factors impacting the underwriting environment.

1) The impact of natural catastrophes and large loss events in 2010

Net losses incurred were higher during the first six months of 2010 as compared to the same period in 2009 as a result of higher levels of natural catastrophe losses in the first and second quarters of 2010, mainly as a result of the Chilean Earthquake, European Windstorm Xynthia and U.S. tornadoes and hailstorm activity. In addition, property losses relating to the Deepwater Horizon oil rig contributed to the higher loss than compared to 2009.

In the first quarter, the Company recorded preliminary loss estimates related to the Chilean Earthquake, pretax and net of reinsurance of approximately \$157.1 million, of which \$78.0 million is attributable to the Insurance segment and \$79.1 million to the Reinsurance segment. Management's preliminary loss estimates related to Windstorm Xynthia, pretax and net of reinsurance, were approximately \$23.5 million almost exclusively in the Reinsurance segment.

In the second quarter, the Company recorded losses related to U.S. tornado and hailstorm activity of \$13.2 million exclusively in the Insurance segment. In addition, there were revisions to the first quarter modeled estimates which increased the reported losses on the Chilean Earthquake by \$7.2 million and reduced the reported losses on the European Windstorm Xynthia by \$2.0 million. The majority of these loss revisions were attributable to the Reinsurance segment. The Company's June 30, 2010 estimates are based on its review of individual treaties and policies expected to be impacted along with the limited client data received to date and reflect current total insured market loss estimates, both from published sources and the Company's internal analysis. To date the Reinsurance segment has received very little reported loss information from its cedents and therefore has relied heavily on modeled loss estimates. These preliminary loss estimates correspond to expected insured market losses in the range of \$6 billion to \$8 billion for the earthquake in Chile and \$1.5 billion to \$3 billion for Windstorm Xynthia. Given there is currently a wide range of estimates for the extent of total economic and insured industry losses, the Company's loss estimates involve the exercise of considerable judgment and are, accordingly, subject to revision as additional information becomes available. Actual losses may differ materially from these preliminary estimates.

Management's preliminary loss estimates of the total property loss exposure to the Deepwater Horizon oil rig, net of reinsurance and reinstatement premium, were approximately \$25.1 million, of which \$12.5 million is attributable to the Insurance segment and \$12.6 million to the Reinsurance segment.

The Company is a major writer of large, complex energy-related (re)insurance coverages and manages its exposure through, among other items, the purchase of reinsurance. The Company is in the process of assessing its potential liability exposure arising out of the Deepwater Horizon oil rig explosion in the Gulf. However, given that the facts are still developing, as well as the complexities of the nature of the event including indemnities from BP, other defenses to liability based on contract and common law and coverage issues, it is too early to estimate losses at this time.

For further details see the segment results in the *Income Statement Analysis* below.

2) Market movement impacts on the Company's investment portfolio

During the three months ended June 30, 2010, there was a flight to quality due to the European sovereign crisis, and interest rates declined in the Company's major markets, offset by slight widening of corporate credit spreads, particularly European financials. The net impact of the market conditions on the Company's investment portfolio for the quarter resulted in a decrease in net unrealized losses on available for sale investments as compared to March 31, 2010 of \$0.4 billion. This represents approximately a 0.9% appreciation on average assets for the quarter ended June 30, 2010.

The following table provides further detail regarding the movements in the global credit markets, as well as in government interest rates using some selected market indices:

| | Interest Rate Movement for the quarter ended June 30, 2010 (1) (+ / - represents increases / decreases in interest rates) | Credit Spread Movement for the quarter ended June 30, 2010 (2) (+ / - represents widening / tightening of credit spreads) |
|----------------|---|--|
| United States | - 77 basis points (5 year Treasury) + 24 basis points (3 month LIBOR) | + 49 basis points (U.S. Corporate A rated) - 32 basis points (U.S. Agency RMBS, AAA rated) + 20 basis points (U.S. CMBS, AAA rated) |
| United Kingdom | - 58 basis points (10 year Gilt) | + 26 basis points (UK Corporate, AA rated) |
| Euro-zone | - 52 basis points (5 year Bund) | + 60 basis points (Europe Corporate, A rated) |

(1) Source: Bloomberg Finance L.P.

(2) Source: Merrill Lynch Global Indices.

Net realized losses on investments in the quarter ended June 30, 2010 totaled \$61.4 million, including net realized losses of approximately \$57.4 million related to the impairment of certain of the Company's fixed income, equity and other investments, where the Company determined that there was an other-than-temporary decline in the value of those investments which was related to credit.

Of the \$57.4 million, there were net realized losses of \$25.0 million related to credit impairments on structured credit securities. Primarily these represented below investment grade non-Agency RMBS, including those with sub-prime and Alt-A collateral. A further \$25.3 million in net realized losses related to intent to sell impairments of medium term notes backed primarily by investment grade European credit. The remaining impairment during the quarter was mainly related to currency loss impairments. Consistent with prior quarters, management continues to evaluate the impairment of the investment portfolio and satisfy itself that the remaining gross unrealized losses are temporary in nature.

3) Continuing competitive factors impacting the underwriting environment**Insurance**

The market conditions within the core lines of business of the Insurance segment during the second quarter 2010 saw renewals and new business reflect persistent competitive pressures. Premium rates reflected an aggregate price decrease of approximately 1.8% for the entire book, largely influenced by 3-5% rate declines in the Insurance segment's professional lines and property books offset by single digit increases in certain niche specialty and casualty lines. Retention ratios have shown significant improvement over the prior year quarter as concerns over the Company's financial condition have dissipated. The overall Insurance segment retention rate has improved from 78% in the prior year quarter to 85% in the current year quarter which is back to historical levels. Gross premiums written in the second quarter of 2010 decreased \$38.5 million or 3.4% versus the prior year quarter primarily driven by two programs that were exited last year. This reflects difficult trading environment in which the Company continues its disciplined underwriting approach to grow on a very selective basis and exit lines where margins are unacceptable.

The following table provides an analysis of gross premiums written, net premiums written and net premiums earned for the Insurance segment for the six month periods ended June 30, 2010 and 2009:

| | (Unaudited) Six Months Ended June 30, 2010 | | | (Unaudited) Six Months Ended June 30, 2009 | | |
|--|--|----------------------------|---------------------------|--|----------------------------|---------------------------|
| | Gross Premiums Written | Net Premiums Written | Net Premiums Earned | Gross Premiums Written | Net Premiums Written | Net Premiums Earned |
| <i>(U.S. dollars in thousands)</i> | | | | | | |
| Casualty professional lines | \$ 607,462 | \$ 547,506 | \$ 665,126 | \$ 581,973 | \$ 538,468 | \$ 626,601 |
| Casualty other lines | 530,573 | 344,042 | 309,549 | 563,034 | 352,661 | 315,158 |
| Property catastrophe | (7) | 115 | 115 | (25) | 1,762 | 1,762 |
| Other property | 423,418 | 214,510 | 205,555 | 407,761 | 186,398 | 214,072 |
| Marine, energy, aviation, and satellite | 357,533 | 302,873 | 274,490 | 344,182 | 266,055 | 287,483 |
| Other specialty lines (1) | 303,230 | 254,537 | 306,457 | 313,147 | 247,430 | 324,087 |
| Other (2) | (5,539) | (5,854) | (609) | 5,183 | 5,790 | 12,508 |
| Structured indemnity | 960 | 959 | 4,994 | 210 | 210 | 9,930 |
| Total | \$ 2,217,630 | \$ 1,658,688 | \$ 1,765,677 | \$ 2,215,465 | \$ 1,598,774 | \$ 1,791,601 |

(1) Other specialty lines within the Insurance segment includes: environmental, programs, equine, warranty, specie, middle markets and excess and surplus lines.

(2) Other includes credit and surety and other lines.

Reinsurance

Competitive market conditions persist for the Reinsurance segment. July 1 renewals saw U.S. catastrophe rates deteriorate on a risk adjusted basis by 10% and international rates decreasing by 5%. Gross premiums written increased by 11.8% during the three months ended June 30, 2010 compared with the three months ended June 30, 2009. The increase was primarily from new business, mainly in Bermuda, reinstatement premiums on non property business in Europe, and additional former clients who returned to the Company as concerns over the Company's financial condition dissipate. However, due to market conditions, the Reinsurance segment continues its philosophy of disciplined underwriting where it has, and will contract the portfolio if market conditions do not warrant deploying capital.

The following table provides an analysis of gross premiums written, net premiums written and net premiums earned for the Reinsurance segment for the six month periods ended June 30, 2010 and 2009:

| | (Unaudited) Six Months Ended June 30, 2010 | | | (Unaudited) Six Months Ended June 30, 2009 | | |
|--|--|----------------------------|---------------------------|--|----------------------------|---------------------------|
| | Gross Premiums Written | Net Premiums Written | Net Premiums Earned | Gross Premiums Written | Net Premiums Written | Net Premiums Earned |
| <i>(U.S. dollars in thousands)</i> | | | | | | |
| Casualty professional lines | \$ 147,285 | \$ 147,331 | \$ 107,385 | \$ 119,465 | \$ 119,466 | \$ 124,129 |
| Casualty other lines | 149,874 | 147,757 | 115,453 | 129,713 | 124,880 | 123,443 |
| Property catastrophe | 321,649 | 283,645 | 165,511 | 295,896 | 251,341 | 146,174 |
| Other property | 416,495 | 322,564 | 228,688 | 431,843 | 324,927 | 283,096 |
| Marine, energy, aviation, and satellite | 82,349 | 74,243 | 42,641 | 62,259 | 58,988 | 41,614 |
| Other (1) | 94,035 | 76,825 | 54,844 | 126,559 | 106,995 | 92,037 |

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| | | | | | | |
|----------------------|---------------------|---------------------|-------------------|---------------------|-------------------|-------------------|
| Structured indemnity | 76 | 76 | (285) | (1,782) | (1,782) | 1,342 |
| Total | <u>\$ 1,211,763</u> | <u>\$ 1,052,441</u> | <u>\$ 714,237</u> | <u>\$ 1,163,953</u> | <u>\$ 984,815</u> | <u>\$ 811,835</u> |

(1) Other includes employers liability, surety, political risk and other lines.

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Other Key Focuses of Management

Throughout the latter part of 2009 and into 2010, the Company remains focused on, among other things, simplifying the Company's business model to focus on core P&C business and enhancing its enterprise risk management capabilities. Details relating to these initiatives are discussed in Other Key Focuses of Management in Item 7 of the Company's Annual Report on Form 10-K for the year ended December 31, 2009. That discussion is updated with the disclosures set forth below.

Redomestication to Ireland from the Cayman Islands (the Redomestication)

On July 1, 2010, XL Capital Ltd changed its name to XL Group Ltd. In addition, on July 1, 2010, XL Group plc, an Irish public limited company (XL Ireland), and XL Group plc (formerly, XL Capital Ltd), a Cayman Islands exempted company (XL-Cayman), completed a redomestication transaction in which all of the ordinary shares of XL-Cayman were exchanged for all of the ordinary shares of XL-Ireland. As a result, XL-Cayman became a wholly owned subsidiary of XL-Ireland. On July 23, 2010, the Irish High Court approved XL Group plc's creation of distributable reserves, subject to the completion of certain formalities under Irish Company law. These formalities are expected to be completed in early August 2010.

Capital Management

Fundamental to supporting the Company's business model is its ability to underwrite business, which is largely dependent upon the quality of its claims paying and financial strength ratings as evaluated by independent rating agencies. As a result, in the event that the Company is downgraded, its ability to write business as well as its financial condition and/or results of operations, could be adversely affected. See Item 1, Business Ratings in the Company's Annual Report on Form 10-K for the year ended December 31, 2009 for further information regarding rating actions by the various rating agencies, as well as details regarding the Company's financial strength and debt ratings.

In relation to the Company's capital position, on February 12, 2010, the Company redeemed approximately 4.4 million Series C Preference Ordinary Shares with a liquidation value of \$110.8 million for approximately \$94.2 million. As a result, a book value gain of approximately \$16.6 million was recorded in the first quarter of 2010 to common shareholders.

Risk Management

XL Group's risk appetite framework guides its strategies relating to, among other things, capital preservation, earnings volatility, net worth at risk, operational loss, liquidity standards, capital rating and capital structure. This framework also addresses XL Group's tolerance to risks from material individual events (e.g., natural or man made catastrophes such as terrorism), XL Group's investment portfolio, realistic disaster scenarios that cross multiple lines of business and from risks related to some or all of the above that may actualize concurrently, with the objective of preserving XL Group's capital base.

In relation to event risk management, XL Group establishes net underwriting limits for individual large events as follows:

1. XL Group imposes limits for each peril region/event type at a 1% exceedance probability. If XL Group was to deploy the full limit, for any given peril region/event type, there would be a 1% probability that an event would occur during the next year which would result in a net underwriting loss in excess of the limit.
2. XL Group also imposes limits for each natural catastrophe peril region at a 1% tail value at risk (TVaR) probability. This statistic indicates the average amount of net loss expected to be incurred given that a loss above the 1% exceedance probability level has occurred.
3. XL Group also imposes limits for certain other event types at a 0.4% exceedance probability. If XL Group were to deploy the full limit, for any given event type, there would be a 0.4% probability that an event would occur during the next year which would result in a net underwriting loss in excess of the limit.

For planning purposes and to calibrate risk tolerances for business to be written during 2010, XL Group set its underwriting limits as a percent of September 30, 2009 Tangible Shareholders' Equity (hereafter, Tangible Shareholders' Equity). Tangible Shareholders' Equity is defined as Total Shareholders' Equity less Goodwill and Other Intangible Assets. These limits may be recalibrated, from time to time, to reflect material changes in Total Shareholders' Equity that have occurred since September 30, 2009, at the discretion of management and as overseen by the Board.

Per event 1% exceedance probability underwriting limits for Tier 1 event types, which include natural catastrophes, terrorism and other realistic disaster scenarios, are set at a level not to exceed approximately 15% of Tangible Shareholders' Equity.

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Per event 1% TVaR underwriting limits for certain peak natural catastrophe peril regions approximate 20% of Tangible Shareholders Equity. 1% TVaR underwriting limits for non-peak natural catastrophe peril regions are set below the per event 1% TVaR limits described above.

Per event 1% exceedance probability underwriting limits for Tier 2 event types, which include country risk, longevity risk and pandemic risk, are set at a level not to exceed 7.5% of Tangible Shareholders Equity.

Per event 0.4% exceedance probability underwriting limits for Tier 2 event types are set at a level not to exceed 15% of Tangible Shareholders Equity. The 0.4% exceedance probability limit is used for Tier 2 event types rather than a TVaR measure due to the difficulty in estimating the full distribution of outcomes in the extreme tail of the distribution for these risk types as required for the TVaR measure.

In all instances, the above referenced underwriting limits reflect pre tax losses net of reinsurance and net of inwards and outwards reinstatement premiums related to the specific events being measured. The limits are not net of underwriting profits expected to be generated in the absence of catastrophic loss activity.

In setting underwriting limits, XL Group also considers such factors as:

- § Correlation of underwriting risk with other risks (e.g. asset/investment risk, operational risk, etc.);
- § Model risk and robustness of data;
- § Geographical concentrations;
- § Exposures at lower return periods;
- § Expected payback period associated with losses;
- § Projected share of industry loss; and
- § Annual aggregate losses at a 1% exceedance probability and at a 1% TVaR level on both a peril region/risk type basis as well as at the portfolio level.

Loss exposure estimates for all event risks are derived from a combination of commercially available and internally developed models together with the judgment of management, as overseen by the Board. Actual incurred losses may vary materially from the XL Group's estimates. Factors that can cause a deviation between estimated and actualized loss potential include:

- § Inaccurate assumption of event frequency and severity;
- § Inaccurate or incomplete data;
- § Changing climate conditions may add to the unpredictability of frequency and severity of natural catastrophes in certain parts of the world and create additional uncertainty as to future trends and exposures;
- § Future possible increases in property values and the effects of inflation may increase the severity of catastrophic events to levels above the modeled levels;
- § Natural catastrophe models incorporate and are critically dependent on meteorological, seismological and other earth science assumptions and related statistical relationships that may not be representative of prevailing conditions and risks, and may therefore misstate how particular events actually materialize, causing a material deviation between forecasted and actual damages associated with such events; and
- § A change in the judicial climate.

The above forecasts assume that amounts due from reinsurance and retrocession purchases are 100% collectible. There may be credit and/or other disputes associated with these potential receivables.

For the above and other reasons, the incidence and severity of catastrophes and other event types are inherently unpredictable and it is difficult to predict the timing of such events with statistical certainty or estimate the amount of loss any given occurrence will generate. As a consequence, there is material uncertainty around the Company's ability to measure exposures associated with individual events and combinations of events. This uncertainty could cause actual exposures and losses to deviate from those amounts estimated below, which in turn can create a material adverse effect on the Company's financial condition and results of operations and may result in substantial liquidation of

investments, possibly at a loss, and outflows of cash as losses are paid.

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The table below shows the Company's estimated per event net 1% and 0.4% exceedance probability exposures for certain peak natural catastrophe perils regions.

| Geographical Zone <i>(U.S. dollars in millions)</i> | Peril | Measurement Date of In- Force Exposures | 1-in 100 Event | | 1-in 250 Event | |
|--|------------|---|---------------------------------|---|---------------------------------|---|
| | | | Probable Maximum Loss (1) | Percentage of Shareholders Equity as of June 30, 2010 | Probable Maximum Loss (1) | Percentage of Shareholders Equity as of June 30, 2010 |
| California | Earthquake | January 1, 2010 | \$ 553 | 5.3% | \$ 864 | 8.2% |
| U.S. | Windstorm | January 1, 2010 | 846 | 8.1% | 1,202 | 11.4% |
| Europe | Windstorm | January 1, 2010 | 397 | 3.8% | 588 | 5.6% |
| Japan | Earthquake | April 1, 2010 | 187 | 1.8% | 302 | 2.9% |
| Japan | Windstorm | April 1, 2010 | 138 | 1.3% | 211 | 2.0% |

- (1) Probable maximum losses include secondary uncertainty which incorporates variability around the expected probable maximum loss for each event, does not represent the Company's maximum potential exposures and are pre tax.
- (2) Detailed analyses of aggregated In-force exposures and maximum loss levels are done periodically. The measurement dates represent the date of the last completed detailed analysis by geographical zone.

Management of Legacy Financial Exposures

Over the past 18 months, the Company has focused on the management of certain legacy financial businesses, which were put into run-off in 2008. These businesses include certain outstanding written credit default swap and financial guarantee contracts. During the second quarter, management was successful in commuting the Company's exposure to the European Investment Bank, and continues to look for opportunities which make business sense to reduce and, where possible, terminate these types of exposures. These exposures and any related transactions are more fully described in Item 1, Note 6, Derivative Instruments (d)(ii) Financial Operations Derivatives Credit Exposure herein and Item 1, Note 12, Financial and Other Guarantee Exposures herein, respectively. The following is a summary of the outstanding exposures:

| Form of Transaction <i>(U.S. dollars in millions)</i> <i>(Unaudited)</i> | Principal and Interest Outstanding June 30, 2010 |
|--|--|
| Financial Guarantee (1) | \$ 619.1 |
| Credit Default Derivatives | 254.5 |
| Total Gross Exposure | \$ 873.6 |
| Reinsurance coverage - Syncora | (386.5) |
| Total Net Exposure (1) | \$ 487.1 |
| Current Reserves / Liabilities Reported | \$ 40.4 |

(1) Included in these exposures is \$386.5 million of notional exposure (including principal and interest) to a Chilean toll road structure as of June 30, 2010. The Issuer has decided to prepay the debt, and an Omnibus Agreement releasing the Company from its financial guarantees has been signed and will be held in escrow subject to the satisfaction of certain conditions precedent. Subject to the prepayment closing and the satisfaction of these conditions precedent, the Company expects to eliminate the \$386.5 million in exposure relating to this transaction, representing another important step in our steady efforts to reduce our book of non-core business.

Regulatory Change

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Management continues to actively monitor the various regulatory bodies and initiatives that impact XL Group globally, and assess the potential for significant impact on results or operations. The European Commission is in the process of implementing changes to the prudential regulation of European insurers, known as Solvency II, with a timeline to achieve full compliance by 2013. Solvency II is designed to impose economic risk-based solvency requirements across all EU Member States. Advice and implementation consists of three pillars: (1) Pillar I quantitative capital requirements, based on a valuation of the entire balance sheet; (2) Pillar II qualitative regulatory review, which includes governance, internal controls, enterprise risk management and supervisory review process, and (3) Pillar III market discipline, which is accomplished through reporting of the insurer's financial condition to regulators and the public. Other jurisdictions such as Bermuda are in the process of implementing consistent changes to strengthen their capital and risk management requirements in order to be considered equivalent for purposes of group regulatory considerations. The Company has significant resources supporting the regulatory process, such as the Solvency II Quantitative Impact Studies, and these resources are also actively engaged in the implementation across XL Group.

Critical Accounting Policies and Estimates

See the discussion of the Company's Critical Accounting Policies and Estimates in Item 7 of the Company's Annual Report on Form 10-K for the year ended December 31, 2009.

Variable Interest Entities and Other Off-Balance Sheet Arrangements

For further information, see the discussion of the Company's variable interest entities and other off-balance sheet arrangements in Item 7 of the Company's Annual Report on Form 10-K for the year ended December 31, 2009 and Item 1, Note 10, "Variable Interest Entities", to the Consolidated Financial Statements included herein.

