

ALLIED WORLD ASSURANCE CO HOLDINGS LTD

Form 10-Q

August 08, 2008

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

**Form 10-Q**

(Mark One)

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

**For the quarterly period ended: June 30, 2008**

**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: 001-32938**

**ALLIED WORLD ASSURANCE COMPANY HOLDINGS, LTD**

*(Exact Name of Registrant as Specified in Its Charter)*

**Bermuda**

*(State or Other Jurisdiction of  
Incorporation or Organization)*

**98-0481737**

*(I.R.S. Employer  
Identification No.)*

**27 Richmond Road, Pembroke HM 08, Bermuda**

*(Address of Principal Executive Offices and Zip Code)*

**(441) 278-5400**

*(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 is a large accelerated filer, an accelerated filer, a non-accelerated filer, or a smaller reporting company. See the definitions of large accelerated filer, accelerated filer and smaller reporting company in Rule 12b-2 of the Exchange Act. (Check one):

Large accelerated filer  Accelerated filer  Non-accelerated filer  Smaller Reporting Company   
(Do not check if a smaller reporting company)

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act). Yes  No

The number of outstanding common shares, par value \$0.03 per share, of Allied World Assurance Company Holdings, Ltd as of August 4, 2008 was 48,978,591.

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**PART I**  
**FINANCIAL INFORMATION**

**Item 1. Financial Statements.**

**ALLIED WORLD ASSURANCE COMPANY HOLDINGS, LTD**  
**UNAUDITED CONDENSED CONSOLIDATED BALANCE SHEETS**

as of June 30, 2008 and December 31, 2007

(Expressed in thousands of United States dollars, except share and per share amounts)

|   | As of<br>June 30,<br>2008 | As of<br>December<br>31,<br>2007 |
|---|---------------------------|----------------------------------|
| <b>ASSETS:</b>  |                           |                                  |
| Fixed maturity investments available for sale, at fair value (amortized cost: 2008: \$5,685,111; 2007: \$5,595,943) | \$ 5,733,523              | \$ 5,707,143                     |
| Other invested assets available for sale, at fair value (cost: 2008: \$81,241; 2007: \$291,458)                     | 77,444                    | 322,144                          |
| Other invested assets, at fair value  | 192,661                   |                                  |
| <b>Total investments</b>  | <b>6,003,628</b>          | <b>6,029,287</b>                 |
| Cash and cash equivalents   | 439,933                   | 202,582                          |
| Restricted cash   | 84,492                    | 67,886                           |
| Securities lending collateral   | 190,960                   | 147,241                          |
| Insurance balances receivable   | 432,468                   | 304,499                          |
| Prepaid reinsurance   | 193,005                   | 163,836                          |
| Reinsurance recoverable   | 778,578                   | 682,765                          |
| Accrued investment income   | 54,735                    | 55,763                           |
| Deferred acquisition costs  | 126,995                   | 108,295                          |
| Goodwill and other intangible assets  | 19,450                    | 3,920                            |
| Balances receivable on sale of investments  | 96,801                    | 84,998                           |
| Net deferred tax assets   | 2,032                     | 4,881                            |
| Other assets  | 45,519                    | 43,155                           |
| <b>Total assets</b>   | <b>\$ 8,468,596</b>       | <b>\$ 7,899,108</b>              |
| <b>LIABILITIES:</b>   |                           |                                  |
| Reserve for losses and loss expenses  | \$ 4,164,220              | \$ 3,919,772                     |
| Unearned premiums   | 945,126                   | 811,083                          |
| Unearned ceding commissions   | 32,356                    | 28,831                           |
| Reinsurance balances payable  | 120,888                   | 67,175                           |
| Securities lending payable  | 190,960                   