Segment Results for the three months ended June 30, 2010 compared to the three months ended June 30, 2009

Following a streamlining of the Company's operating segments in the first quarter of 2009, the Company is organized into three operating segments: Insurance, Reinsurance and Life operations. The Company's general investment and financing operations are reflected in Corporate.

The Company evaluates the performance of both the Insurance and Reinsurance segments based on underwriting profit and the performance of its Life operations segment based on contribution. Other items of revenue and expenditure of the Company are not evaluated at the segment level for reporting purposes. In addition, the Company does not allocate investment assets by segment for its P&C operations. Investment assets related to the Company's Life operations and certain structured products included in the Insurance and Reinsurance segments are held in separately identified portfolios. As such, net investment income from these assets is included in the contribution from each of these segments.

Income Statement Analysis

Insurance

The Company's Insurance segment provides commercial property, casualty and specialty insurance products on a global basis. Products generally provide tailored coverages for complex corporate risks and include the following lines of business: property, casualty, professional liability, environmental liability, aviation and satellite, marine and offshore energy, equine, fine art and specie, excess and surplus lines and other insurance coverages including program business. These lines of business are divided across operating units: North America P&C, International P&C, Global Professional Lines and Global Specialty Lines.

The following table summarizes the underwriting results for this segment:

| | (Unaudited) Three Months Ended June 30, | | |
|------------------------------------|---|--------------|----------|
| | 2010 | 2009 | % Change |
| <i>(U.S. dollars in thousands)</i> | | | |
| Gross premiums written | \$ 1,085,740 | \$ 1,124,220 | (3.4)% |
| Net premiums written | 757,424 | 766,606 | (1.2)% |
| Net premiums earned | 868,666 | 881,490 | (1.5)% |
| Net losses and loss expenses | 592,184 | 598,784 | (1.1)% |
| Acquisition costs | 92,236 | 112,430 | (18.0)% |
| Operating expenses | 163,005 | 167,931 | (2.9)% |
| Underwriting profit (loss) | \$ 21,241 | \$ 2,345 | NM* |
| Net results - structured products | \$ 2,940 | \$ 4,093 | (28.2)% |
| Fee income and other | (4,337) | (3,220) | (34.7)% |

* NM - Not meaningful

Gross premiums written decreased by 3.4% during the three months ended June 30, 2010 compared with the three months ended June 30, 2009. Gross premiums written decreased by 0.5% in local currency. The decrease was mainly driven by the termination of a large aerospace program in 2009 and the run-off of a North American P&C automobile warranty program, fewer long term agreements, as well as unfavorable foreign exchange impacts. In addition, continued challenging market conditions and strong competition still negatively impact new business and pricing across many lines. These decreases have been partially offset by improved retention rates across most lines of business, prior year premium adjustments in London Markets relating to the 2008 and 2009 underwriting years, strong new business in aviation and continued premium growth in specie, equine and upper middle market businesses.

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Net premiums written decreased by 1.2% in the three month period ended June 30, 2010 compared with the three month period ended June 30, 2009. The modest decrease resulted from the gross written premium decreases outlined above partially offset by a reduction in ceded written premiums. Ceded written premiums decreased by 8.2% in the three month period ended June 30, 2010 compared with the three month period ended June 30, 2009 due largely to reinsurance savings relating to property and professional excess of loss treaties. In addition, certain premium adjustments and return premiums in aviation and property also gave rise to a positive variance on the second quarter of 2009.

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Net premiums earned decreased by 1.5% in the three month period ended June 30, 2010 compared with the three month period ended June 30, 2009. The decrease primarily resulted from challenging market conditions and strong competition as outlined above, the planned exit of certain lines of business and the overall earn-out of lower net premiums written in the past twelve months partially offset by the reinsurance cost savings on the 2010 treaties for property and professional as already noted above.

The following table presents the ratios for this segment:

| | (Unaudited) Three Months Ended June 30, | |
|-----------------------------|---|--------------|
| | 2010 | 2009 |
| Loss and loss expense ratio | 68.2% | 67.9% |
| Underwriting expense ratio | 29.4% | 31.8% |
| Combined ratio | 97.6% | 99.7% |

The loss and loss expense ratio includes net losses incurred for both the current quarter and any favorable or adverse prior year development of loss and loss expense reserves held at the beginning of the year. The following table summarizes the net (favorable) adverse prior year development relating to the Insurance segment for the three month periods ended June 30, 2010 and 2009:

| | (Unaudited) Three Months Ended June 30, | |
|--|---|------------------|
| | 2010 | 2009 |
| <i>(U.S. dollars in millions)</i> | | |
| Property | \$ (3.6) | \$ (5.7) |
| Casualty | 20.4 | 5.6 |
| Professional | (32.8) | (51.9) |
| Specialty and other | (17.5) | 17.7 |
| Total | \$ (33.5) | \$ (34.3) |
| Loss and loss expense ratio excluding prior year development | 72.0% | 71.8% |

Excluding prior year development, the loss ratio for the three months ended June 30, 2010 increased by 0.2 loss percentage points as compared to the same period in 2009 due primarily to natural catastrophe losses occurring in the second quarter of 2010. The Chilean Earthquake, European Windstorm Xynthia and U.S. tornado and hailstorm activity contributed \$2.2 million, \$0.7 million and \$13.2 million in losses respectively to the quarter. Excluding favorable prior year development, natural catastrophe losses and reinstatement premiums in both quarters, the loss ratio decreased by 1.7 points from 2009 to 2010 due largely to improved loss experience in property, environmental, European professional lines and aerospace.

Net favorable prior year reserve development of \$33.5 million for the three months ended June 30, 2010 was mainly attributable to the following:

For property lines, net prior year development during the quarter was \$3.6 million favorable due to lower actual losses than estimated in the second quarter. The favorable development was \$6.1 million from International P&C business offset by reserve strengthening of \$2.5 million on the North America P&C business.

For casualty lines, net prior year development during the quarter was \$20.4 million unfavorable due mainly to a \$15.7 million strengthening in the North American risk management lines where reserve assumptions have been revised to use actual development rather than industry benchmarks and in International P&C where there was an \$8.3 million strengthening relating primarily to a 2009 transportation loss. The remainder of the unfavorable development was due to marginally worse than expected attritional loss activity

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offset by a decrease in the uncollectible reinsurance reserve from reduced exposures and lower estimated risk levels from the Swiss operations.

For professional lines, net prior year development was \$32.8 million favorable. The U.K. and U.S. professional lines contributed the majority with \$55.1 million favorable development due to redundancies in most underwriting years 2006 and prior. Offsetting this was \$13.6 million of reserve strengthening in the small and midsize professional services book from recent unfavorable loss experience in the miscellaneous and real estate books and \$8.7 million from the architects programs in the U.S. and U.K. for underwriting years 2006 and 2007 due to higher than expected loss experience in recent quarters.

For specialty and other lines, net prior year development was \$17.5 million favorable mainly from the marine lines where there was better than expected experience on the cargo and hull books as well as a reduction in the provision for unrecoverable reinsurance due to favorable collection experience on 2001 and prior underwriting years.

The decrease in the underwriting expense ratio in the three months ended June 30, 2010, compared to the same period in 2009 was due to a decrease in the operating expense ratio of 0.2 points (18.8% as compared to 19.0%) and a decrease in the acquisition expense ratio of 2.2 points (10.6% as compared to 12.8%). The decrease in the operating expense ratio was as a result of cost savings associated with the Company's expense reduction initiatives announced in the third quarter of 2008 and first quarter of 2009, including changes to the Company's previously communicated operational transformation program. The decrease in the acquisition expense ratio is largely attributable to a favorable adjustment in guaranty fund assessments, partially offset by increased ceding commissions for U.S. aerospace.

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Fee income and other decreased in the second quarter of 2010 as compared to the second quarter of 2009 mainly as a result of lower engineering fee income associated with the Company's loss prevention consulting services business coupled with other expenses in professional lines related to the cost of an endorsement facility with National Indemnity Company, under which National Indemnity Company issued endorsements to Side A directors and officers liability insurance policies underwritten by XL Specialty Insurance Company. For further information, see Note 11, Other Investments to the Consolidated Financial Statements in the Company's Annual Report on Form 10-K for the year ended December 31, 2009. During the first quarter of 2010, Management concluded that it will not require the \$100 million extension to this endorsement facility and will not purchase the related payment obligation.

Net results from structured insurance products include certain structured indemnity contracts that are accounted for as deposit contracts. Net results from these contracts for the three months ended June 30, 2010 have decreased compared to the same period in 2009 mainly due to higher interest expense associated with an accretion adjustment recorded in the current quarter based on changes in expected cash flows on one of the larger deposit accounted transactions. Partially offset against this was structured products operating expense credit in the current quarter and continued favorable development in the liability interest rate hedges in place.

Reinsurance

The Company's Reinsurance segment provides casualty, property risk (including energy and engineering), property catastrophe, marine, aviation, and other specialty reinsurance on a global basis with business being written on both a proportional and non-proportional basis and in certain limited instances on a direct basis.

The following table summarizes the underwriting results for this segment:

| | (Unaudited) Three Months Ended June 30, | | |
|------------------------------------|--|-------------|-----------------|
| <i>(U.S. dollars in thousands)</i> | 2010 | 2009 | % Change |
| Gross premiums written | \$ 421,340 | \$ 376,970 | 11.8% |
| Net premiums written | 357,180 | 311,672 | 14.6% |
| Net premiums earned | 347,647 | 400,259 | (13.1)% |
| Net losses and loss expenses | 154,981 | 180,844 | (14.3)% |
| Acquisition costs | 75,572 | 85,302 | (11.4)% |
| Operating expenses | 43,662 | 47,019 | (7.1)% |
| Underwriting profit | \$ 73,432 | \$ 87,094 | (15.7)% |
| Net results - structured products | \$ 5,776 | \$ 6,172 | (6.4)% |
| Fee income and other | 575 | 545 | 5.5% |

Gross premiums written increased by 11.8% during the three months ended June 30, 2010 compared with the three months ended June 30, 2009. Gross premiums written increased by 0.9% in local currency. The increase was mainly due to new and recovered business and reinstatement premiums on non property business in Europe. Premiums relating to the Bermuda book increased by \$26.4 million from new property quota share business and from a renewal of multi year structured transactions where all the written premiums were recorded at inception. South America premium growth was \$16.1 million primarily in property other and marine lines while the North American and European markets experienced small decreases in premium (excluding reinstatement premiums) due to difficult market conditions with limited growth, unfavorable premium adjustments and cedants increasing their net retentions.

Net premiums written increased by 14.6% in the three month period ended June 30, 2010 compared with the three month period ended June 30, 2009. The increase resulted from the gross written premium increases outlined above coupled with a slight reduction in ceded written premiums. The decrease in ceded written premiums is due to decreases in Bermuda driven partially by a decrease in Common Account updates, and North America due to a reduction in volume associated with an agricultural program and partially offset by reinstatement premiums in Europe as a result of property losses relating to the Deepwater Horizon oil rig.

Net premiums earned decreased by 13.1% in the three month period ended June 30, 2010 compared with the three month period ended June 30, 2009. The decrease is a reflection of the overall reduction in net premiums written over the last 24 months and the resulting earn-out of these lower net premiums written.

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The following table presents the ratios for this segment:

| | (Unaudited) Three Months Ended June 30, | |
|-----------------------------|---|-------|
| | 2010 | 2009 |
| Loss and loss expense ratio | 44.6% | 45.2% |
| Underwriting expense ratio | 34.3% | 33.0% |
| Combined ratio | 78.9% | 78.2% |

The loss and loss expense ratio includes net losses incurred for both the current year and any favorable or adverse prior year development of loss and loss expense reserves held at the beginning of the year. The following table summarizes the net (favorable) adverse prior year development relating to the Reinsurance segment for the three month periods ended June 30, 2010 and 2009:

| | (Unaudited) Three Months Ended June 30, | |
|--|---|-----------|
| | 2010 | 2009 |
| <i>(U.S. dollars in millions)</i> | | |
| Property and other short-tail lines | \$ (27.9) | \$ (36.3) |
| Casualty and other | (21.0) | (19.0) |
| Total | \$ (48.9) | \$ (55.3) |
| Loss and loss expense ratio excluding prior year development | 58.6% | 59.0% |

Excluding prior year development, the loss ratio for the quarter ended June 30, 2010 decreased by 0.4 loss percentage points as compared to the quarter ended June 30, 2009. Excluding favorable prior year development, catastrophe losses and reinstatement premiums in both quarters, the loss ratio decreased by 0.8 percentage points from 2009 to 2010. These improvements relate primarily to changes in business mix.

Net favorable prior year reserve development for the Reinsurance segment of \$48.9 million for the quarter ended June 30, 2010 was mainly attributable to the following:

Net favorable prior year development of \$27.9 million for the short-tailed lines in the quarter and details of these by specific lines are as follows:

\$7.7 million in favorable property catastrophe development due mainly to one contract in Europe where higher recoveries reduced the overall exposure on the 2002 underwriting year and from a reserve re-class to property other.

\$12.1 million in favorable property other development due to reported losses coming in better than expected across most underwriting years, mainly in the U.S. book.

\$8.1 million in marine and aviation lines due to favorable development of \$4.5 million for aviation and \$3.6 million for marine coming from the European and Bermuda books where there has been better than expected activity in most underwriting years.

Net favorable prior year development of \$21.0 million for the long-tailed lines in the quarter is wholly attributable to favorable casualty development as outlined below:

\$13.5 million in favorable casualty development from better than expected activity in the European and U.S. books and favorable run-off of Australia exposures in the Asia Pacific book, partially offset by adverse development related to an account impacted by Italian hospital medical malpractice exposures for underwriting years 2001, 2004 and 2005.

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\$7.5 million in favorable other lines development relating primarily to favorable loss experience on bond exposures in the U.S.

The increase in the underwriting expense ratio in the three months ended June 30, 2010 compared to the same period in 2009 was due to a increase in the acquisition expense ratio of 0.4 points (21.7% as compared to 21.3% in 2009) and by an increase in the operating expense ratio of 0.9 points (12.6% as compared to 11.7% in 2009). The increase in the acquisition expense ratio was a result of reduced net earned premium compared to the reduction in acquisition costs. The increase in the operating expense ratio is attributable to the reduced net earned premium compared to the reduction in operating expenses.

Fee income and other was flat in the second quarter of 2010 as compared to the second quarter of 2009.

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Net results from structured reinsurance products include certain structured indemnity contracts that are accounted for as deposit contracts. Results from these products for the three months ended June 30, 2010 decreased compared to the same period in 2009 mainly due to lower net investment income as a result of lower yields combined with a smaller investment base offset by a commutation gain realized in the current quarter on one of the structured indemnity transactions.

Life Operations

During 2009, the Company completed a strategic review of its life reinsurance business. In relation to this initiative, the Company sold the renewal rights to its Continental European short-term life, accident and health business in December 2008. The Company also announced in March 2009 that it would run-off its existing book of U.K. and Irish traditional life and annuity business, and not accept new business. In addition, during July 2009, the Company entered into an agreement to sell its U.S. life reinsurance business. The transaction closed during the fourth quarter of 2009. In December 2009, the Company entered into an agreement to novate and recapture a number of U.K. and Irish term assurance and critical illness treaties. The transaction closed during the fourth quarter of 2009. During the first quarter of 2010, the Company entered into an agreement to recapture three U.K. and Irish term assurance treaties, and this transaction closed during March 2010.

Prior to the decision being made to run-off the business, products offered included a broad range of underlying lines of life reinsurance business, including term assurances, group life, critical illness cover, immediate annuities and disability income. In addition, prior to selling the renewal rights, the products offered included short-term life, accident and health business. The segment also covers a range of geographic markets, with an emphasis on the U.K., U.S., Ireland and Continental Europe.

The following summarizes the contribution from this segment:

| <i>(U.S. dollars in thousands)</i> | (Unaudited) Three Months Ended June 30, | | |
|---|--|--------------------|-----------------|
| | 2010 | 2009 | % Change |
| Gross premiums written | \$ 92,838 | \$ 150,711 | (38.4)% |
| Net premiums written | 86,094 | 140,674 | (38.8)% |
| Net premiums earned | 86,448 | 147,951 | (41.6)% |
| Claims and policy benefits | 123,375 | 174,588 | (29.3)% |
| Acquisition costs | 12,752 | 25,540 | (50.1)% |
| Operating expenses | 2,765 | 4,269 | (35.2)% |
| Net investment income | 75,389 | 82,855 | (9.0)% |
| Fee income and other | 114 | 123 | (7.3)% |
| Realized and unrealized gains (losses) on investments | (5,445) | (51,663) | NM* |
| Contribution from Life operations | \$ 17,614 | \$ (25,131) | NM* |

* NM Not meaningful

The following table is an analysis of the Life operations gross premiums written, net premiums written and net premiums earned for the three month periods ended June 30, 2010 and 2009:

| <i>(U.S. dollars in thousands)</i> | (Unaudited) Three Months Ended June 30, 2010 | | | (Unaudited) Three Months Ended June 30, 2009 | | |
|------------------------------------|---|-------------------------------------|------------------------------------|---|-------------------------------------|------------------------------------|
| | Gross Premiums Written | Net Premiums Written | Net Premiums Earned | Gross Premiums Written | Net Premiums Written | Net Premiums Earned |
| Other Life | \$ 55,474 | \$ 55,525 | \$ 55,879 | \$ 109,648 | \$ 107,283 | \$ 114,560 |
| Annuity | 37,364 | 30,569 | 30,569 | 41,063 | 33,391 | 33,391 |

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| | | | | | | |
|--------------|-----------|-----------|-----------|------------|------------|------------|
| Total | \$ 92,838 | \$ 86,094 | \$ 86,448 | \$ 150,711 | \$ 140,674 | \$ 147,951 |
|--------------|-----------|-----------|-----------|------------|------------|------------|

Gross premiums written relating to other life business decreased by \$54.2 million in the three months ended June 30, 2010 as compared to the same period in 2009 mainly due to a \$33.4 million decrease as a result of the novation of a long-term care treaty and the novation and the recapture by cedants of a number of term assurance treaties during the second half of 2009 and at the end of the first quarter, 2010, \$8.0 million from the sale of the U.S. business during the fourth quarter of 2009, a \$9.0 million decrease from the short-term life, accident and health business in line with run-off expectations, and unfavorable foreign exchange movement of \$8.7 million, offset by a \$5.0 million increase from a block of U.S. term life business due to higher premiums relating to policies passing out of their guaranteed premium period. Gross premiums written relating to annuity business decreased by \$3.7 million in the three months ended June 30, 2010 as compared to the three months ended June 30, 2009 mainly due to unfavorable foreign exchange rate movements. Ceded premiums written during the quarter ended June 30, 2010 decreased by \$3.3 million as compared to the quarter ended June 30, 2009 as a result of both the prior year higher cession ratio associated with short-term life, accident and health business underwritten in the 2009 underwriting year, which occurred as part of the sale of the renewal rights as mentioned above, and the sale of the U.S. business, as well as favorable foreign exchange movement.

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Net premiums earned in the second quarter of 2010 decreased 41.6% as compared to the second quarter of 2009. This decrease was consistent with the decrease in gross and net premiums written as described above.

Claims and policy benefit reserves decreased by \$51.2 million or 29.3% in the three months ended June 30, 2010 as compared to the three months ended June 30, 2009, a decrease consistent with the decrease in gross premiums written associated with term assurance business as noted above, as well as the sale of the U.S. business during the fourth quarter of 2009, including favorable foreign exchange movements. Changes in claims and policy benefits include the movement in policy benefit reserves related to other contracts (such as immediate annuities) where investment assets were acquired with the assumption of the policy benefit reserves at the inception of the contract.

For the three months ended June 30, 2010, acquisition costs decreased by 50.1% as compared to the same period in 2009, largely as a result of the decrease in net premium written associated with the term assurance business as noted above, as well as lower acquisition costs associated with the run-off of the short-term life, accident and health business. Operating expenses decreased by 35.2% in the second quarter of 2010 as compared to the same period in the prior year due mainly to lower compensation expenses as a result of overall lower staffing levels.

Net investment income is included in the calculation of contribution from Life operations, as it relates to income earned on portfolios of separately identified and managed life investment assets and other allocated assets. Net investment income decreased by \$7.5 million or 9.0% in the three months ended June 30, 2010, as compared to the same period in 2009, primarily as a result of foreign exchange impacts.

See below for an analysis of the Company's total realized losses on investments during the three months ended June 30, 2010.

Investment Activities

The following table illustrates the change in net investment income from P&C operations, net income from investment fund affiliates, net realized gains (losses) on investments and net realized and unrealized gains (losses) on investment derivative instruments for the three months ended June 30, 2010 and 2009:

| <i>(U.S. dollars in thousands)</i> | (Unaudited) Three Months Ended June 30, | | |
|---|--|-------------|-----------------|
| | 2010 | 2009 | % Change |
| Net investment income - P&C operations | \$ 222,544 | \$ 237,887 | (6.4)% |
| Net income (loss) from investment fund affiliates (1) | 19,084 | 37,086 | (48.5)% |
| Net realized gains (losses) on investments (2) | (61,386) | (80,430) | NM* |
| Net realized and unrealized gains (losses) on investment and other derivative instruments | (19,896) | 969 | NM* |

- (1) The Company records the income related to alternative fund affiliates on a one month lag and the private investment fund affiliates on a three month lag in order for the Company to meet the accelerated filing deadlines.
- (2) Results to June 30, 2009 include charges for OTTI related to the non-credit impairment of unrealized losses. From April 1, 2009, the non-credit impairment is excluded from realized losses.

* NM - Not meaningful

Net investment income related to P&C operations decreased in the second quarter of 2010 as compared to the second quarter of 2009 due primarily to declining portfolio yields. Overall, portfolio yields have decreased as a result of the impact of declines in U.S. interest rates, lower prevailing reinvestment yields and investment portfolio de-risking efforts.

Net income from investment fund affiliates decreased in the second quarter of 2010 compared to the second quarter of 2009. The results from the alternative funds in second quarter of 2010 were significantly lower than the exceptionally strong results in the Company's alternative funds in the second quarter of 2009, which reflected the challenging market conditions, principally in May. Improved results for the private investment portfolio due to a loss during the second quarter of 2009 helped offset the lower alternative portfolio returns.

The Company manages its investment grade fixed income securities in accordance with investment guidelines approved by the Finance Committee of the Board of Directors. Due to the unique nature of the underlying liabilities, customized benchmarks are used to measure investment performance and comparison to standard market indices is not meaningful. Investment performance is not monitored for certain assets primarily consisting of operating cash and special regulatory deposits. The following is a summary of the investment portfolio returns for the three months ended June 30, 2010 and 2009:

| | (Unaudited) Three Months Ended June 30, | |
|-----------------------------------|---|----------|
| | 2010(1) | 2009 (1) |
| Fixed income portfolios | | |
| USD fixed income portfolio | 2.1% | 4.4% |
| GBP fixed income portfolio | 2.2% | 7.5% |
| EUR fixed income portfolio | 2.0% | 3.8% |
| Other portfolios | | |
| Alternative portfolio (2) | 1.0% | 5.5% |
| Equity portfolio (3) | NM* | (2.0)% |
| High-Yield fixed income portfolio | 0.2% | 18.2% |

- (1) Portfolio returns are calculated by dividing the sum of net investment income or net income from investment affiliates, realized gains (losses) and unrealized gains (losses) by the average market value of each portfolio. Performance is measured in the underlying asset currency.
- (2) Performance on the alternative portfolio reflects the three months ended May 31, 2010 and May 31, 2009, respectively.
- (3) Equity portfolio is negligible in 2010 and accordingly, performance returns are not presented.
- * NM Not meaningful

Net Realized Gains and Losses and Other than Temporary Declines in the Value of Investments

Net realized losses on investments in the quarter ended June 30, 2010 included net realized losses of approximately \$57.4 million related to the write-down of certain of the Company's fixed income, equity and other investments. Impairment charges to March 31, 2009 include charges of OTTI related to the non-credit impairment of unrealized losses. From April 1, 2009, as a result of changes in GAAP, the non-credit impairment is excluded from net impairments. In addition, included in the net realized losses noted above are net realized losses of \$4.0 million from sales of investments.

The significant components of the net impairment charges of \$57.4 million consist of:

- § For structured credit securities, the Company recorded net impairments of \$25.0 million for the quarter ended June 30, 2010. The Company determined that the likely recovery on these securities was below the amortized cost, and accordingly impaired the securities to the discounted value of the cash flows of these securities.
- § For corporate securities, excluding medium term notes backed primarily by investment grade European credit, the Company recorded negligible net impairments for the quarter ended June 30, 2010. The impairment charges consisted of below investment grade securities, with respect to which the Company considered impairment factors consistent with an equity impairment model, along with a debt impairment model, and accordingly recorded impairment charges to fair value, or determined that the securities in an unrealized loss position would be sold.
- § For equities, the Company recorded impairments of \$0.4 million for the quarter ended June 30, 2010 because the security was impaired for more than 11 months.
- § The Company recorded impairments of \$6.7 million related to currency losses for the quarter ended June 30, 2010.
- § The Company recorded impairments totaling \$25.3 million in relation to medium term notes backed primarily by investment grade European credit as a result of its intent to sell these securities.

Net realized losses in the second quarter of 2009 included net realized losses of \$85.0 million related to the write-down of certain of the Company's fixed income, equity and other investments with respect to which the Company determined that there was an other-than-temporary decline in the value of those investments as well as net realized gains of \$4.5 million from sales of investments. Of the other-than-temporary impairments, \$30.2 million related to intent to sell securities, primarily representing exchanges of hybrid securities.

Net Realized and Unrealized Gains and Losses on Derivatives

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Net realized and unrealized gains on investment derivatives for the three months ended June 30, 2010 resulted from the Company's investment strategy to manage interest rate risk, foreign exchange risk and credit risk, and to replicate permitted investments. For further information, see Item 1, Note 6, Derivative Instruments herein as well Item 8, Note 2 of the Consolidated Financial Statements, Significant Accounting Policies, in the Company's Annual Report on Form 10-K for the year ended December 31, 2009.

Other Revenues and Expenses

The following table sets forth other revenues and expenses for the three months ended June 30, 2010 and 2009:

| | (Unaudited) Three Months Ended June 30, | | |
|---|--|-------------|-----------------|
| | 2010 | 2009 | % Change |
| <i>(U.S. dollars in thousands)</i> | | | |
| Net income (loss) from operating affiliates (1) | \$ 21,013 | \$ 17,667 | 18.9% |
| Exchange (gains) losses | (32,276) | 145,221 | NM* |
| Amortization of intangible assets | 464 | 464 | NM* |
| Corporate operating expenses | 22,793 | 32,219 | (29.3)% |
| Interest expense (2) | 38,551 | 42,912 | (10.2)% |
| Income tax expense | 42,976 | 16,045 | NM* |

(1) The Company generally records the income related to certain operating affiliates on a three month lag in order for the Company to meet accelerated filing deadlines.

(2) Interest expense does not include interest expense related to structured products as reported within the Insurance and Reinsurance segments and Corporate.

* NM Not meaningful

The following table sets forth the net income (loss) from operating affiliates for the three months ended June 30, 2010 and 2009:

| | (Unaudited) Three Months Ended June 30, | | |
|--|--|-------------|-----------------|
| | 2010 | 2009 | % Change |
| <i>(U.S. dollars in thousands)</i> | | | |
| Net (loss) from financial operating affiliates | \$ 543 | \$ 3,883 | (86.0)% |
| Net income (loss) from investment manager affiliates | 9,736 | 4,407 | NM* |
| Net income from other strategic operating affiliates | 10,734 | 9,377 | 14.5% |
| Total | \$ 21,013 | \$ 17,667 | 18.9% |

* NM Not meaningful

Investment manager affiliate income increased during the second quarter of 2010 as compared to the same period in the prior year primarily as a result of more benign capital market conditions in the first quarter of 2010 compared to the challenging conditions for alternative asset managers reported in the first quarter of 2009.

Income from other strategic operating affiliates increased in the second quarter of 2010 as compared to the same period in the prior year mainly due to higher earnings reported in the second quarter of 2010 relating to an insurance affiliate which writes largely direct U.S. homeowners insurance and from the sale during the quarter of the Company's Brazilian joint venture ITAÚ XL Seguros Corporativos S.A. (ITAU).

Foreign exchange gains in the quarter ended June 30, 2010 and losses in the quarter ended June 30, 2009 were due primarily to the change in the value of the U.S. dollar against certain European currencies, including the U.K. Sterling and the Euro, on certain inter-company balances and net underwriting liability balances.

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Corporate operating expenses in the three months ended June 30, 2010 decreased compared to the three months ended June 30, 2009 primarily as a result of the restructuring costs incurred in 2009 as well as the cost savings achieved from these restructuring activities during the three months ended June 30, 2010.

Interest expense for the three months ended June 30, 2010 as compared to the same period in 2009 was lower mainly as a result of the interest associated retirement of the 2011 Senior Notes in February 2009. For more information on the Company's financial structure, see Liquidity and Capital Resources.

The increase in the Company's income taxes in the quarter ended June 30, 2010, compared to the same period in 2009, arose principally from higher income generated in taxable jurisdictions in the quarter ended June 30, 2010.

Segment Results for the six months ended June 30, 2010 compared to the six months ended June 30, 2009**Insurance**

The following table summarizes the underwriting results for this segment:

| (U.S. dollars in thousands) | (Unaudited) Six months Ended June 30, | | % Change |
|---------------------------------|---|--------------|-------------|
| | 2010 | 2009 | |
| Gross premiums written | \$ 2,217,630 | \$ 2,215,465 | 0.1% |
| Net premiums written | 1,658,688 | 1,598,774 | 3.7% |
| Net premiums earned | 1,765,677 | 1,791,601 | (1.4)% |
| Net losses and loss expenses | 1,240,503 | 1,213,998 | 2.2% |
| Acquisition costs | 202,378 | 217,842 | (7.1)% |
| Operating expenses | 316,241 | 347,259 | (8.9)% |
| Underwriting profit (loss) | \$ 6,555 | \$ 12,502 | (47.6)% |
| Net results structured products | \$ 8,579 | \$ 7,214 | 18.9% |
| Fee income and other | (8,123) | (4,220) | (92.5)% |

Gross premiums written marginally increased by 0.1% during the six months ended June 30, 2010 compared with the six months ended June 30, 2009. Gross premiums written increased by 1.1% in local currency. The increase has been achieved despite continued challenging market conditions and strong competition which continues to negatively impact new business and pricing. This has been partially offset by improved retention rates across most lines of business as a result of the Company's stronger market position since the second quarter of 2009. More specifically, continued growth in U.S. general aviation, European professional, marine and upper middle market businesses has been offset by decreases in North America P&C lines mainly due to the run-off of a large U.S. automobile warranty program combined with lower new business volume and pricing and in specialty lines, due to the termination of an aviation program in 2009.

Net premiums written increased by 3.7% in the six month period ended June 30, 2010 compared with the six month period ended June 30, 2009. The increase resulted from the gross written premium increases outlined above coupled with the reduction in ceded written premiums. The decrease in ceded written premiums is largely related to specialty lines due to cost savings from a restructuring of the marine and specie global excess of loss reinsurance treaties as well as certain premium adjustments and return premiums in aviation and property also gave rise to a positive variance over 2009.

Net premiums earned decreased by 1.4% in the six month period ended June 30, 2010 compared with the six month period ended June 30, 2009. The decrease primarily resulted from planned exit of certain lines of business and the overall earn-out of lower net premiums written in the past twelve months.

The following table presents the ratios for this segment:

| | (Unaudited) Six months Ended June 30, | |
|-----------------------------|---|-------|
| | 2010 | 2009 |
| Loss and loss expense ratio | 70.3% | 67.8% |
| Underwriting expense ratio | 29.3% | 31.5% |
| Combined ratio | 99.6% | 99.3% |

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The loss and loss expense ratio includes net losses incurred for both the current year and any favorable or adverse prior year development of loss and loss expense reserves held at the beginning of the year. The following table summarizes the net (favorable) adverse prior year development relating to the Insurance segment for the six month periods ended June 30, 2010 and 2009:

| <i>(U.S. dollars in millions)</i> | (Unaudited) Six months Ended June 30, | |
|--|--|-------------|
| | 2010 | 2009 |
| Property | \$ (27.6) | \$ (14.7) |
| Casualty | 13.4 | 8.6 |
| Professional | (34.6) | (64.4) |
| Specialty and other | (17.6) | 29.5 |
| Total | \$ (66.4) | \$ (41.0) |
| Loss and loss expense ratio excluding prior year development | 74.0% | 70.1% |

Excluding prior year development, the loss ratio for the six months ended June 30, 2010 increased by 3.9 loss percentage points as compared to the same period in 2009 due primarily to higher levels of natural catastrophe losses occurring in the first six months of 2010. The Chilean Earthquake, European Windstorm Xynthia and U.S. tornado and hailstorm activity contributed \$80.2 million, \$2.2 million and \$13.2 million in losses respectively for the period. Excluding favorable prior year development, natural catastrophe losses and reinstatement premiums in both quarters, the loss ratio decreased by 1.2 points from 2009 to 2010 largely due to improved loss experience in property, environmental, European professional lines and aerospace as well as changes in business mix.

Net favorable prior year reserve development of \$66.4 million for the six months ended June 30, 2010 was mainly attributable to the following:

- § For property lines, net prior year development in the six months was \$27.6 million favorable due to lower actual losses than estimated in the first quarter for non-catastrophe exposures for North America P&C and International P&C business.
- § For casualty lines, net prior year development in the six months was \$13.4 million unfavorable due mainly to a \$15.7 million strengthening in the North American risk management lines where reserve assumptions have been revised to use actual development rather than industry benchmarks and in International P&C where there was an \$8.3 million strengthening relating primarily to a 2009 transportation loss. The remainder of the unfavorable development was due to marginally worse than expected attritional loss activity offset by a decrease in the uncollectible reinsurance reserve from reduced exposures and lower estimated risk levels from the Swiss operations.
- § For professional lines, net prior year development was \$34.6 million favorable with the majority of the development occurring in the second quarter as outlined above in the segment results for the three months ended June 30, 2010.
- § For specialty and other lines, net prior year development was \$17.6 million favorable with the majority of the development occurring in the second quarter as outlined in the segment results for the three months ended June 30, 2010.

The decrease in the underwriting expense ratio in the six months ended June 30, 2010, compared to the same period in 2009 was due to a decrease in the operating expense ratio of 1.5 points (17.8% as compared to 19.3%), and a decrease in the acquisition expense ratio of 0.7 points (11.5% as compared to 12.2%). The decrease in the operating expense ratio was as a result of costs savings associated with the Company's expense reduction initiatives announced in the third quarter of 2008 and first quarter of 2009, including changes to the Company's previously communicated operational transformation program. The decrease in the acquisition expense ratio is attributable to changes in business mix partially offset by the impact of higher commission rates in certain professional and North American P&C lines.

Fee income and other decreased in the six months ended June 30, 2010 as compared to the same period in 2009 mainly as a result of lower engineering fee income associated with the Company's loss prevention consulting services business coupled with other expenses in professional lines related to the cost of an endorsement facility with National Indemnity Company, under which National Indemnity Company issued endorsements to Side A directors and officers liability insurance policies underwritten by XL Specialty Insurance Company. For further information, see Note 11, Other Investments to the Consolidated Financial Statements in the Company's Annual Report on Form 10-K for the year ended December 31, 2009. During the first quarter of 2010 Management concluded that it will not require the \$100 million extension to this endorsement facility and will not purchase the related payment obligation.

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Net results from structured insurance products include certain structured indemnity contracts that are accounted for as deposit contracts. Net results from these contracts for the six months ended June 30, 2010 have increased compared to the same period in 2009 mainly due to a structured products operating expense credit in the current quarter and continued favorable development in the liability interest rate hedges in place.

Reinsurance

The following table summarizes the underwriting results for this segment:

| | (Unaudited) Six months Ended June 30, | | |
|------------------------------------|---|--------------|----------|
| | 2010 | 2009 | % Change |
| <i>(U.S. dollars in thousands)</i> | | | |
| Gross premiums written | \$ 1,211,763 | \$ 1,163,953 | 4.1% |
| Net premiums written | 1,052,441 | 984,815 | 6.9% |
| Net premiums earned | 714,237 | 811,835 | (12.0)% |
| Net losses and loss expenses | 398,862 | 355,913 | 12.1% |
| Acquisition costs | 148,177 | 181,026 | (18.1)% |
| Operating expenses | 85,690 | 94,107 | (8.9)% |
| Underwriting profit | \$ 81,508 | \$ 180,789 | (54.9)% |
| Net results structured products | \$ 8,252 | \$ 14,596 | (43.5)% |
| Fee income and other | 894 | 2,596 | (65.6)% |

Gross premiums written increased by 4.1% during the six months ended June 30, 2010 compared with the six months ended June 30, 2009. Gross premiums written increased by 2.1% in local currency. Premium growth was mainly due to the recapture of previously lost business as well as new business in Europe, Bermuda and Asia and loss related premium adjustments in Europe. Offsetting the growth was reduced premiums from a U.S. agricultural program due to a fall in winter wheat prices and reduced premiums from the exit of certain casualty facultative markets.

Net premiums written increased by 6.9% in the six months ended June 30, 2010 compared with the six months ended June 30, 2009. The increase resulted from the gross written premium increases outlined above coupled with the reduction in ceded written premiums. The decrease in ceded written premiums is due to the reduction in volume associated with the U.S. agricultural program already mentioned above, of which a significant portion has retroceded.

Net premiums earned decreased by 12.0% in the six months ended June 30, 2010 compared with the six months ended June 30, 2009. The decrease is a reflection of the overall reduction in net premiums written over the last 24 months and the resulting earn-out of these lower net premiums written.

The following table presents the ratios for this segment:

| | (Unaudited) Six months Ended June 30, | |
|-----------------------------|---|-------|
| | 2010 | 2009 |
| Loss and loss expense ratio | 55.8% | 43.8% |
| Underwriting expense ratio | 32.8% | 33.9% |
| Combined ratio | 88.6% | 77.7% |

The loss and loss expense ratio includes net losses incurred for both the current year and any favorable or adverse prior year development of loss and loss expense reserves held at the beginning of the year. The following table summarizes the net (favorable) adverse prior year development relating to the Reinsurance segment for the six months ended June 30, 2010 and 2009:

(Unaudited)
Six months Ended
June 30,

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(U.S. dollars in millions)

| | <u>2010</u> | <u>2009</u> |
|--|-------------------|-------------------|
| Property and other short-tail lines | \$ (77.9) | \$ (94.2) |
| Casualty and other | (24.8) | (44.5) |
| | <u> </u> | <u> </u> |
| Total | \$ (102.7) | \$ (138.7) |
| | <u> </u> | <u> </u> |
| Loss and loss expense ratio excluding prior year development | 70.2% | 60.9% |
| | <u> </u> | <u> </u> |

Excluding prior year development, the loss ratio for the six months ended June 30, 2010 increased by 9.3 loss percentage points as compared to the six months ended June 30, 2009 attributable primarily to the impact of catastrophe losses in the first six months of 2010 compared to the first six months of 2009. The Chilean Earthquake and European Windstorm Xynthia contributed \$84.1 million and \$19.3 million in losses respectively in the first quarter of 2010 with the property losses relating to the Deepwater Horizon oil rig contributing \$12.6 million losses in the second quarter of 2010. Excluding favorable prior year development, catastrophe losses and reinstatement premiums in both six month periods ending June 30, the loss ratio decreased by 2.1 percentage points from 2009 to 2010. This improvement relates to changes in business mix.

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Net favorable prior year reserve development for the Reinsurance segment of \$102.7 million for the six months ended June 30, 2010 was mainly attributable to the following:

- § Net favorable prior year development of \$77.9 million for the short-tailed lines in the six months ended June 30, 2010 and details of these by specific lines are as follows:
 - § \$21.2 million in favorable property catastrophe development due to reductions in expected loss ratios to attritional levels on the 2007, 2008 and 2009 underwriting years and also from one contract in Europe where higher recoveries reduced the overall exposure on the 2002 underwriting year.
 - § \$46.8 million in favorable property other development due to reported losses coming in better than expected across most underwriting years and geographies.
 - § \$9.9 million in marine and aviation lines due to favorable aviation development of \$10.6 million partially offset by adverse marine development of \$0.7 million related to adverse development on two claims occurring late in 2009.
- § Net favorable prior year development of \$24.8 million for the long-tailed lines for the six months ended June 30, 2010 and details of these by specific lines are as follows:
 - § \$1.2 million in favorable casualty development primarily driven by better than expected activity in casualty for most underwriting years in Europe, underwriting years 2002 and prior in North American and the Asia Pacific business for the Australia run-off book giving rise to favorable development of \$17.3 million, \$4.5 million and \$4.5 million favorable activity, respectively. In addition, there was \$6.9 million of favorable development primarily related to North American D&O exposures. Partially offsetting this is adverse development of \$14.0 million related to a Bermuda account impacted by Italian hospital medical malpractice exposures for the 2007 underwriting year and unfavorable development from the London book where the bulk of this, \$11.3 million, is from one cedant's Italian hospital medical malpractice exposures in underwriting years 2008 and prior.
 - § \$23.6 million in favorable other lines development primarily related to a reduction of \$7.5 million in a political risks loss, \$6.6 million releases related to non-proportional whole account contracts written in Lloyds syndicates and the reflection of the reinsurance-to-close (RITC) process for years of account 2003 to 2006, \$5.6 million in North American bond run-off exposures due to better than expected activity in underwriting years 2006 and prior and Latin America Surety releases related to better than expected loss experience across most underwriting years.

The decrease in the underwriting expense ratio for the six months ended June 30, 2010 compared to the same period in 2009 was due to a decrease in the acquisition expense ratio of 1.6 points (20.7% as compared to 22.3% in 2009) and partially offset by an increase in the operating expense ratio of 0.5 points (12.1% as compared to 11.6% in 2009). The decrease in the acquisition expense ratio was a result of reduced net earned premiums in relation to a large U.S. agricultural program which carries very low acquisition costs partially combined with the reinstatement premium adjustments. The marginal increase in the operating expense ratio is attributable to the reduced net earned premium compared to the reduction in operating expenses.

Fee income and other decreased in the first six months of 2010 as compared to the first six months of 2009, which included the sale of underwriting year 2009 renewal rights for the European life, accident and health business.

Net results from structured reinsurance products include certain structured indemnity contracts that are accounted for as deposit contracts. Results from these products for the six months ended June 30, 2010 decreased compared to the same period in 2009. This decrease was mainly due to higher interest expense associated with an accretion adjustment recorded in the first quarter of 2010 based on changes in expected cash flows on some structured indemnity contracts combined with lower net investment income as a result of lower yields and smaller investment base, partially offset by a commutation gain on one of the deposit accounted transactions which was realized in the second quarter.

Life Operations

The following summarizes the contribution from this segment:

| | (Unaudited) Six months Ended June 30, | | |
|---|---|-------------|----------|
| | 2010 | 2009 | % Change |
| <i>(U.S. dollars in thousands)</i> | | | |
| Gross premiums written | \$ 205,739 | \$ 285,823 | (28.0)% |
| Net premiums written | 190,760 | 262,259 | (27.3)% |
| Net premiums earned | 191,332 | 277,785 | (31.1)% |
| Claims and policy benefits | 247,118 | 332,547 | (25.7)% |
| Acquisition costs | 31,142 | 42,623 | (26.9)% |
| Operating expenses | 5,773 | 8,110 | (28.8)% |
| Net investment income | 155,733 | 160,377 | (2.9)% |
| Fee income and other | 154 | 174 | (11.5)% |
| Realized and unrealized gains (losses) on investments | (9,858) | (126,313) | 92.2% |
| Contribution from Life operations | \$ 53,328 | \$ (71,257) | NM* |

* NM Not meaningful

The following table is an analysis of the Life operations gross premiums written, net premiums written and net premiums earned for the six month periods ended June 30, 2010 and 2009:

| | (Unaudited) Six months Ended June 30, 2010 | | | (Unaudited) Six months Ended June 30, 2009 | | |
|------------------------------------|--|----------------------------|---------------------------|--|----------------------------|---------------------------|
| | Gross Premiums Written | Net Premiums Written | Net Premiums Earned | Gross Premiums Written | Net Premiums Written | Net Premiums Earned |
| <i>(U.S. dollars in thousands)</i> | | | | | | |
| Other Life | \$ 129,836 | \$ 128,760 | \$ 129,332 | \$ 208,571 | \$ 199,441 | \$ 214,967 |
| Annuity | 75,903 | 62,000 | 62,000 | 77,252 | 62,818 | 62,818 |
| Total | \$ 205,739 | \$ 190,760 | \$ 191,332 | \$ 285,823 | \$ 262,259 | \$ 277,785 |

Gross premiums written relating to other life business decreased by \$78.7 million in the six months ended June 30, 2010 as compared to the same period in 2009 mainly due to a \$59.0 million decrease as a result of the novation of a long-term care treaty and the novation and recapture of a number of term assurance treaties during the second half of 2009 and at the end of the first quarter, 2010 (offset by \$11.4 million higher premiums from increased business volumes on remaining term assurance treaties), \$17.5 million from the sale of the U.S. business during the fourth quarter of 2009, a \$14.8 million decrease from the short-term life, accident and health business in line with run-off expectations, and unfavorable foreign exchange movement of \$3.8 million. These are offset by a \$4.9 million increase from the block of U.S. term life business due to higher premiums relating to policies passing out of their guaranteed premium period. Gross premiums written relating to annuity business decreased by \$1.3 million in the six months ended June 30, 2010 as compared to the six months ended June 30, 2009 mainly due to unfavorable foreign exchange rate movements. Ceded premiums written during the six months ended June 30, 2010 decreased by \$8.6 million as compared to the six months ended June 30, 2009 as a result of both last year's higher cession ratio associated with short-term life, accident and health business underwritten in the 2009 underwriting year, which occurred as part of the sale of the renewal rights as mentioned above, and of the sale of the U.S. business, as well as favorable foreign exchange movements.

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Net premiums earned in the first six months of 2010 decreased 31.1% as compared to the first six months of 2009. This decrease was consistent with the decrease in gross and net premiums written as described above.

Claims and policy benefit reserves decreased by \$85.4 million or 25.7% in the six months ended June 30, 2010 as compared to the six months ended June 30, 2009, as a result of a \$13.6 million gain on recapture of three treaties during the first quarter, 2010, combined with a decrease in incurred losses consistent with the decrease in gross premiums written associated with term assurance business as noted above, as well as the sale of the U.S. business during the fourth quarter of 2009, and including favorable foreign exchange movements. Changes in claims and policy benefits include the movement in policy benefit reserves related to other contracts (such as immediate annuities) where investment assets were acquired with the assumption of the policy benefit reserves at the inception of the contract.

For the six months ended June 30, 2010, acquisition costs decreased by 26.9% as compared to the same period in 2009, largely as a result of the decrease in net premiums written associated with the term assurance business as noted above, as well as lower acquisition costs associated with the run-off of the short-term life, accident and health business. Operating expenses decreased by 28.8% in the first six months of 2010 as compared to the same period in the prior year due mainly to lower compensation expenses as a result of overall lower staffing levels and due to the same period last year containing higher severance costs.

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Net investment income is included in the calculation of contribution from Life operations, as it relates to income earned on portfolios of separately identified and managed life investment assets and other allocated assets. Net investment income decreased by \$4.6 million or 2.9% in the six months ended June 30, 2010, as compared to the same period in 2009, primarily as a result of foreign exchange impact.

See below for an analysis of the Company's total realized losses on investments during the six months ended June 30, 2010.

Investment Activities

The following table illustrates the change in net investment income from P&C operations, net income from investment fund affiliates, net realized gains (losses) on investments and net realized and unrealized gains (losses) on investment derivative instruments for the six months ended June 30, 2010 and 2009:

| <i>(U.S. dollars in thousands)</i> | (Unaudited) Six months Ended June 30, | | % Change |
|---|--|-------------|---------------------|
| | 2010 | 2009 | |
| Net investment income P&C operations | \$ 446,183 | \$ 500,347 | (10.8)% |
| Net income (loss) from investment fund affiliates (1) | 27,262 | 10,193 | NM* |
| Net realized gains (losses) on investments (2) | (97,562) | (332,367) | NM* |
| Net realized and unrealized gains (losses) on investment and other derivative instruments | (40,376) | (438) | NM* |

-
- (1) The Company records the income related to alternative fund affiliates on a one month lag and the private investment fund affiliates on a three month lag in order for the Company to meet the accelerated filing deadlines.
- (2) Results to June 30, 2009 include charges for OTTI related to the non-credit impairment of unrealized losses. From April 1, 2009, the non-credit impairment is excluded from realized losses.

* NM Not meaningful

Net investment income related to P&C operations decreased in the six months ended June 30, 2010 as compared to the same period in 2009 due primarily to declining portfolio yields. Overall, portfolio yields have decreased as a result of the impact of declines in U.S. interest rates, and particularly the impact of decreased U.S. Dollar Libor on the Company's floating rate securities previously supporting the GIC and funding agreement business. In addition, the Company increased its holdings in lower-yielding cash, government and agency RMBS securities in connection with its investment portfolio de-risking efforts as the Company re-aligned its portfolio to one more typical of a P&C portfolio.

Net income from investment fund affiliates increased in the first half of 2010 compared to the first half of 2009. These results reflect solid year to date results from the Company's private investment portfolio, as compared to a loss during the first half of 2009, offset by earnings from alternative funds, which were lower than the results during the first half of 2009.

The Company manages its investment grade fixed income securities in accordance with investment guidelines approved by the Finance Committee of the Board of Directors. Due to the unique nature of the underlying liabilities, customized benchmarks are used to measure investment performance and comparison to standard market indices is not meaningful. Investment performance is not monitored for certain assets primarily consisting of operating cash and special regulatory deposits. The following is a summary of the investment portfolio returns for the six months ended June 30, 2010 and 2009:

| | (Unaudited) Six months Ended June 30, | |
|-----------------------------------|---|----------|
| | 2010(1) | 2009 (1) |
| Fixed income portfolios | | |
| USD fixed income portfolio | 4.5% | 2.2% |
| GBP fixed income portfolio | 6.5% | 1.0% |
| EUR fixed income portfolio | 5.5% | 1.3% |
| Other portfolios | | |
| Alternative portfolio (2) | 2.1% | 7.4% |
| Equity portfolio (3) | NM* | (13.9)% |
| High-Yield fixed income portfolio | 2.6% | 26.3% |

- (1) Portfolio returns are calculated by dividing the sum of net investment income or net income from investment affiliates, realized gains (losses) and unrealized gains (losses) by the average market value of each portfolio. Performance is measured in the underlying asset currency.
- (2) Performance on the alternative portfolio reflects the three months ended May 31, 2010 and May 31, 2009, respectively.
- (3) Equity portfolio is negligible in 2010 and accordingly, performance returns are not presented.
- * NM Not meaningful

Net Realized Gains and Losses and Other than Temporary Declines in the Value of Investments

Net realized losses on investments in the six months ended June 30, 2010 included net realized losses of approximately \$97.6 million related to the write-down of certain of the Company's fixed income, equity and other investments. Impairment charges to March 31, 2009 include charges of OTTI related to the non-credit impairment of unrealized losses. From April 1, 2009, as a result of changes in GAAP, the non-credit impairment is excluded from net impairments. In addition, included in the net realized losses noted above are negligible net realized gains from sales of investments.

The significant components of the net impairment charges of \$97.6 million consist of:

§ For corporate securities, excluding medium term notes backed primarily by investment grade European credit, the Company recorded net impairments totaling \$0.2 million for the six months ended June 30, 2010. The impairment charges consisted of below-investment grade securities, with respect to which the Company considered impairment factors consistent with an equity impairment model, along with a debt impairment model, and accordingly recorded impairment charges to fair value, or determined that the securities in an unrealized loss position would be sold.

In addition the Company recorded impairments totaling \$5.3 million for the six months ended June 30, 2010 in relation to medium term notes backed primarily by investment grade European credit. Management has concluded that, following recent credit spread movements since 2009, future yields within the supporting collateral were not sufficient to support the previously reported amortized cost.

§ For structured credit securities, the Company recorded net impairments of \$53.9 million for the six months ended June 30, 2010. The Company determined that the likely recovery on these securities was below the carrying value, and accordingly impaired the securities to the discounted value of the cash flows of these securities.

§ For the non-equity accounted alternative fund, the Company recorded impairments of \$5.8 million for the six months ended June 30, 2010 because the fund that was impaired by more than 50% of amortized cost.

§ For equities, the Company recorded impairments of \$0.4 million for the six months ended June 30, 2010 because the security was impaired for more than 11 months.

§ The Company recorded impairments of \$6.7 million related to currency losses for the six months ended June 30, 2010.

§ The Company recorded impairments totaling \$25.3 million in relation to medium term notes backed primarily by investment grade European credit as a result of its intent to sell these securities.

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Net realized losses in the first six months of 2009 included net realized losses of \$370.0 million related to the write-down of certain of the Company's fixed income, equity and other investments with respect to which the Company determined that there was an other-than-temporary decline in the value of those investments as well as net realized gains of \$37.6 million from sales of investments. Of the other-than-temporary impairments, \$147.7 million related to intent to sell securities.

Net Realized and Unrealized Gains and Losses on Derivatives

Net realized and unrealized gains on investment derivatives for the six months ended June 30, 2010 resulted from the Company's investment strategy to manage interest rate risk, foreign exchange risk and credit risk, and to replicate permitted investments. For further information, see Item 1, Note 6, Derivative Instruments herein as well Item 8, Note 2 of the Consolidated Financial Statements, Significant Accounting Policies, in the Company's Annual Report on Form 10-K for the year ended December 31, 2009.

Other Revenues and Expenses

The following table sets forth other revenues and expenses for the six months ended June 30, 2010 and 2009:

| | (Unaudited) Six months Ended June 30, | | % Change |
|---|---|----------|-------------|
| | 2010 | 2009 | |
| <i>(U.S. dollars in thousands)</i> | | | |
| Net income (loss) from operating affiliates (1) | \$ 32,619 | \$ 7,339 | NM* |
| Exchange (gains) losses | (53,359) | 120,597 | NM* |
| Amortization of intangible assets | 929 | 929 | NM* |
| Corporate operating expenses | 41,656 | 58,931 | (29.3)% |
| Interest expense (2) | 75,451 | 92,527 | (18.5)% |
| Income tax expense | 72,812 | 61,998 | 17.4% |

(1) The Company generally records the income related to certain operating affiliates on a three month lag in order for the Company to meet accelerated filing deadlines.

(2) Interest expense does not include interest expense related structured products as reported within the Insurance and Reinsurance segments and Corporate.

* NM Not meaningful

The following table sets forth the net income (loss) from operating affiliates for the six months ended June 30, 2010 and 2009:

| | (Unaudited) Six months Ended June 30, | | % Change |
|--|---|----------|----------|
| | 2010 | 2009 | |
| <i>(U.S. dollars in thousands)</i> | | | |
| Net (loss) from financial operating affiliates | \$ (785) | \$ 3,883 | NM* |
| Net income (loss) from investment manager affiliates | 14,743 | (11,132) | NM* |
| Net income from other strategic operating affiliates | 18,661 | 14,588 | 27.9% |
| Total | \$ 32,619 | \$ 7,339 | NM* |

* NM Not meaningful

Investment manager affiliate income increased during the first six months of 2010 as compared to the same period in the prior year primarily as a result of more benign capital market conditions in the fourth quarter of 2009 and first quarter of 2010 compared to the challenging conditions for alternative asset managers reported in the fourth quarter of 2008 and first quarter of 2009. The Company also benefited from a modest gain associated with the sale of its stake in one of the investment manager affiliates in the first quarter of 2010.

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Income from other strategic operating affiliates increased in the first six months of 2010 as compared to the first six months of 2009 mainly due to higher earnings reported in the first quarter of 2010 relating to an insurance affiliate which writes largely direct U.S. homeowners insurance and a net loss from the Company's Brazilian joint venture ITAU in the first quarter of 2009. The Company's investment in ITAU was sold during the second quarter of 2010.

Foreign exchange gains in the six months ended June 30, 2010 and in the six months ended June 30, 2009 were due primarily to the change in the value of the U.S. dollar against certain European currencies, including the U.K. Sterling and the Euro, on certain inter-company balances and net underwriting liability balances.

Corporate operating expenses in the six months ended June 30, 2010 decreased compared to the six months ended June 30, 2009 primarily as a result of the restructuring costs incurred in 2009 as well as the cost savings achieved from these restructuring activities during the six months ended June 30, 2010.

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Interest expense for the six months ended June 30, 2010 as compared to the same period in 2009 was lower mainly as a result of the interest associated retirement of the 2011 Senior Notes in February 2009. For more information on the Company's financial structure, see Liquidity and Capital Resources.

The increase in the Company's income taxes in the six months ended June 30, 2010, compared to the same period in 2009 arose principally from higher income generated in taxable jurisdictions in the six months ended June 30, 2010.

Balance Sheet Analysis

Investments

The primary objectives of the investment strategy are to support the liabilities arising from the operations of the Company, generate stable investment income and build book value for the Company over the longer term. The strategy strives to balance investment returns against market and credit risk. The Company's overall investment portfolio is structured to take into account a number of variables including local regulatory requirements, business needs, collateral management and risk tolerance.

At June 30, 2010 and December 31, 2009, total investments, cash and cash equivalents, accrued investment income and net payable for investments purchased was \$35.8 billion and \$35.9 billion, respectively. The following table summarizes the composition of the Company's invested assets at June 30, 2010 and December 31, 2009:

| <i>(U.S. dollars in thousands)</i> | Carrying value June 30, 2010 (1) | Percent of Total | Carrying Value December 31, 2009 (1) | Percent of Total |
|---|--|---------------------|---|---------------------|
| Cash and cash equivalents | \$ 3,801,194 | 10.6% | \$ 3,643,697 | 10.2% |
| Net receivable/ (payable) for investments sold/ (purchased) | (2,522) | 0.0% | 47,638 | 0.1% |
| Accrued investment income | 326,297 | 0.9% | 350,055 | 1.0% |
| Short-term investments | 1,552,301 | 4.3% | 1,777,360 | 5.0% |
| Fixed maturities, available for sale: | | | | |
| U.S. Government and Government-Related/Supported Corporate | 2,491,906 | 7.0% | 2,664,625 | 7.4% |
| Residential mortgage-backed securities Agency | 10,703,216 | 29.9% | 9,799,000 | 27.3% |
| Residential mortgage-backed securities Non-Agency | 5,937,179 | 16.6% | 6,228,501 | 17.4% |
| Commercial mortgage-backed securities | 1,331,601 | 3.7% | 1,421,315 | 4.0% |
| Collateralized debt obligations | 1,259,834 | 3.5% | 1,216,799 | 3.4% |
| Other asset-backed securities | 699,445 | 2.0% | 698,561 | 1.9% |
| U.S. States and political subdivisions of the States | 1,187,782 | 3.3% | 1,167,985 | 3.3% |
| Non-U.S. Sovereign Government, Supranational and Government-Related | 1,140,876 | 3.2% | 913,473 | 2.5% |
| | 2,930,000 | 8.2% | 3,401,773 | 9.5% |
| Total fixed maturities | \$ 27,681,839 | 77.4% | \$ 27,512,032 | 76.7% |
| Fixed maturities, held to maturity | 468,738 | 1.3% | 546,067 | 1.5% |
| Equity securities | 19,975 | 0.1% | 17,779 | 0.0% |
| Investments in affiliates | 1,080,570 | 3.0% | 1,185,604 | 3.3% |
| Other investments | 858,636 | 2.4% | 783,189 | 2.2% |
| Total investments and cash and cash equivalents | \$ 35,787,028 | 100.0% | \$ 35,863,421 | 100.0% |

(1) Carrying value represents the fair value for available for sale fixed maturities and amortized cost for held to maturity securities.

The Company reviews on a regular basis its corporate debt concentration, credit quality and compliance with established guidelines. At both June 30, 2010 and December 31, 2009, the average credit quality of the Company's total fixed income portfolio (including fixed maturities, short-term investments, cash and cash equivalents and net payable for investment purchased) was AA. As at June 30, 2010, approximately 54.9% of the fixed income portfolio excluding operating cash was rated AAA by one or more of the principal ratings agencies. Approximately 3.7% was below investment grade or not rated.

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Refer to **Significant Items Affecting the Results of Operations** for further discussion surrounding the impact of credit market movements on the Company's investment portfolio and exposure to sub-prime related assets.

Gross and Net Unrealized Losses on Investments

At June 30, 2010, the Company had net unrealized losses on fixed maturities and short-term investments of \$305.9 million. Of these amounts, gross unrealized losses on fixed maturities and short-term investments were \$1.3 billion. The information presented below for the gross unrealized losses on the Company's investments at June 30, 2010 shows the potential effect upon future earnings and financial position should management later conclude that some of the current declines in the fair value of these investments are other-than-temporary. Realized losses or impairments, depending on their magnitude, may have a material adverse effect on the Company's operations. The decrease in net unrealized losses on investments during the three months ended June 30, 2010 was primarily due to tightening credit spreads. See Item 3 Quantitative and Qualitative Disclosures about Market Risk Credit Risk.

The following is an analysis of how long each of those securities with an unrealized loss at June 30, 2010 had been in a continual unrealized loss position:

| <i>(U.S. dollars in thousands)</i> Type of Securities | Length of time in a continual unrealized loss position | (Unaudited) Amount of unrealized loss at June 30, 2010 (1) | (Unaudited) Fair Value of Securities in an unrealized loss position at June 30, 2010 |
|--|---|---|---|
| Fixed Maturities and Short-Term Investments | Less than six months | \$ 43,301 | \$ 1,139,287 |
| | At least 6 months but less than 12 months | 72,339 | 665,440 |
| | At least 12 months but less than 2 years | 253,005 | 1,067,490 |
| | 2 years and over | 979,023 | 3,833,057 |
| | Total | \$ 1,347,668 | \$ 6,705,274 |
| Equities | Less than six months | \$ 507 | \$ 5,002 |
| | At least 6 months but less than 12 months | | |
| | Total | \$ 507 | \$ 5,002 |

- (1) Time of impairment on securities impacted by April 1, 2009 changes to OTTI values is measured from the point at which securities returned to a net unrealized loss position (i.e. from April 1, 2009).

The following is the maturity profile of the fixed income securities that were in a gross unrealized loss position at June 30, 2010:

| <i>(U.S. dollars in thousands)</i> Maturity profile in years of fixed maturities in a continual gross unrealized loss position | (Unaudited) Amount of unrealized loss at June 30, 2010 | (Unaudited) Fair value of securities in an unrealized loss position at June 30, 2010 |
|---|---|---|
| Less than 1 year remaining | \$ 7,380 | \$ 251,704 |
| At least 1 year but less than 5 years remaining | 136,528 | 1,326,925 |
| At least 5 years but less than 10 years remaining | 62,822 | 680,814 |
| At least 10 years but less than 20 years remaining | 51,437 | 577,501 |
| At least 20 years or more remaining | 236,282 | 1,408,963 |
| Residential mortgage-backed securities - Agency | 1,225 | 56,311 |
| Residential mortgage-backed securities - Non-Agency | 460,218 | 1,166,685 |
| Commercial mortgage-backed securities | 25,204 | 194,395 |
| Collateralized debt obligations | 323,414 | 682,851 |
| Other asset-backed securities | 43,158 | 359,125 |

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| | | | | |
|-------|----|-----------|----|-----------|
| Total | \$ | 1,347,668 | \$ | 6,705,274 |
|-------|----|-----------|----|-----------|

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Gross Unrealized Gains and Losses

The following tables summarizes the fair value, gross unrealized losses, credit rating and asset class of securities in a gross unrealized loss position within the Company's structured credit and corporate portfolios, which comprised 94.2% of the Company's total gross unrealized loss position of \$1.3 billion at June 30, 2010. The remaining gross unrealized loss is related to government and government-related/supported securities and is primarily driven by foreign exchange.

(U.S. dollars in millions)

| Corporates: | AAA | AA | A | BBB | BB & Below | Total |
|---|------------|-----------|------------|------------|-----------------------|--------------|
| Financials (1) | | | | | | |
| Fair value | \$ 66.8 | \$ 216.2 | \$ 967.3 | \$ 418.2 | \$ 41.9 | \$ 1,710.4 |
| Gross unrealized loss | \$ (2.5) | \$ (13.1) | \$ (158.5) | \$ (95.3) | \$ (10.4) | \$ (279.8) |
| Non-Financials (2) | | | | | | |
| Fair value | \$ 5.8 | \$ 195.2 | \$ 422.7 | \$ 418.7 | \$ 179.6 | \$ 1,222.0 |
| Gross unrealized loss | \$ (0.5) | \$ (16.8) | \$ (35.3) | \$ (64.9) | \$ (16.4) | \$ (133.9) |
| Total | | | | | | |
| Fair value | \$ 72.6 | \$ 411.4 | \$ 1,390.0 | \$ 836.9 | \$ 221.5 | \$ 2,932.4 |
| Gross unrealized loss | \$ (3.0) | \$ (29.9) | \$ (193.8) | \$ (160.2) | \$ (26.8) | \$ (413.7) |
| % Impaired (of amortized cost) (3) | 4.0% | 6.9% | 12.5% | 16.4% | 10.9% | 12.6% |
| Structured Credit: | | | | | | |
| CMBS | | | | | | |
| Fair value | \$ 114.8 | \$ 50.1 | \$ 13.9 | \$ 3.1 | \$ 13.2 | \$ 195.1 |
| Gross unrealized loss | \$ (3.3) | \$ (5.7) | \$ (6.7) | \$ (0.6) | \$ (8.8) | \$ (25.1) |
| Non Agency RMBS | | | | | | |
| Fair value | \$ 191.5 | \$ 121.7 | \$ 130.6 | \$ 79.5 | \$ 528.7 | \$ 1,052.0 |
| Gross unrealized loss | \$ (21.9) | \$ (35.8) | \$ (55.4) | \$ (50.2) | \$ (283.2) | \$ (446.5) |
| Core CDOs (4) | | | | | | |
| Fair value | \$ 52.6 | \$ 97.9 | \$ 264.5 | \$ 111.5 | \$ 160.7 | \$ 687.2 |
| Gross unrealized loss | \$ (6.3) | \$ (19.5) | \$ (94.0) | \$ (49.6) | \$ (152.1) | \$ (321.5) |
| Other Asset & Mortgage Backed Securities | | | | | | |
| Fair value | \$ 192.6 | \$ 96.6 | \$ 87.4 | \$ 90.5 | \$ 30.1 | \$ 497.2 |
| Gross unrealized loss | \$ (12.2) | \$ (5.6) | \$ (6.1) | \$ (9.9) | \$ (21.2) | \$ (55.0) |
| Agency RMBS | | | | | | |
| Fair value | \$ 57.1 | \$ | \$ | \$ | \$ | \$ 57.1 |
| Gross unrealized loss | \$ (1.2) | \$ | \$ | \$ | \$ | \$ (1.2) |
| Total | | | | | | |
| Fair Value | \$ 608.6 | \$ 366.3 | \$ 496.4 | \$ 284.6 | \$ 732.7 | \$ 2,488.6 |
| Gross unrealized loss | \$ (44.9) | \$ (66.6) | \$ (162.2) | \$ (110.3) | \$ (465.3) | \$ (849.3) |
| % Impaired (of amortized cost) (3) | 6.9% | 15.4% | 24.7% | 28.0% | 39.0% | 25.5% |

- (1) Included in the gross unrealized losses on corporate financials are gross unrealized losses of \$185.3 million on Tier One and upper Tier Two securities of financial institutions, as well as \$63.5 million in unrealized losses on subordinated debt with a fair value of \$1.0 billion.
- (2) Included within Corporate are certain floating rate medium term notes supported primarily by pools of European corporate bonds with varying degrees of leverage. The notes have a fair value of \$552.6 million and an amortized cost of \$620.2 million. These securities have been allocated ratings of the underlying pool of collateral. These notes allow the investor to participate in cash flows of the underlying bonds including certain residual values, which could serve to either decrease or increase the ultimate values of these notes.
- (3) Management considers these impairments to be temporary.
- (4) The Company defines Core CDOs as investments in non-subprime collateralized debt obligations, which primarily consisted of collateralized loan obligations.

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Management, in its assessment of whether securities in a gross unrealized loss position are temporarily impaired, considers the significance of the impairments. The Company had structured credit securities with gross unrealized losses of \$243.1 million, with a fair value of \$135.5 million, which as at June 30, 2010 were impaired by greater than 50% of amortized costs. All of these are asset-backed securities. Of these gross unrealized losses, \$52.2 million are rated investment grade. The Company has evaluated each of these securities in conjunction with its investment manager service providers and believes it is more likely than not that the issuer will be able to fund sufficient principal and interest payments to support the current amortized cost. These securities include gross unrealized losses of \$139.3 million on non-Agency RMBS, \$85.8 million on Core CDOs and \$7.7 million on CMBS holdings.

Included in the gross unrealized losses associated with the Company's corporate portfolio as of June 30, 2010 are gross unrealized losses of \$7.8 million related to Tier One and Upper Tier Two securities that have been rated below investment grade by at least one major rating agency. Of this total, none have gross unrealized losses representing greater than 50% of amortized cost. The Company has completed its review of this portfolio and believes, at this time, that these impairments remain temporary in nature. The primary basis for this conclusion was the analysis of the fundamentals of these securities using a debt-based impairment model, which indicated these securities continue to meet their obligations, and the issuer has the ability to call these obligations at their call date. In addition, as these securities are below investment grade, the Company considered these securities using an equity impairment model. Factors that were considered and supported the belief that these impairments were temporary included that the vast majority of these securities had only been rated below investment grade beginning in the first quarter of 2009, in certain cases alternative ratings were available that indicated these securities remained investment grade, or the securities were only slightly below investment grade and recent improvement in the prices of these securities. At June 30, 2010, the Company believes that it is likely that the fair values of these securities will ultimately increase to equal the cost basis over a reasonable period of time. However, there is a high degree of judgment in reaching this conclusion, including an assessment of how various governments will treat these securities in the event of governmental intervention in these institutions' operations or management's decision to defer calls or coupons. Management will closely monitor the developments related to these securities.

Net Unrealized Gains and Losses

The following table details the Company's corporate credit exposures by certain asset classes as well as ratings levels within the Company's fixed income investment portfolio and the current net unrealized (loss) position at June 30, 2010:

(U.S. dollars in millions)

| Corporates: | AAA | AA | A | BBB | BB & Below | Total |
|----------------------------|------------|------------|------------|------------|-----------------------|--------------|
| Financials | | | | | | |
| Fair value | \$ 460.6 | \$ 1,148.7 | \$ 1,848.6 | \$ 494.4 | \$ 46.6 | \$ 3,998.9 |
| Net unrealized gain (loss) | \$ 12.9 | \$ 20.9 | \$ (119.0) | \$ (91.8) | \$ (9.7) | \$ (186.7) |
| Non-Financials | | | | | | |
| Fair value | \$ 138.2 | \$ 1,695.2 | \$ 4,095.0 | \$ 1,204.9 | \$ 367.7 | \$ 7,501.0 |
| Net unrealized gain (loss) | \$ 7.0 | \$ 63.2 | \$ 176.1 | \$ (3.9) | \$ (1.8) | \$ 240.6 |
| Total | | | | | | |
| Fair value | \$ 598.8 | \$ 2,843.9 | \$ 5,943.6 | \$ 1,699.3 | \$ 414.3 | \$ 11,499.9 |
| Net unrealized gain (loss) | \$ 19.9 | \$ 84.1 | \$ 57.1 | \$ (95.7) | \$ (11.5) | \$ 53.9 |

At June 30, 2010, approximately \$1.6 billion of the Company's \$4.0 billion in corporate financial sector securities was held in the portfolios supporting the Company's Life operations portfolio. The assets associated with that business are more heavily weighted towards longer term securities from financial institutions, including a significant portion of the Company's Tier 1 and Upper Tier 2 securities, representing committed term debt and hybrid instruments senior to the common and preferred equity of the financial institutions. Financials held in Life portfolios accounted for \$182.6 million of the Company's net unrealized loss as at June 30, 2010. At June 30, 2010 approximately 43% of the overall sensitivity to interest rate risk and 33% to credit risk was related to the Life operations portfolio, despite these portfolios accounting for only 18.1% of the fixed income portfolio.

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The following table details the Company's structured credit exposures by certain asset classes as well as ratings levels within the Company's fixed income investment portfolio and the current net unrealized gain (loss) position at June 30, 2010:

(U.S. dollars in millions)

| Structured Credit: | AAA | AA | A | BBB | BB & Below | Total |
|---|------------|-----------|------------|------------|-----------------------|--------------|
| CMBS | | | | | | |
| Fair value | \$ 1,024.5 | \$ 183.5 | \$ 25.3 | \$ 7.9 | \$ 24.8 | \$ 1,266.0 |
| Net unrealized gain (loss) | \$ 34.2 | \$ (1.5) | \$ (6.1) | \$ (0.3) | \$ (4.0) | \$ 22.3 |
| Non-Agency RMBS | | | | | | |
| Fair value | \$ 210.2 | \$ 139.6 | \$ 138.0 | \$ 88.6 | \$ 572.1 | \$ 1,148.5 |
| Net unrealized gain (loss) | \$ (20.6) | \$ (35.1) | \$ (54.8) | \$ (48.8) | \$ (272.3) | \$ (431.6) |
| Core CDOs (1) | | | | | | |
| Fair value | \$ 52.8 | \$ 97.9 | \$ 265.6 | \$ 111.5 | \$ 174.1 | \$ 701.9 |
| Net unrealized gain (loss) | \$ (6.3) | \$ (19.5) | \$ (93.9) | \$ (49.6) | \$ (144.9) | \$ (314.2) |
| Other Asset & Mortgage Backed Securities | | | | | | |
| Fair value | \$ 850.2 | \$ 190.2 | \$ 221.3 | \$ 115.7 | \$ 30.7 | \$ 1,408.1 |
| Net unrealized gain (loss) | \$ 6.9 | \$ (2.8) | \$ (0.7) | \$ (8.4) | \$ (20.9) | \$ (25.9) |
| Agency RMBS | | | | | | |
| Fair value | \$ 5,986.1 | \$ | \$ | \$ | \$ | \$ 5,986.1 |
| Net unrealized gain (loss) | \$ 206.0 | \$ | \$ | \$ | \$ | \$ 206.0 |
| Total | | | | | | |
| Fair value | \$ 8,123.8 | \$ 611.2 | \$ 650.2 | \$ 323.7 | \$ 801.7 | \$ 10,510.6 |
| Net unrealized gain (loss) | \$ 220.2 | \$ (58.9) | \$ (155.5) | \$ (107.1) | \$ (442.1) | \$ (543.4) |

(1) The Company defines Core CDOs as investments in non-mortgage collateralized debt obligations, primarily consisting of collateralized loan obligations.

The following table details the current exposures to Non-Agency RMBS and Core CDOs within the Company's fixed income portfolio as well as the current net unrealized (loss) gain position at June 30, 2010 and December 31, 2009:

| | June 30, 2010 | | | December 31, 2009 | | |
|---|------------------------------|--|-----------------------------------|------------------------------|--|-----------------------------------|
| | Holding at Fair Value | Percent of Fixed Income Portfolio | Net Unrealized (Loss) Gain | Holding at Fair Value | Percent of Fixed Income Portfolio | Net Unrealized (Loss) Gain |
| Non-Agency RMBS: | | | | | | |
| Sub-prime first lien mortgages | \$ 383,739 | 1.1% | \$ (201,751) | \$ 377,609 | 1.1% | \$ (252,745) |
| Alt-A mortgages | 307,889 | 0.9% | (169,133) | 316,795 | 0.9% | (209,731) |
| Second lien mortgages (including sub-prime second lien mortgages) | 38,208 | 0.1% | (12,522) | 37,776 | 0.1% | (19,920) |
| ABS CDOs with sub-prime collateral | 5,573 | % | 802 | 5,429 | % | 32 |
| Prime RMBS | 413,021 | 1.2% | (49,047) | 484,004 | 1.4% | (88,153) |
| Total exposure to Non-Agency RMBS | \$ 1,148,430 | 3.3% | \$ (431,651) | \$ 1,221,613 | 3.5% | \$ (570,517) |
| Core CDOs | \$ 701,889 | 2.1% | (314,168) | \$ 700,884 | 2.1% | (333,257) |

Of the total Non-Agency RMBS with fair value exposure at June 30, 2010 and December 31, 2009 of \$1,148.4 million and \$1,221.6 million, respectively, approximately \$35.6 million and \$32.8 million, respectively, of the related securities had ratings dependent on guarantees issued by third party guarantors (i.e., monoline insurers). Decreases in the ratings of such third party guarantors would typically decrease the fair

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value of guaranteed securities; however, at June 30, 2010, in the event of non-performance at such date on the part of these third party guarantors, the Company estimated that the average credit quality of this portfolio would be A and that approximately 91.6% would have remained investment grade at such date. In addition, of the total fixed income portfolio of \$33.8 billion at June 30, 2010 and \$33.9 billion at December 31, 2009, less than 2% were guaranteed by such third parties with no individual third party representing more than 1%.

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At June 30, 2010, the Company's Non-Agency RMBS exposures had adequate underlying loan characteristics and the Company believed at such date that the current amortized cost levels were at or below the discounted cash flow value of the holdings, based on an analysis of subordination levels relative to current expectations of house price declines, loss severities and default levels. The Company had approximately \$265.6 million of Non-Agency RMBS downgraded during the quarter ended June 30, 2010. However, 50.2% of the Company's holdings excluding operating cash remain rated investment grade at June 30, 2010.

Refer to *Significant Items Affecting the Results of Operations* for further discussion surrounding the impact of credit market movements on the Company's investment portfolio and exposure to sub-prime related assets.

As noted in Item 8, Note 2 to the Consolidated Financial Statements, *Significant Accounting Policies*, in the Company's Annual Report on Form 10-K for the year ended December 31, 2009, the determination of the amount of OTTI varies by investment type and is based upon management's periodic evaluation and assessment of known and inherent risks associated with the respective asset class. Such evaluations and assessments are revised as conditions change and new information becomes available. Management considers a wide range of factors about the securities and uses their best judgment in evaluating the cause of the decline in the estimated fair value of the security and in assessing the prospects for near-term recovery. Inherent in management's evaluation of the security are assumptions and estimates about the operations of the issuer and its future earnings potential. Management updates its evaluations regularly and reflects additional impairments in net income as determinations are made. Management's determination of the amount of the impairment taken on investments is highly subjective and could adversely impact the Company's results of operations. There can be no assurance that management has accurately assessed the level of OTTI taken and reflected in the Company's financial statements. Furthermore, additional impairments may need to be taken in the future. Historical trends may not be indicative of future impairments.

Levels of write-down or OTTI are also impacted by the Company's assessment of the intent to sell securities that have declined in value until recovery. If, due to changes in circumstances, the Company determines to reposition or realign portions of the portfolio and the Company determines not to hold certain securities in an unrealized loss position to recovery, then the Company will incur OTTI charges, which charges could be significant.

Fair Value Measurements of Assets and Liabilities

The Company provides disclosures by level within the fair value hierarchy of the Company's assets and liabilities that are carried at fair value in Item 1, Note 3 to the Consolidated Financial Statements, *Fair Value Measurements*. For a full description of the valuation methodologies utilized by the Company for all asset and liabilities carried at fair value, see Item 8, Notes 2 and 3 of the Consolidated Financial Statements, *Significant Accounting Policies* and *Fair Value Measurements*, in the Company's Annual Report on Form 10-K for the year ended December 31, 2009.

At June 30, 2010, Level 3 assets represented approximately 3.4% of the Company's assets that are measured at fair value and less than 3% of total assets. Level 3 liabilities represented approximately 112.5% of the Company's liabilities that are measured at fair value and less than 1% of total liabilities at June 30, 2010. As defined in the hierarchy, those assets and liabilities categorized as Level 3 have valuations determined using unobservable inputs. Unobservable inputs may include the entity's own assumptions about market participant assumptions, applied to a modeled valuation; however, this is not the case with respect to the Company's Level 3 assets and liabilities. The vast majority of the assets and liabilities classified as Level 3 are made up of those securities for which the values were obtained from brokers where either significant inputs were utilized in determining the value that were difficult to corroborate with observable market data, or sufficient information regarding the specific inputs utilized by the broker were not obtained to support a Level 2 classification. In limited instances, the Company utilized internal valuation models.

At June 30, 2010, the Company did not have any liabilities that were carried at fair value based on Level 3 inputs other than derivative instruments in a liability position.

During the six months ended June 30, 2010, certain CDOs that were previously classified as Level 2 due to sufficient market data being available to allow a price to be determined and provided by third party pricing vendors, were transferred to Level 3 because third party vendor prices were no longer believed to be the most appropriate pricing source, therefore, broker quotes are the primary source of the valuations for these CDOs.

Controls over Valuation of Financial Instruments

The Company performs quarterly reviews of the prices received from its third party valuation sources to assess if the prices represent a reasonable estimate of fair value. This process is completed by investment and accounting personnel who are independent of those responsible for providing the valuations. These reviews include, but are not limited to, valuation comparisons between external sources and the completion of recurring reviews of third party pricing services methodologies. As a result of this analysis, if the Company determines there is a more appropriate fair value based upon available market data, the price received from one third party may be substituted for another or, in limited circumstances, management may determine that an adjustment is required to a third party value. In addition, similar valuation controls are followed by external parties responsible for sourcing appropriate valuations from third parties on the Company's behalf, which provides additional support regarding the reasonableness of the fair values recorded in the Company's financial statements.

Unpaid Losses and Loss Expenses

The Company establishes reserves to provide for estimated claims, the general expenses of administering the claims adjustment process and losses incurred but not reported. These reserves are calculated using actuarial and other reserving techniques to project the estimated ultimate net liability for losses and loss expenses. The Company's reserving practices and the establishment of any particular reserve reflects management's judgment concerning sound financial practice and do not represent any admission of liability with respect to any claims made against the Company.

Unpaid losses and loss expenses totaled \$20.2 billion at June 30, 2010, and \$20.8 billion at December 31, 2009. The table below represents a reconciliation of the Company's P&C unpaid losses and loss expenses for the six months ended June 30, 2010:

| <i>(U.S. dollars in thousands)</i> | (Unaudited) Gross unpaid losses and loss expenses | (Unaudited) Unpaid losses and loss expenses recoverable | (Unaudited) Net unpaid losses and loss expenses |
|---|--|--|--|
| Balance as at December 31, 2009 | \$ 20,823,524 | \$ (3,557,391) | \$ 17,266,133 |
| Losses and loss expenses incurred | 2,053,820 | (414,455) | 1,639,365 |
| Losses and loss expenses paid/recovered | (2,147,663) | 462,878 | (1,684,785) |
| Foreign exchange and other | (575,789) | 79,453 | (496,336) |
| Balance as at June 30, 2010 | <u>\$ 20,153,892</u> | <u>\$ (3,429,515)</u> | <u>\$ 16,724,377</u> |

While the Company reviews the adequacy of established reserves for unpaid losses and loss expenses regularly, no assurance can be given that actual claims made and payments related thereto will not be in excess of the amounts reserved. In the future, if such reserves develop adversely, such deficiency would have a negative impact on future results of operations. See Unpaid Losses and Loss Expenses in Item 1, Critical Accounting Policies and Estimates in Item 7 and Item 8, Note 12 to the Consolidated Financial Statements, each in the Company's Annual Report on Form 10-K for the year ended December 31, 2009 for further discussion.

Unpaid Losses and Loss Expenses Recoverable and Reinsurance Balances Receivable

As a significant portion of the Company's net premiums written incept in the first six months of the year, certain assets and liabilities have increased at June 30, 2010 compared to December 31, 2009. This includes deferred acquisition costs, unearned premiums, premiums receivable and prepaid reinsurance premiums.

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. While reinsurance agreements are designed to limit the Company's losses from large exposures and permit recovery of a portion of direct unpaid losses, reinsurance does not relieve the Company of its ultimate liability to its insureds. Accordingly, the loss and loss expense reserves on the balance sheet represent the Company's total unpaid gross losses. Unpaid losses and loss expenses recoverable relate to estimated reinsurance recoveries on the unpaid loss and loss expense reserves.

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Unpaid losses and loss expense recoverables were \$3.5 billion and \$3.7 billion at June 30, 2010, and December 31, 2009, respectively. At June 30, 2010 and December 31, 2009, reinsurance balances receivable were \$0.3 billion and \$0.5 billion, respectively. The table below presents the Company's net paid and unpaid losses and loss expenses recoverable and reinsurance balances receivable at June 30, 2010 and December 31, 2009.

| <i>(U.S. dollars in thousands)</i> | (Unaudited) June 30, 2010 | December 31, 2009 |
|---|--|----------------------------------|
| | | |
| Reinsurance balances receivable | \$ 305,884 | \$ 454,660 |
| Reinsurance recoverable on future policy benefits | 24,489 | 26,637 |
| Reinsurance recoverable on unpaid losses and loss expenses | 3,518,667 | 3,667,344 |
| Bad debt reserve on unpaid losses and loss expenses recoverable and reinsurance balances receivable | (158,982) | (189,769) |
| | | |
| Net paid and unpaid losses and loss expenses recoverable and reinsurance balances receivable | \$ 3,690,058 | \$ 3,958,872 |

Liquidity and Capital Resources

Liquidity is a measure of the Company's ability to generate sufficient cash flows to meet the short- and long-term cash requirements of the Company's business operations.

As a global insurance and reinsurance company, one of XL Group's principal responsibilities to its clients is to ensure that it has ready access to funds with which to settle large unforeseen claims. XL Group would generally expect that positive cash flow from operations (underwriting activities and investment income) will be sufficient to cover cash outflows under most future loss scenarios. However, there is a possibility that unforeseen demands could be placed on XL Group due to extraordinary events and as such the Company's liquidity needs may change. Such events include, among other things, several significant catastrophes occurring in a relatively short period of time resulting in material incurred losses; rating agency downgrades of XL Group's core insurance and reinsurance subsidiaries that would require posting of collateral, return of unearned premium and/or the settlement of derivative transactions; and large scale uncollectible reinsurance recoverables on paid losses (as a result of coverage disputes, reinsurers' credit problems or decreases in the value of collateral supporting reinsurance recoverables). Any one or a combination of such events may cause a liquidity strain. In addition, a liquidity strain could also occur in an illiquid market, such as that which was experienced in 2008. Investments that may be used to meet liquidity needs in the event of a liquidity strain may not be liquid, given inactive markets, or may have to be sold at a significant loss as a result of depressed prices. Because each subsidiary focuses on a more limited number of specific product lines than is collectively available from the consolidated group of companies, the mix of business tends to be less diverse at the subsidiary level. As a result, the probability of a liquidity strain, as described above, may be greater for individual subsidiaries than when liquidity is assessed on a consolidated basis. If such a liquidity strain were to occur in a subsidiary, XL Group plc may be required to contribute capital to the particular subsidiary and/or curtail dividends from the subsidiary to support holding company operations.

A downgrade below A- of XL Group's principal insurance and reinsurance subsidiaries by either S&P or A.M. Best, which is two notches below the current S&P financial strength rating of A (Negative) and the A.M. Best financial strength rating of A (Stable) of these subsidiaries, may trigger cancellation provisions in a significant amount of XL Group's assumed reinsurance agreements and may potentially require XL Group to return unearned premiums to cedants. In addition, due to collateral posting requirements under letter of credit and revolving credit facilities, such a downgrade may require the posting of cash collateral in support of certain in use portions of these facilities. Specifically, a downgrade below A- by A.M. Best would trigger such collateral requirements for XL Group's largest credit facility. In certain limited instances, such downgrades may require XL Group to return cash or assets to counterparties or to settle derivative and/or other transactions with the respective counterparties. See Item 1, Business Ratings, in the Company's Annual Report on Form 10-K for the year ended December 31, 2009 for further information. See Item 1A, Risk Factors, A downgrade or potential downgrade in the Company's financial strength and credit ratings by one or more rating agencies could materially and negatively impact our business, financial condition, results of operations and/or cash flows in the Company's Annual Report on Form 10-K for the year ended December 31, 2009.

Holding Company Liquidity

As a holding company, XL Group plc has no operations of its own and its assets consist primarily of its investments in its subsidiaries. Accordingly, XL Group plc's future cash flows largely depend on the availability of dividends or other statutorily permissible payments from its subsidiaries. The ability to pay such dividends is limited by the applicable laws and regulations of the various countries and states in which XL Group plc's subsidiaries operate, including, among others, Bermuda, New York, Ireland, Switzerland and the United Kingdom. See the Company's Annual Report on Form 10-K for the year ended December 31, 2009 Item 8, Note 26 to the Consolidated Financial Statements,

Statutory Financial Data, for further discussion and details regarding the dividend capacity of XL Group's major operating subsidiaries. See also Item 1A to XL Group's Annual Report on Form 10-K for the year ended December 31, 2009 Risk Factors - Risks Related to the Company - Our holding company structure and certain regulatory and other constraints affect our ability to pay dividends, make payments on our debt securities and make other payments. The ability to pay such dividends is also limited by the regulations of the Society of Lloyd's and certain contractual provisions. No assurance can be given that XL Group's subsidiaries will pay dividends in the future to XL Group plc.

As part of the Redomestication, under Irish law, dividends must be paid and share redemptions and buy backs generally must be funded out of distributable reserves, which XL-Ireland did not have immediately following the Redomestication. On July 23, 2010, the Irish High Court approved XL-Ireland's creation of \$5.0 billion of distributable reserves, subject to the completion of certain formalities under Irish Company law to enable XL Group to pay dividends and redeem and buy back shares prior to generating sufficient post-Redomestication earnings.

At June 30, 2010, the Company had cash and investments of \$1.8 billion compared to \$1.5 billion at December 31, 2009 (net of liabilities associated with cash sweeping arrangements).

XL Group plc's principal uses of liquidity are for dividend payments to holders of its ordinary shares and preferred shares, interest and principal payments on debt, capital investments in its subsidiaries and corporate operating expenses.

XL Capital Finance (Europe) plc (XLCFE) is a wholly owned finance subsidiary of XL Group plc. In January 2002, XLCFE issued \$600 million par value 6.5% Guaranteed Senior Notes due January 2012. These notes are fully and unconditionally guaranteed by XL Company Switzerland GmbH.

See also the Consolidated Statements of Cash Flows included in Item 1, Financial Statements, above.

Sources of Liquidity for the Company

At June 30, 2010, the consolidated Company had cash and cash equivalents of approximately \$3.8 billion as compared to approximately \$3.6 billion at December 31, 2009. There are three main sources of cash flows for the Company - those provided by operations, investing activities and financing activities.

Operating Cash Flows

Historically, cash receipts from operations, consisting of premiums and investment income, generally have provided sufficient funds to pay losses as well as operating expenses of the Company's subsidiaries and to fund dividends to the holding company. However, as a result of the combination of current soft market conditions, the decision to put the Life segment and certain P&C lines into run-off and lower investment yields, operating cash flows excluding extraordinary events are expected to be lower than prior years. Cash receipts from operations is generally derived from the receipt of investment income on XL Group's investment portfolio as well as the net receipt of premiums less claims and expenses related to XL Group's underwriting activities in its P&C operations as well as its Life operations segment. XL Group's operating subsidiaries provide liquidity in that premiums are generally received months or even years before losses are paid under the policies related to such premiums. Premiums and acquisition expenses are settled based on terms of trade as stipulated by an underwriting contract, and generally are received within the first year of inception of a policy when the premium is written, but can be up to three years on certain reinsurance business assumed. Operating expenses are generally paid within a year of being incurred. Claims especially for casualty business, may take a much longer time before they are reported and ultimately settled, requiring the establishment of reserves for unpaid losses and loss expenses. Therefore, the amount of claims paid in any one year is not necessarily related to the amount of net losses incurred, as reported in the consolidated statement of income.

During the six months ended June 30, 2010, net cash flows provided by operating activities were \$371.0 million compared to net cash flows used of \$521.0 million for the same period in 2009. The cash flows provided in the six months ended June 30, 2010 resulted primarily from lower levels of claim payments from previous underwriting years being offset by premium income. During the first six months of 2009 the cash flows used in operating activities were primarily as a result of claims payments associated with Hurricane Ike and Gustav losses.

Investing Cash Flows

Generally, positive cash flow from operations and financing activities is invested in XL Group's investment portfolio, including affiliates or acquisition of subsidiaries.

Net cash provided by investing activities was \$136.5 million in the six months ended June 30, 2010 compared to net cash provided of \$700.9 million for the same period in 2009. The 2010 cash inflow was mainly associated with normal purchase and sale of portfolio investments.

Financing Cash Flows

Cash flows related to financing activities include ordinary and preferred share related transactions, the payment of dividends, the issue or repayment of preferred ordinary shares and deposit liability transactions.

Net cash used in financing activities was \$266.6 million in the six months ended June 30, 2010 compared to net cash used of \$605.4 million for the same period in 2009. The 2010 net cash outflows related primarily to the redemption of Series C Preference Ordinary Shares, repayment of deposit liabilities and the payment of common and preferred dividends. For more information on the repurchase of debt please see Item 1, Note 7 to the Consolidated Financial Statements, Share Capital.

In addition XL Group maintains letter of credit facilities which provide liquidity. Details of these facilities are described below in Capital Resources.

Capital Resources

At June 30, 2010 and December 31, 2009, XL Group had total shareholders' equity of \$10.5 billion and \$9.4 billion, respectively. In addition to ordinary share capital, XL Group depends on external sources of financing, including debt, preference shares, contingent capital, letter of credit and other collateral facilities, to support its underwriting activities.

In particular, XL Group requires, among other things:

- § sufficient capital to maintain its financial strength and credit ratings, as issued by several ratings agencies, at levels considered necessary by management to enable XL Group's key operating subsidiaries to compete;
- § sufficient capital to enable its regulated subsidiaries to meet the regulatory capital levels required in the U.S., the U.K., Bermuda, Ireland, Switzerland and other key markets;
- § letters of credit and other forms of collateral that are required to be posted or deposited, as the case may be, by XL Group's operating subsidiaries that are non-admitted under U.S. state insurance regulations in order for the U.S. cedant to receive statutory credit for reinsurance. XL Group also uses letters of credit to support its operations at Lloyd's; and
- § revolving credit to meet short-term liquidity needs.

The following risks are associated with XL Group's requirement to renew its credit facilities:

- § the credit available from banks may be reduced resulting in XL Group's need to pledge its investment portfolio to customers. This could result in a lower investment yield;
- § XL Group may be downgraded by one or more rating agencies which could materially and negatively impact its business, financial condition, results of operations and/or liquidity; and
- § the volume of business that XL Group's subsidiaries that are not admitted in the U.S. are able to transact could be reduced if XL Group is unable to renew its letter of credit facilities at an appropriate amount.

Continued consolidation within the banking industry may result in the aggregate amount of credit provided to XL Group being reduced. XL Group attempts to mitigate this risk by identifying and/or selecting additional banks that can participate in the credit facilities upon renewal.

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The following table summarizes the components of the Company's current capital resources at June 30, 2010 and December 31, 2009:

| <i>(U.S. dollars in thousands)</i> | June 30, 2010 | December 31, 2009 |
|---|--------------------------|------------------------------|
| Preferred share capital | \$ 1,071,900 | \$ 1,182,673 |
| Ordinary share capital | 9,507,232 | 8,432,417 |
| Total Ordinary and Preferred capital | \$ 10,579,132 | \$ 9,615,090 |
| Notes payable and debt | 2,446,233 | 2,445,733 |
| Total capital | \$ 13,025,365 | \$ 12,060,823 |

a) Ordinary Share Capital

The following table reconciles the opening and closing common equity positions at June 30, 2010 and December 31, 2009:

| <i>(U.S. dollars in thousands)</i> | June 30, 2010 | December 31, 2009 |
|---|--------------------------|------------------------------|
| Ordinary share equity – beginning of period | \$ 8,432,417 | \$ 5,116,831 |
| Net income (loss) attributable to XL Capital Ltd. | 337,885 | 74,991 |
| Share repurchases | (1,840) | (626) |
| Share issues | 1,095 | 741,291 |
| Common share dividends | (68,636) | (136,804) |
| Preferred share dividends | (34,694) | (80,200) |
| Gain on redemption of Series C preference ordinary shares | 16,616 | 211,816 |
| Change in accumulated other comprehensive income | 803,734 | 2,222,460 |
| Impact of adoption of new authoritative OTTI guidance, net of tax | | 229,670 |
| Share based compensation and other | 20,655 | 52,988 |
| Ordinary equity – end of period | \$ 9,507,232 | \$ 8,432,417 |

b) Debt

The following table presents the Company's debt under outstanding securities and lenders' commitments as at June 30, 2010:

| Notes Payable and Debt (U.S. dollars in thousands) | Commitment/ Debt | In Use/ Outstanding | Year of Expiry | Payments Due by Period | | | |
|---|-----------------------------|--------------------------------|---------------------------|-------------------------------|-------------------------|-------------------------|--------------------------|
| | | | | Less than 1 Year | 1 to 3 Years | 3 to 5 Years | After 5 Years |
| 5-year revolvers | \$ 1,000,000 | \$ | 2012 | \$ | \$ | \$ | \$ |
| 5-year revolver | 100,000 | | 2010 | | | | |
| 6.50% Guaranteed Senior Notes | 600,000 | 599,508 | 2012 | | 600,000 | | |
| 5.25% Senior Notes | 600,000 | 597,259 | 2014 | | | 600,000 | |
| 8.25% Senior Notes | 575,000 | 575,000 | 2021 | | | | 575,000 |
| 6.375% Senior Notes | 350,000 | 350,000 | 2024 | | | | 350,000 |
| 6.25% Senior Notes | 325,000 | 324,466 | 2027 | | | | 325,000 |
| Total | \$ 3,550,000 | \$ 2,446,233 | | \$ | \$ 600,000 | \$ 600,000 | \$ 1,250,000 |
| Adjustment to carrying value – impact of fair value hedges | | 21,159 | | | | | |

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Carrying value

\$ 2,467,392

In Use and Outstanding data represents June 30, 2010 accreted values. Payments Due by Period data represents ultimate redemption values.

In addition, see Item 1, Note 16 to the Consolidated Financial Statements, Notes Payable and Debt and Financing Arrangements, in the Company's Annual Report on Form 10-K for the year ended December 31, 2009 for further information.

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At June 30, 2010, banks and investors provided the Company and its subsidiaries with \$3.6 billion of debt capacity, of which \$2.5 billion was utilized by the Company. This debt capacity consists of:

- § revolving credit facilities of \$1.1 billion in aggregate; and
- § senior unsecured notes of approximately \$2.4 billion. These notes require the Company to pay a fixed rate of interest during their terms. At June 30, 2010, there were five outstanding issues of senior unsecured notes:
 - § \$600 million senior notes due January 2012, with a fixed coupon of 6.5%. The security is publicly traded. The notes were issued at \$99.469 and gross proceeds were \$596.8 million. Related expenses of the offering amounted to \$7.9 million.
 - § \$600 million senior notes due September 2014, with a fixed coupon of 5.25%. The security is publicly traded. The notes were issued in two tranches of \$300 million aggregate principal amount each one tranche at 99.432% and the other at 98.419%. Aggregate gross proceeds were \$593.6 million. Related expenses of the offering amounted to \$4 million.
 - § \$575 million of senior notes due August 2021, with a fixed coupon of 8.25%. These securities are a component of the 10.75% equity security units that are publicly traded. In addition to the coupon paid on the senior notes, quarterly contract adjustment payments at an annual rate of 2.50% per annum are paid on forward purchase contracts for the Company's common shares for a total distribution of 10.75% per annum. The purchase contracts mature in 2011, and the senior notes mature in 2021. In August 2011, the senior notes will be remarketed to generate sufficient remarketing proceeds to satisfy the 10.75% equity security unit holders' obligations under the purchase contracts.
 - § \$350 million senior notes due November 2024, with a fixed coupon of 6.375%. The security is publicly traded. The notes were issued at 100.0% and gross proceeds were \$350 million. Related expenses of the offering amounted to \$2 million.
 - § \$325 million of senior notes due 2027, with a fixed coupon of 6.25%. The security is publicly traded. The notes were issued at 99.805% and gross proceeds were \$324.4 million. Related expenses of the offering amounted to \$2.5 million.

c) Preferred shares

At June 30, 2010 the Company's preferred share capital was made up of \$1.0 billion Series E Preference ordinary shares and \$71.9 million Series C Preference ordinary shares. At December 31, 2009 the Company's preferred share capital was made up of \$1.0 billion Series E Preference ordinary shares and \$182.7 million Series C Preference ordinary shares.

On February 12, 2010, the Company repurchased approximately 4.4 million Series C Preference Ordinary Shares with a liquidation value of \$110.8 million for approximately \$94.2 million, which was a portion of its outstanding Series C Preference Ordinary Shares. As a result, a book value gain of approximately \$16.6 million was recorded in the first quarter of 2010 to ordinary shareholders. In addition, see Note 7 to the Consolidated Financial Statements, *Share Capital*, for further information.

On March 26, 2009, the Company completed a cash tender offer for its outstanding Series C Preference Ordinary Shares that resulted in approximately 12.7 million Series C Preference Ordinary Shares with a liquidation value of \$317.3 million being purchased by the Company for approximately \$104.7 million plus accrued and unpaid dividends, combined with professional fees totaling \$0.8 million. As a result, a book value gain of approximately \$211.8 million was recorded in the first quarter of 2009 to ordinary shareholders. In addition, see Item 1, Note 7 to the Consolidated Financial Statements, *Share Capital*, above for further information.

d) Contingent Capital

At June 30, 2010, the Company has one contingent capital transaction where the outstanding put option has not been exercised. No up-front proceeds were received by the Company under this transaction. In the event that the associated irrevocable put option agreement is exercised, proceeds previously raised from investors from the issuance of pass-through trust securities would be received in return for the issuance of preferred shares. See below for further details on this transaction.

On December 5, 2006, the Company and certain operating subsidiaries (*Ceding Insurers*) entered into a securities issuance agreement (the *Securities Issuance Agreement*), and certain of the Company's foreign insurance and reinsurance subsidiaries (*Ceding Insurers*) entered into an excess of loss reinsurance agreement (the *Reinsurance Agreement*), with Stoneheath Re (*Stoneheath*). The net effect of these agreements to the Company is the creation of a contingent put option to issue \$350.0 million of preference ordinary shares in the aggregate. The agreements provide the Company with a Reinsurance Collateral Account in support of certain covered perils named in the Reinsurance Agreement. The covered perils include United States wind, European wind, California earthquake and terrorism worldwide. After an initial three-month period, the covered perils as well as the attachment points and aggregate retention amounts may be changed by the *Ceding Insurers* in their sole

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discretion. This may result in a material increase or decrease in the likelihood of payment under the Reinsurance Agreement. On each date on which a Ceding Insurer withdraws funds from the Reinsurance Collateral Account, the Company must issue and deliver to Stoneheath an amount of XL Group Ltd Series D Preference Shares having an aggregate liquidation preference that is equal to the amount of funds so withdrawn from the Collateral Account. The Company is obligated to reimburse Stoneheath for certain fees and ordinary expenses. The initial term of the Reinsurance Agreement was for the period from the Closing Date through June 30, 2007, with four annual mandatory extensions through June 30, 2011 (unless coverage is exhausted thereunder prior to such date). The Ceding Insurers may thereafter extend the Reinsurance Agreement at their option for additional calendar quarters without limit (unless coverage is exhausted thereunder). The contingent put option is recorded at fair value with changes in fair value recognized in earnings. The Series D Preference Shares, if issued, will pay dividends on a non-cumulative basis at a fixed rate of 6.868% per annum through October 15, 2011 and thereafter at a floating rate based on 3-month LIBOR, plus 3.12%.

e) Letter of Credit Facilities and other sources of collateral

At June 30, 2010, the Company had five letter of credit facilities in place with total availability of \$5.0 billion, of which \$2.7 billion was utilized.

| Other Commercial Commitments (U.S. dollars in thousands) | Commitment | In Use | Year of Expiry | Amount of Commitment Expiration per period | | | |
|--|--------------|--------------|-------------------|---|-----------------|-----------------|------------------|
| | | | | Less than 1 Year | 1 to 3 Years | 3 to 5 Years | After 5 Years |
| Letter of Credit Facility | \$ 250,000 | 112,462 | Continuous | | | | |
| Letter of Credit Facility (1) | 4,000,000 | 2,124,399 | 2012 | | 4,000,000 | | |
| Letter of Credit Facility | 21 | 21 | Continuous | | | | |
| Letter of Credit Facility | 93 | 93 | Continuous | | | | |
| Letter of Credit Facility | 750,000 | 491,989 | Continuous | | | | |
| | | | | | | | |
| Five letter of credit facilities | \$ 5,000,114 | \$ 2,728,964 | | | \$ 4,000,000 | | |

(1) Of the total letter of credit facilities above, \$1 billion is also included in the revolvers under notes payable and debt.

In the event that such credit support is insufficient, the Company could be required to provide alternative security to cedants. This could take the form of insurance trusts supported by the Company's investment portfolio or funds withheld (amounts retained by ceding companies to collateralize loss or premium reserves) using the Company's cash resources or combinations thereof. The face amount of letters of credit required is driven by, among other things, loss development of existing reserves, the payment pattern of such reserves, the expansion of business written by the Company and the loss experience of such business. In addition to letters of credit, the Company has established insurance trusts in the U.S. that provide cedants with statutory credit for reinsurance under state insurance regulation in the U.S.

The Company reviews current and projected collateral requirements on a regular basis, as well as new sources of collateral. Management's objective is to maintain an excess amount of collateral sources over expected uses. The Company also reviews its liquidity needs on a regular basis.

Ratings

XL Group's ability to underwrite business is dependent upon the quality of its claims paying and financial strength ratings as evaluated by independent rating agencies. As a result, in the event that XL Group is downgraded, its ability to write business as well as its financial condition and/or results of operations could be adversely affected. XL Group regularly evaluates its capital needs to support the volume of business written in order to maintain its claims paying and financial strength ratings.

For further information, see the Risk Factor titled "A downgrade or potential downgrade in our financial strength and credit ratings by one or more rating agencies could materially and negatively impact our business, financial condition, results of operations and/or cash flows" in Item 1A to the Company's Annual Report on Form 10-K for the year ended December 31, 2009.

On July 1, 2010, FitchRatings (Fitch) revised the outlook of the financial strength rating of XL Group's principal insurance and reinsurance subsidiaries to Stable from Negative. Also in this announcement Fitch affirmed the financial strength rating as A-. In their public announcement, Fitch noted that the change in the outlook reflects XL Group's improved capitalization, reduced financial leverage, lower investment risk and stabilization of its competitive position.

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The following are the financial strength and claims paying ratings at August 4, 2010 from internationally recognized rating agencies in relation to XL Group's principal insurance and reinsurance subsidiaries and pools:

| <u>Rating agency</u> | <u>Rating</u> |
|---------------------------|---------------|
| A.M. Best | A (Stable) |
| Standard & Poor's | A (Negative) |
| Moody's Investor Services | A2 (Stable) |
| Fitch | A (Stable) |

In addition, at August 4, 2010 XL Group Ltd. had the following long-term debt ratings: bbb (Stable) from A.M. Best, BBB+ (Negative) from S&P, Baa2 (Stable) from Moody's and BBB+ (Stable) from Fitch.

Other

For information regarding cross-default and certain other provisions in the Company's debt and convertible securities documents, see Item 7 of the Company's Annual Report on Form 10-K for the year ended December 31, 2009.

See Part II, Item 2 Unregistered Sales of Equity Securities and Use of Proceeds, below.

Cautionary Note Regarding Forward-Looking Statements

The Private Securities Litigation Reform Act of 1995 (PSLRA) provides a safe harbor for forward-looking statements. Any prospectus, prospectus supplement, XL Group s Annual Report to ordinary shareholders, any proxy statement, any other Form 10-K, Form 10-Q or Form 8-K of XL Group or any other written or oral statements made by or on behalf of XL Group may include forward-looking statements that reflect XL Group s current views with respect to future events and financial performance. Such statements include forward-looking statements both with respect to XL Group in general, and to the insurance and reinsurance sectors in particular (both as to underwriting and investment matters). Statements that include the words expect, intend, plan, believe, project, anticipate, will, may and similar statements of a future or forward-looking nature identify forward-looking statements for purposes of the PSLRA or otherwise.

All forward-looking statements address matters that involve risks and uncertainties. Accordingly, there are or will be important factors that could cause actual results to differ materially from those indicated in such statements. XL Group believes that these factors include, but are not limited to, the following: (i) changes in the size of XL Group s claims relating to natural catastrophe losses due to the preliminary nature of some reports and estimates of loss and damage to date; (ii) trends in rates for property and casualty insurance and reinsurance; (iii) the timely and full recoverability of reinsurance placed by XL Group with third parties, or other amounts due to XL Group; (iv) changes in ratings, rating agency policies or practices; (v) changes in the projected amount of ceded reinsurance recoverables and the ratings and creditworthiness of reinsurers; (vi) the timing of claims payments being faster or the receipt of reinsurance recoverables being slower than anticipated by XL Group; (vii) XL Group s ability to successfully implement its business strategy especially during the soft market cycle; (viii) increased competition on the basis of pricing, capacity, coverage terms or other factors; (ix) greater frequency or severity of claims and loss activity than XL Group s underwriting, reserving or investment practices anticipate based on historical experience or industry data; (x) the effects of inflation on XL Group s business, including on pricing and reserving; (xi) developments, including uncertainties related to the depth and duration of the current recession, and future volatility, in the world s credit, financial and capital markets that adversely affect the performance and valuation of XL s investments or access to such markets; (xii) the potential impact on XL Group from government-mandated insurance coverage for acts of terrorism; (xiii) the potential for changes to methodologies, estimations and assumptions that underlie the valuation of XL Group s financial instruments that could result in changes to investment valuations; (xiv) changes to XL Group s assessment as to whether it is more likely than not that XL Group will be required to sell, or has the intent to sell, available for sale debt securities before their anticipated recovery; (xv) developments in bankruptcy proceedings or other developments related to bankruptcies of companies insofar as they affect property and casualty insurance and reinsurance coverages or claims that XL Group may have as a counterparty; (xvi) availability of borrowings and letters of credit under XL Group s credit facilities; (xvii) the ability of XL Group s subsidiaries to pay dividends to XL Group plc; (xviii) the potential effect of regulatory developments in the jurisdictions in which XL Group operates, including those which could impact the financial markets or increase XL Group s business costs and required capital levels; (xix) changes in regulation or laws applicable to XL Group or its subsidiaries, brokers or customers; (xx) acceptance of XL Group s products and services, including new products and services; (xxi) changes in the availability, cost or quality of reinsurance; (xxii) changes in the distribution or placement of risks due to increased consolidation of insurance and reinsurance brokers; (xxiii) loss of key personnel; (xxiv) the effects of mergers, acquisitions and divestitures; (xxv) changes in accounting policies or practices or the application thereof; (xxvi) legislative or regulatory developments including, but not limited to, changes in regulatory capital balances that must be maintained by XL Group s operating subsidiaries and governmental actions for the purpose of stabilizing the financial markets; (xxvii) other changes in general economic conditions, including changes in interest rates, credit spreads, foreign currency exchange rates, inflation and other factors; (xxviii) the effects of business disruption or economic contraction due to war, terrorism or other hostilities; (xxix) changes in applicable tax laws, tax treaties or tax regulations or the interpretation or enforcement thereof; (xxx) XL Group s ability to realize the expected benefits from the redomestication; (xxxi) any unanticipated costs in connection with the redomestication; and (xxxii) the other factors set forth in XL Group s other documents on file with the SEC. The foregoing review of important factors should not be construed as exhaustive and should be read in conjunction with the other cautionary statements that are included herein or elsewhere. XL Group undertakes no obligation to update publicly or revise any forward-looking statement, whether as a result of new information, future developments or otherwise, except as required by the federal securities laws.

ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

Except as described below, there have been no material changes in the Company's market risk exposures or how those exposures are managed since December 31, 2009. The following discussion should be read in conjunction with "Quantitative and Qualitative Disclosures about Market Risk," presented under Item 7A of the Company's Form 10-K for the year ended December 31, 2009.

Market risk represents the potential for loss due to adverse changes in the fair value of financial instruments. The Company is principally exposed to the following market risks: interest rate risk, foreign currency exchange rate risk, equity price risk, credit risk, and other related market risks.

The majority of the Company's market risk arises from its investment portfolio which consists of fixed income securities, alternative investments, public equities, private investments, derivatives, other investments, and cash, denominated in both U.S. and foreign currencies, which are sensitive to changes in interest rates, credit spreads, equity prices, foreign currency exchange rates and other related market risks. The Company's fixed income and equity securities are generally classified as available for sale, and as such changes in interest rates, credit spreads on corporate and structured credit, equity prices, foreign currency exchange rates or other related market instruments will have an immediate effect on comprehensive income and shareholders' equity but will not ordinarily have an immediate effect on net income. Nevertheless, changes in interest rates, credit spreads, equity prices and other related market instruments effect consolidated net income when, and if, a security is sold or impaired.

On a limited basis the Company enters into derivatives and other financial instruments primarily for risk management purposes. The Company uses derivatives to hedge foreign exchange and interest rate risk related to its consolidated net exposures. From time to time, the Company also uses investment derivative instruments such as futures, options, interest rate swaps, credit default swaps and foreign currency forward contracts to manage the duration of its investment portfolio and foreign currency exposures and also to obtain exposure to a particular financial market. Historically, the Company entered into credit derivatives outside of the investment portfolio in conjunction with the legacy financial guarantee and financial products operations. The Company attempts to manage the risks associated with derivative use with guidelines established by senior management. Derivative instruments are carried at fair value with the resulting changes in fair value recognized in income in the period in which they occur. For further information, see Item 1, Note 6, "Derivative Instruments," herein.

This risk management discussion and the estimated amounts generated from the sensitivity and value at risk (VaR) analyses for the investment portfolio presented in this document are forward-looking statements of market risk assuming certain adverse market conditions occur. Actual results in the future may differ materially from these estimated results due to, among other things, actual developments in the global financial markets and changes in the composition of the Company's investment portfolio. The results of analysis used by the Company to assess and mitigate risk should not be considered projections of future events of losses. See generally "Cautionary Note Regarding Forward-Looking Statements" in Item 2.

Interest Rate Risk

The Company's fixed income portfolio is exposed to interest rate risk. Interest rate risk is the price sensitivity of a fixed income security to changes in interest rates. The Company manages interest rate risk within the context of its overall asset liability management strategy by setting duration targets for its investment portfolio in line with the estimated duration of its liabilities, thus mitigating the overall economic effect of interest rate risk. Nevertheless, the Company remains exposed to interest rate risk with respect to the Company's overall net asset position and more generally from an accounting standpoint since the assets are marked to market, thus subject to market conditions, while liabilities are accrued at a static rate.

In addition, while the company's debt is not carried at fair value and not adjusted for market changes, changes in market interest rates could have an impact on debt values at the time of refinancing.

Foreign Currency Exchange Rate Risk

Many of the Company's non-U.S. subsidiaries maintain both assets and liabilities in local currencies, therefore foreign exchange risk is generally limited to net assets denominated in foreign currencies.

Foreign currency exchange rate gains and losses in the Company's Statement of Income arise for accounting purposes when net assets or liabilities are denominated in foreign currencies that differ from the functional currency of those subsidiaries. While unrealized foreign exchange gains and losses on underwriting balances are reported in earnings, the offsetting unrealized gains and losses on invested assets are recorded as a

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separate component of shareholders' equity, to the extent that the asset currency does not match that entity's functional currency. This results in an accounting mismatch that will result in foreign exchange gains or losses in the consolidated statements of income depending on the movement in certain currencies. In order to improve administrative efficiencies as well as to address this accounting imbalance, the Company formed several branches with Euro and U.K. Sterling functional currencies. Management continues to focus on attempting to limit this type of exposure in the future.

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Foreign currency exchange rate risk in general is reviewed as part of the Company's risk management process. Within its asset liability framework for the investment portfolio, the Company pursues a general policy of holding the assets and liabilities in the same currency and as such the Company is not exposed to the risks associated with foreign exchange movements within its investment portfolio as currency impacts on the assets are generally matched by corresponding impacts on the related liabilities. Foreign exchange contracts within the investment portfolio are utilized to manage individual portfolio foreign exchange exposures, subject to investment management service providers' guidelines established by management. These contracts are not designated as specific hedges for financial reporting purposes and, therefore, realized and unrealized gains and losses on these contracts are recorded in income in the period in which they occur. These contracts generally have maturities of three months or less. The Company also attempts to manage the foreign exchange volatility arising on certain transactions denominated in foreign currencies. These include, but are not limited to, premium receivable, reinsurance contracts, claims payable and investments in subsidiaries.

The principal currencies creating foreign exchange risk for the Company are the British pound Sterling, the Euro, the Swiss Franc, and the Canadian dollar. The following tables provide more information on the Company's exposure to foreign exchange rate risk at June 30, 2010 and December 31, 2009:

| June 30, 2010 (Foreign Currency in millions) | Euro | British Pound | Swiss Franc | Canadian Dollar |
|---|-------------|----------------------|--------------------|------------------------|
| Net exposure to key foreign currencies (1) | 331.7 | (68.2) | 360.2 | 452.9 |

| December 31, 2009 (Foreign Currency in millions) | Euro | British Pound | Swiss Franc | Canadian Dollar |
|---|-------------|----------------------|--------------------|------------------------|
| Net exposure to key foreign currencies | 258.6 | (120.0) | 261.9 | 508.1 |

(1) Subsequent to June 30, 2010, the Company has entered into additional hedging activity reducing the aggregate net exposure to these currencies to approximately \$400.0 million.

Credit Risk

The Company is exposed to credit risk within its investment portfolio as well as through general counterparties, including customers and reinsurers. Credit risk relates to the uncertainty of an obligor's continued ability to make timely payments in accordance with the contractual terms of the instrument or contract. The Company manages credit risk through established investment credit policies which address quality of obligors and counterparties, credit concentration limits, and diversification requirements. The Company's exposure to market credit spreads primarily relates to market price and cash flow variability associated with changes in credit spreads.

Credit Risk - Investment Portfolio

Credit risk is the exposure to adverse changes in the creditworthiness of individual investment holdings, issuers, groups of issuers, industries and countries. A widening of credit spreads will increase the net unrealized loss position, will increase losses associated with credit based non-qualifying derivatives where the Company assumes credit exposure, and, if issuer credit spreads increase significantly or for an extended period of time, would likely result in higher other-than-temporary impairments. All else held equal, credit spread tightening will reduce net investment income associated with new purchases of fixed maturities. In addition, market volatility can make it difficult to value certain of the Company's securities if trading becomes less frequent. As such, valuations may include assumptions or estimates that may have significant period to period changes which could have a material adverse effect on the Company's consolidated results of operations or financial condition.

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The table below shows the Company's aggregate fixed income portfolio by credit rating in percentage terms of the Company's aggregate fixed income exposure (including fixed maturities, short-term investments, cash and cash equivalents and net payable for investments purchased) at June 30, 2010.

| | Percentage of Aggregate Fixed Income Portfolio |
|------------|---|
| AAA | 54.9 |
| AA | 14.1 |
| A | 20.5 |
| BBB | 6.8 |
| BB & below | 3.7 |
| NR | |
| | |
| Total (1) | 100.0% |

(1) Included in the above are \$374.3 million or 1.1% of the portfolio which represents medium term notes rated at the average credit rating of the underlying asset pools backing the notes.

At June 30, 2010, the average credit quality of the Company's aggregate fixed income investment portfolio was AA, excluding operating cash.

The Company is closely monitoring its corporate financial bond holdings in light of the current credit market conditions. The table below summarizes the Company's significant exposures (defined as bonds issued by financial institutions with an amortized cost in excess of \$50.0 million) to corporate bonds of financial issuers held within its available for sale investment portfolio at June 30, 2010, representing both amortized cost and unrealized gains (losses):

(U.S. dollars in millions)

| Issuer (by Global Ultimate Parent) | Amortized Cost June 30, 2010 (1) | Unrealized Gain/ (Loss) June 30, 2010 |
|--|-------------------------------------|--|
| Bank Of America Corporation | \$ 215.0 | \$ (9.7) |
| Lloyds Banking Group Plc | 159.5 | 3.8 |
| The Goldman Sachs Group, Inc. | 134.0 | (3.9) |
| Citigroup Inc. | 129.8 | (6.9) |
| Morgan Stanley | 128.0 | 0.7 |
| Wells Fargo & Company | 118.7 | 3.6 |
| Cooperatieve Centrale Raiffeisen-Boerenleenbank B.A. | 114.7 | (1.8) |
| JP Morgan Chase & Co. | 111.9 | (3.3) |
| HSBC Holdings Plc | 110.4 | (3.6) |
| Barclays Plc | 108.2 | (21.1) |
| Banco Santander, S.A. | 106.7 | (18.9) |
| BNP Paribas | 103.1 | (5.2) |
| Australia And New Zealand Banking Group Limited | 96.5 | 2.0 |
| Credit Agricole Sa | 81.8 | (11.2) |
| Aviva Plc | 75.3 | (16.1) |
| National Australia Bank Limited | 72.9 | (2.2) |
| Credit Suisse Group AG | 70.7 | 1.5 |
| The Bank Of Nova Scotia | 60.2 | 1.0 |
| RFS Holdings B.V. | 59.8 | 3.6 |
| Nationwide Building Society | 59.7 | (6.0) |
| Standard Chartered Plc | 58.5 | (1.6) |

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| | | |
|-------------------------------|------|--------|
| Legal & General Group Plc | 54.9 | (8.2) |
| Societe Generale | 54.8 | (1.0) |
| Assicurazioni Generali S.P.A. | 54.7 | (11.1) |
| Westpac Banking Corporation | 52.8 | 1.4 |
| Danske Bank A/S | 50.5 | (8.2) |

(1) Government-guaranteed paper has been excluded from the above figures.

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Within the Company's corporate financial bond holdings, the Company is further monitoring its exposures to hybrid securities, representing Tier One and Upper Tier Two securities of various financial institutions. The following table summarizes the top ten exposures to hybrid securities, listed by amortized cost representing both amortized cost and unrealized (losses):

(U.S. dollars in millions)

| Issuer (by Global Ultimate Parent) | Tier One Amortized Cost June 30, 2010 | Upper Tier Two Amortized Cost June 30, 2010 | Total Amortized Cost June 30, 2010 | Net Unrealized (Loss) June 30, 2010 |
|------------------------------------|--|---|---|---|
| Barclays, Plc | \$ 51.6 | \$ 55.9 | \$ 107.5 | \$ (20.5) |
| Banco Santander, S.A. | 45.6 | 31.1 | 76.7 | (17.3) |
| Aviva PLC | 5.5 | 49.6 | 55.1 | (14.0) |
| Assicurazioni Generali S.P.A | 54.7 | | 54.7 | (11.1) |
| Danske Bank A/S | 31.8 | 18.5 | 50.3 | (8.0) |
| Credit Agricole SA | 9.3 | 39.5 | 48.8 | (10.8) |
| Unicredit S.P.A. | 33.2 | | 33.2 | (10.0) |
| Bank of America Corporation | 28.5 | | 28.5 | (8.0) |
| Nordea Bank AB (PUBL) | | 27.2 | 27.2 | (1.6) |
| BNP Paribas | 25.9 | | 25.9 | (4.9) |
| Total | \$ 286.1 | \$ 221.8 | \$ 507.9 | \$ (106.2) |

At June 30, 2010, the top 10 corporate holdings listed below represent the direct exposure to the corporations listed below, including their subsidiaries, and excludes any securitized, credit enhanced and collateralized asset or mortgage backed securities, cash and cash equivalents, pooled notes and any OTC derivative counterparty exposure, if applicable.

| Top 10 Corporate Holdings (1) | Percentage of Aggregate Fixed Income Portfolio (2) |
|-------------------------------|---|
| Bank of America Corporation | 0.6% |
| Pfizer Inc. | 0.6% |
| General Electric Company | 0.6% |
| Lloyds Banking Group PLC | 0.5% |
| Wal-Mart Stores, Inc. | 0.5% |
| AT&T Inc. | 0.5% |
| Verizon Communications, Inc. | 0.5% |
| Glaxosmithkline PLC | 0.4% |
| The Goldman Sachs Group, Inc. | 0.4% |
| Morgan Stanley | 0.4% |

(1) Corporate issuers exclude government-backed, government-sponsored enterprises and cash and cash equivalents.

(2) Includes fixed maturities, short-term investments, cash and cash equivalents and net payable for investments purchased and excludes government-guaranteed paper.

At June 30, 2010, the top 5 corporate sector exposures listed below represented 26.9% of the aggregate fixed income investment portfolio and 79.5% of all corporate holdings.

(U.S. dollars in millions)

| Top 5 Sector Exposures | Fair Value | Percentage of Aggregate Fixed Income Portfolio |
|------------------------|------------|---|
|------------------------|------------|---|

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| | | |
|------------------------|------------|-------|
| Financials (1) | \$ 3,998.9 | 11.8% |
| Consumer, Non-Cyclical | 2,069.5 | 6.1% |
| Utilities | 1,233.8 | 3.6% |
| Communications | 962.1 | 2.8% |
| Energy | 864.1 | 2.6% |
| Total | \$ 9,128.4 | 26.9% |

(1) Government-guaranteed paper has been excluded from the above figures.

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Within the Company's fixed income portfolios, the Company is further monitoring its exposures to holdings representing risk in certain Eurozone countries. In particular, the Company has government holdings of \$29.0 million, corporate holdings of \$421.3 million and structured credit holdings of \$7.1 million in Greece, Ireland, Italy, Portugal and Spain. The corporate holdings primarily consist of multinationals with low reliance on local economics and systemically important industries such as utilities and telecoms.

The Company also has exposure to market movement related to credit risk associated with its mortgage-backed and asset-backed securities. The table below shows the breakdown of the \$10.6 billion structured credit portfolio, of which 76.9% is AAA rated:

| <i>(U.S. dollars in millions)</i> | <u>Fair Value</u> | <u>Percentage of Structured Portfolio</u> |
|---|--------------------|---|
| CMBS | \$ 1,266.1 | 12.0% |
| Agency RMBS | 5,986.1 | 57.0% |
| Prime RMBS | 413.0 | 3.9% |
| Core CDO (non-ABS CDOs and CLOs) | 701.9 | 6.7% |
| Other ABS: | | |
| ABS - Auto | 306.5 | 2.9% |
| ABS - Credit Cards | 219.3 | 2.1% |
| ABS - Other | 882.3 | 8.3% |
| Topical: | | |
| Sub-prime first lien | 383.7 | 3.7% |
| Alt-A | 307.9 | 2.9% |
| Second lien (including sub-prime second lien mortgages) | 38.2 | 0.4% |
| ABS CDO's with sub-prime collateral | 5.6 | 0.1% |
| Total | \$ 10,510.6 | 100.0% |

Credit Risk - Other

Credit derivatives are purchased within the Company's investment portfolio, have been sold through a limited number of contracts written as part of the Company's previous XL Financial Solutions business, and were previously entered into through the Company's prior reinsurance agreements with Syncora, as described below. From time to time, the Company may purchase credit default swaps to hedge an existing position or concentration of holdings. The credit derivatives are recorded at fair value. For further details with respect to the Company's exposure to Credit derivatives see Item 1, Note 6 to the Company's Consolidated Financial Statements, "Derivative Instruments", herein.

The Company has exposure to many different industries and counterparties, and routinely executes transactions with counterparties in the financial services industry, including brokers and dealers, commercial banks, investment banks, alternatives and other investment funds and other institutions. Many of these transactions expose the Company to credit risk in the event of default of the Company's counterparty. In addition, with respect to secured transactions, the Company's credit risk may be exacerbated when the collateral held by the Company cannot be sold or is liquidated at prices not sufficient to recover the full amount of the loan or derivative exposure that is due. The Company also has exposure to financial institutions in the form of unsecured debt instruments, derivative transactions, revolving credit facility and letter of credit commitments and equity investments. There can be no assurance that any such losses or impairments to the carrying value of these assets would not materially and adversely affect the Company's business and results of operations.

With regards to unpaid losses and loss expenses recoverable and reinsurance balances receivable, the Company has credit risk should any of its reinsurers be unable or unwilling to settle amounts due to the Company; however, these exposures are not marked to market. For further information relating to reinsurer credit risk, see Item 2, "Management's Discussion and Analysis of Financial Condition and Results of Operations - Unpaid Losses and Loss Expenses Recoverable and Reinsurance Balances Receivable."

The Company is exposed to credit risk in the event of non-performance by the other parties to its derivative instruments in general; however, the Company does not anticipate non-performance. The difference between the notional principal amounts and the associated market value is the Company's maximum credit exposure.

Equity Price Risk

The Company's equity investment portfolio as well as other investments, primarily representing certain derivatives and certain affiliate investments, are exposed to mark to market movements associated with equity price risk. Equity price risk is the potential loss arising from changes in the market value of equities. At June 30, 2010, the Company's equity portfolio was approximately \$19.0 million as compared to \$12.0 million at December 31, 2009. This excludes fixed income fund investments that generally do not have the risk characteristics of equity investments. At June 30, 2010 and December 31, 2009, the Company's direct allocation to equity securities was a negligible percentage of the total investment portfolio (including cash and cash equivalents, accrued investment income and net payable for investments purchased). The Company also estimates the equity risk embedded in certain alternative and private investments. Such estimates are derived from market exposures provided to the Company by certain individual fund investments and/or internal statistical analyses.

Other Market Risks

The Company's private investment portfolio is invested in limited partnerships and other entities which are not publicly traded. In addition to normal market risks, these positions may also be exposed to liquidity risk, risks related to distressed investments, and risks specific to startup or small companies. At June 30, 2010, the Company's exposure to private investments was \$341.7 million, as compared to \$322.4 million at December 31, 2009.

The Company's alternative investment portfolio, which is exposed to equity and credit risk as well as certain other market risks, had a total exposure of \$878.0 million making up approximately 2.5% of the total investment portfolio (including cash and cash equivalents, accrued investment income and net payable for investments purchased) at June 30, 2010, as compared to December 31, 2009, where the Company had a total exposure of \$800.2 million representing approximately 2.4% of the total investment portfolio.

At June 30, 2010, bond and stock index futures outstanding had a net long position of \$90.1 million as compared to a net long position of \$81.8 million at December 31, 2009. The Company may reduce its exposure to these futures through offsetting transactions, including options and forwards.

As noted above, the Company also invests in certain derivative positions which can be impacted by market value movements. For further details on derivative instruments see Item 1, Note 6 to the Company's Consolidated Financial Statements, "Derivative Instruments", herein.

Sensitivity and Value-at-Risk Analysis

The table below summarizes the Company's assessment of the estimated impact on the value of the Company's investment portfolio at June 30, 2010 associated with an immediate and hypothetical: +100bps increase in interest rates, a -10% decline in equity markets, a +100bps widening in spreads and a +10% widening in spreads. The table also reports the 95%, 1-year VaRs for the Company's investment portfolios at June 30, 2010, excluding foreign exchange.

The interest rate, spread risk, and VaR referenced in the table below include the impact of market movements on the Company's held-to-maturity fixed maturities. While the market value of these holdings is sensitive to prevailing interest rates and credit spreads, the Company's book value is not impacted as these holdings are carried at amortized cost. As at June 30, 2010, if the Company were to exclude these impacts in order to present the impact of these risks to the Company's book value, the interest rate risk would be reduced by approximately \$66.0 million, absolute spread risk would be reduced by approximately \$11.7 million, relative spread risk would be reduced by approximately \$1.0 million, and VaR would be reduced by approximately \$43.5 million. On August 1, 2010, the Company reclassified an additional \$2.1 billion of fixed maturity securities to held to maturity.

The table below excludes the impact of foreign exchange rate risk on the investment portfolio. The investment portfolio is managed on an asset-liability matched basis, and accordingly any foreign exchange movements impact the assets and liabilities equally. See foreign exchange rate risk for further details. The Company considers that the investment portfolio VaR estimated results as well as P&C and Life investment portfolios VaR estimated results excluding foreign exchange rate risk are the more relevant and appropriate metrics to consider when assessing the actual risk of the portfolio.

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The estimated results below also do not include any risk contributions from our various operating affiliates (strategic, investment manager or financial operating affiliates) or other investments carried at amortized cost.

| <i>(U.S. dollars in thousands)</i> | Interest Rate Risk(2) | Equity Risk (3) | Absolute Spread Risk (4) | Relative Spread Risk (5) | VaR (6), (7) |
|---|--------------------------|--------------------|--------------------------------|--------------------------------|-------------------|
| Total Investment Portfolio (1) | \$ (1,208.1) | \$ (56.0) | \$ (1,219.0) | \$ (234.5) | \$ 1,217.1 |
| A. P&C Investment Portfolio | \$ (716.8) | \$ (56.0) | \$ (800.9) | \$ (150.4) | \$ 831.0 |
| (I) P&C Fixed Income Portfolio | (716.8) | □ | (800.9) | (150.4) | 821.2 |
| (a) Cash & 0-1 Yr | (3.9) | □ | □ | □ | 10.9 |
| (b) Total Government Related | (215.0) | □ | (145.6) | (4.8) | 173.7 |
| (c) Total Corporate Credit | (288.1) | □ | (336.8) | (53.9) | 346.8 |
| (d) Total Structured Credit | (209.8) | □ | (318.5) | (91.7) | 437.5 |
| (II) P&C Non-Fixed Income Portfolio | □ | (56.0) | □ | □ | 111.2 |
| (e) Equity Portfolio | □ | (1.2) | □ | □ | 17.0 |
| (f) Alternative Portfolio | □ | (19.8) | □ | □ | 56.0 |
| (g) Private Investments | □ | (35.0) | □ | □ | 99.9 |
| B. Life Investment Portfolio | \$ (481.7) | \$ □ | \$ (397.8) | \$ (84.0) | \$ 470.6 |
| (III) Life Fixed Income Portfolio | (481.7) | □ | (397.8) | (84.0) | 470.6 |
| (i) Cash & 0-1 Yr | (0.6) | □ | (0.3) | □ | 0.6 |
| (j) Total Government Related | (195.1) | □ | (75.6) | (3.3) | 206.9 |
| (k) Total Corporate Credit | (240.0) | □ | (269.7) | (69.6) | 280.1 |
| (l) Total Structured Credit | (46.0) | □ | (52.2) | (11.1) | 53.0 |
| (IV) Life Non-Fixed Income Portfolio | □ | □ | □ | □ | □ |

- (1) The Company's Total Investment Portfolio comprises the Company's P&C Investment Portfolio and Life Investment Portfolio as well as the Company's Business and Other Investments which do not form part of the Company's P&C Investment Portfolio or Life Investment Portfolio. The individual results reported in the above table for the Company's Total Investment Portfolio therefore represent the aggregate impact on the Company's P&C Investment Portfolio, Life Investment Portfolio and the Company's Business and Other Investments.
- (2) The estimated impact on the fair value of the Company's fixed income portfolio of an immediate hypothetical +100 bps adverse parallel shift in global bond curves.
- (3) The estimated impact on the fair value of the Company's investment portfolio of an immediate hypothetical -10% change in the value of equity exposures in the Company's equity portfolio, certain equity-sensitive alternative investments and private equity investments. This includes the Company's estimate of equity risk embedded in the alternatives and private investment portfolio with such estimates utilizing market exposures provided to the Company by certain individual fund investments and /or internal statistical analyses.
- (4) The estimated impact on the fair value of the Company's fixed income portfolio of an immediate hypothetical +100 basis point increase in all global corporate and structured credit spreads to which the Company's fixed income portfolio is exposed. This excludes exposure to credit spreads in the Company's alternative investments, private investments, and counterparty exposure.
- (5) The estimated impact on the fair value of the Company's fixed income portfolio of an immediate hypothetical +10% increase in all global corporate and structured credit spreads to which the Company's fixed income portfolio is exposed. This excludes exposure to credit spreads in the Company's alternative investments, private investments, and counterparty exposure.
- (6) The VaR results are based on a 95% confidence interval, with a one year holding period, excluding foreign exchange rate risk. The Company's investment portfolio VaR as at June 30, 2010 is not necessarily indicative of future VaR levels.
- (7) The VaR results are the standalone VaRs, based on the prescribed methodology, for each component of the Company's Total Investment Portfolio. The standalone VaRs of the individual components are non-additive, with the difference between the summation of the individual component VaRs and their respective aggregations being due to diversification benefits across the individual components. In the case of the VaR results for the Company's Total Investment Portfolio, the results also include the impact associated with the Company's Business and Other Investments.

- (6) The VaR results are based on a 95% confidence interval, with a one year holding period, excluding foreign exchange rate risk. The Company's investment portfolio VaR as at June 30, 2010 is not necessarily indicative of future VaR levels.
- (7) The VaR results are the standalone VaRs, based on the prescribed methodology, for each component of the Company's Total Investment Portfolio. The standalone VaRs of the individual components are non-additive, with the difference between the summation of the individual component VaRs and their respective aggregations being due to diversification benefits across the individual components. In the case of the VaR results for the Company's Total Investment Portfolio, the results also include the impact associated with the Company's Business and Other Investments

Stress Testing

VaR does not provide the means to estimate the magnitude of the loss in the 5% of occurrences when the Company expects the VaR level to be exceeded. To complement the VaR analysis based on normal market environments, the Company considers the impact on the investment portfolio in several different stress scenarios to analyze the effect of unusual market conditions. The Company establishes certain stress scenarios which are applied to the actual investment portfolio. As these stress scenarios and estimated gains and losses are based on scenarios established by the Company, they will not necessarily reflect future stress events or gains and losses from such events. The results of the stress scenarios are reviewed on a regular basis to ensure they are appropriate, based on current shareholders equity, market conditions and the Company's total risk tolerance. It is important to note that when assessing the risk of the Company's investment portfolio, the Company does not take into account either the value or risk associated with the liabilities arising from the Company's operations.

ITEM 4. CONTROLS AND PROCEDURES

Conclusion Regarding the Effectiveness of Disclosure Controls and Procedures

The Company carried out an evaluation, under the supervision and with the participation of the Company's management, including the Chief Executive Officer and Chief Financial Officer, of the effectiveness of disclosure controls and procedures pursuant to Rules 13a-15 and 15d-15 promulgated under the Securities Exchange Act of 1934, as amended, as of the end of the period covered by this report. Based on that evaluation, the Chief Executive Officer and Chief Financial Officer concluded that the disclosure controls and procedures are effective to provide reasonable assurance that all material information relating to the Company required to be included in this report has been made known to them in a timely fashion.

Changes in Internal Control Over Financial Reporting

There have been no changes in internal control over financial reporting identified in connection with the Company's evaluation required pursuant to Rules 13a-15 and 15d-15 promulgated under the Securities Exchange Act of 1934, as amended, that occurred during the most recent fiscal quarter that have materially affected, or are reasonably likely to materially affect, the Company's internal control over financial reporting.

PART II OTHER INFORMATION**ITEM 1. LEGAL PROCEEDINGS**

In November 2006, a subsidiary of the Company received a grand jury subpoena from the Antitrust Division of the U.S. Department of Justice (DOJ) and a subpoena from the Securities and Exchange Commission (the SEC), both of which sought documents in connection with an investigation into the municipal GICs market and related products. In June 2008, subsidiaries of the Company also received a subpoena from the Connecticut Attorney General and an Antitrust Civil Investigative Demand from the Office of the Florida Attorney General in connection with a coordinated multi-state Attorneys General investigation into the matters referenced in the DOJ and SEC subpoenas. The Company is fully cooperating with these investigations.

Commencing in March 2008, the Company and two of its subsidiaries were named, along with approximately 20 other providers and insurers of municipal Guaranteed Investment Contracts and similar derivative products in the U.S. (collectively Municipal Derivatives) as well as fourteen brokers of such products, in several purported federal antitrust class actions. The Judicial Panel on Multidistrict Litigation ordered that these be consolidated for pretrial purposes and assigned them to the Southern District of New York. The consolidated amended complaint filed in August 2008 alleges that there was a conspiracy among the defendants during the period from January 1, 1992 to the present to rig bids and otherwise unlawfully decrease the yield for Municipal Derivative products. The purported class of plaintiffs consists of purchasers of Municipal Derivatives. On October 21, 2008 most of the defendants filed motions to dismiss the consolidated amended complaint. The District Judge granted the motions by order dated April 29, 2009, but allowed plaintiffs leave to file a second amended complaint. Plaintiffs filed a Second Consolidated Amended Class Action Complaint on June 18, 2009, but did not include the Company or any subsidiaries as a defendant. The remaining defendants in that action again moved to dismiss, which motion was denied by the Court on March 25, 2010.

In addition, the Company and three subsidiaries of the Company (along with numerous other parties) were named as defendants in eleven individual (i.e., non-class) actions filed by various municipalities or other local government bodies in California state and federal courts. The allegations are similar to the allegations in the Second Consolidated Amended Class Action Complaint described above. The defendants removed the state court cases to federal court, and all eleven cases were then transferred to the Southern District of New York by the Judicial Panel on Multidistrict Litigation. On April 26, 2010, the District Judge dismissed all eleven cases against the Company and its subsidiaries without prejudice, but denied motions to dismiss as respects most of the other defendants.

In August 2005, plaintiffs in a proposed class action (the Class Action) that was consolidated into a multidistrict litigation in the United States District Court for the District of New Jersey, captioned In re Brokerage Antitrust Litigation, MDL No. 1663, Civil Action No. 04-5184 (the MDL), filed a consolidated amended complaint (the Amended Complaint), which named as new defendants approximately 30 entities, including Greenwich Insurance Company, Indian Harbor Insurance Company and XL Group plc. In the MDL, the Class Action plaintiffs asserted various claims purportedly on behalf of a class of commercial insureds against approximately 113 insurance companies and insurance brokers through which the named plaintiffs allegedly purchased insurance. The Amended Complaint alleged that the defendant insurance companies and insurance brokers conspired to manipulate bidding practices for insurance policies in certain insurance lines and failed to disclose certain commission arrangements and asserted statutory claims under the Sherman Act, various state antitrust laws and the Racketeer Influenced and Corrupt Organizations Act (RICO), as well as common law claims alleging breach of fiduciary duty, aiding and abetting a breach of fiduciary duty and unjust enrichment. By Opinion and Order dated August 31, 2007, the Court dismissed the Sherman Act claims with prejudice and, by Opinion and Order dated September 28, 2007, the Court dismissed the RICO claims with prejudice. The plaintiffs then appealed both Orders to the U.S. Court of Appeals for the Third Circuit. Oral argument before the appellate court was held on April 21, 2009. In accordance with the Third Circuit's April 23, 2009 directive, the parties submitted on May 13, 2009 their respective supplemental letter briefs addressing a question raised by the Court. The appeal remains pending.

Various XL entities have been named as defendants in three of the many tag-along actions that have been consolidated into the MDL for pretrial purposes. The complaints in these tag-along actions make allegations similar to those made in the Amended Complaint but do not purport to be class actions. On April 4, 2006, a tag-along complaint was filed in the U.S. District Court for the Northern District of Georgia on behalf of New Cingular Wireless Headquarters LLC and several other corporations against approximately 100 defendants, including Greenwich Insurance Company, XL Specialty Insurance Company, XL Insurance America, Inc., XL Insurance Company Limited, Lloyd's syndicates 861, 588 and 1209 and the Company (now XL Group plc). On or about May 21, 2007, a tag-along complaint was filed in the U.S. District Court for the District of New Jersey on behalf of Henley Management Company, Big Bear Properties, Inc., Northbrook Properties, Inc., RCK Properties, Inc., Kitchens, Inc., Aberfeldy LP and Payroll and Insurance Group, Inc. against multiple defendants, including XL Winterthur International. On October 12, 2007, a complaint in a third tag-along action was filed in the U.S. District Court for the Northern District of Georgia by Sears, Roebuck & Co., Sears Holdings Corporation, Kmart Corporation and Lands' End Inc. against many named defendants including X.L. America, Inc., XL Insurance America, Inc., XL Specialty Insurance Company and XL Insurance (Bermuda) Ltd. The three tag-along actions are currently stayed.

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The Company and one of its subsidiaries (collectively "XL"), Syncora, four Syncora officers, and various underwriters of Syncora securities were named in a Consolidated Amended Complaint ("CAC") filed in August 2008 on behalf of shareholders of Syncora in the Southern District of New York. By Order dated March 31, 2010, Judge Deborah Batts granted motions to dismiss all claims asserted in the CAC as against all defendants principally on the basis of absence of loss causation and, granted the Plaintiffs leave to amend the CAC. The Plaintiffs filed a further amended complaint in June 2010. This complaint alleges violations of the Securities Act of 1933 arising out of the secondary public offering of Syncora common shares held by XL on June 6, 2007 as well as under the Securities Exchange Act of 1934 arising out of trading in Syncora securities during the asserted class period of July 24, 2007 to December 20, 2007. The principal allegations are that Syncora failed to appropriately and timely disclose its processes with respect to underwriting certain derivative contracts and insurance of tranches of structured securities. A subsidiary of the Company is named as a party that sold stock in the secondary public offering and the Company is named as a party that controlled Syncora during the relevant time period. The Company will vigorously defend this matter.

In connection with the secondary offering of the Company's Syncora shares, the Company and Syncora each agreed to indemnify the several underwriters of that offering against certain liabilities, including liabilities under the Securities Act of 1933 for payment of legal fees and expenses, settlements and judgments incurred with respect to litigation such as this. The Company and Syncora have agreed to each bear 50% of this indemnity obligation.

The Company is subject to litigation and arbitration in the normal course of its business. These lawsuits and arbitrations principally involve claims on policies of insurance and contracts of reinsurance and are typical for the Company and for the property and casualty insurance and reinsurance industry in general. Such legal proceedings are considered in connection with the Company's loss and loss expense reserves. Reserves in varying amounts may or may not be established in respect of particular claims proceedings based on many factors, including the legal merits thereof. In addition to litigation relating to insurance and reinsurance claims, the Company and its subsidiaries are subject to lawsuits and regulatory actions in the normal course of business that do not arise from or directly relate to claims on insurance or reinsurance policies. This category of business litigation typically involves, amongst other things, allegations of underwriting errors or misconduct, employment claims, regulatory activity, shareholder disputes or disputes arising from business ventures. The status of these legal actions is actively monitored by management. The Company believes that the expected ultimate outcome of all outstanding litigation and arbitration will not have a material adverse effect on its consolidated financial condition, operating results and/or cash flow, although an adverse resolution of one or more of these items could have a material adverse effect on the Company's results of operations in a particular fiscal quarter or year.

ITEM 1A. RISK FACTORS

Refer to Item 1A. Risk Factors in the Company's Annual Report on Form 10-K for the year ended December 31, 2009 for further information.

ITEM 2. UNREGISTERED SALES OF EQUITY SECURITIES AND USE OF PROCEEDS

(c) Purchases of Equity Securities by the Issuer and Affiliate Purchasers

The following table provides information about purchases by the Company during the three months ended June 30, 2010 of equity securities that are registered by the Company pursuant to Section 12 of the Exchange Act:

| Period | Total Number of Shares Purchased (1) | Average Price Paid per Share | Total Number of Shares Purchased as Part of Publicly Announced Plans or Programs | Approximate Dollar Value of Shares that May Yet Be Purchased Under the Plans or Programs (2) |
|------------------|---|---------------------------------------|--|--|
| April 1-30, 2010 | | | | 375.5 million |
| May 1-31, 2010 | | | | 375.5 million |
| June 1-30, 2010 | | | | 375.5 million |
| Total | | | | 375.5 million |

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- (1) All shares were purchased in connection with the vesting of restricted shares granted under the Company's restricted stock plan. All of these purchases were made in connection with satisfying tax withholding obligations of those employees. These shares were not purchased as part of the Company's share repurchase program noted below.
 - (2) On September 24, 2007, the Board of Directors of the Company approved a share repurchase program, authorizing the Company to repurchase up to \$500.0 million of its Class A ordinary shares. During the quarter ended June 30, 2010, no share repurchases were made under the share repurchase program. As at June 30, 2010, the Company could repurchase \$375.5 million of its equity securities under the share repurchase program.

ITEM 6. **EXHIBITS**

- 10.1** 1991 Performance Incentive Program (as amended and restated).
- 10.2** Directors Stock and Option Plan (as amended and restated).
- 10.3** Supplemental Deferred Compensation Plan (as amended and restated).
- 10.4** 2009 Cash Long Term Incentive Program (as amended and restated).
- 10.5** Form of Option Award Agreement (for use with awards granted on or after July 1, 2010).
- 10.6** Form of Restricted Stock Unit Award Agreement (for use with awards granted on or after July 1, 2010).
- 10.7** Form of Restricted Stock Unit Award Agreement for Employees Subject to IRC Section 457A (for use with awards granted on or after July 1, 2010).
- 10.8** Form of Performance Unit Award Agreement (for use with awards granted on or after July 1, 2010).
- 10.9** Form of Performance Unit Award Agreement for Employees Subject to IRC Section 457A (for use with awards granted on or after July 1, 2010).
- 31** Rule 13a-14(a)/15d-14(a) Certifications.
- 32** Section 1350 Certification.

** Filed herewith

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SIGNATURES

Pursuant to the requirements of the Securities and Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned thereunto duly authorized.

Date: August 6, 2010

XL Group plc
(Registrant)

/s/ MICHAEL S. MCGAVICK

Name: Michael S. McGavick
Title: Chief Executive Officer and Director
XL Group plc

Date: August 6, 2010

/s/ IRENE M. ESTEVES

Name: Irene M. Esteves
Title: Executive Vice President and Chief Financial Officer
XL Group plc

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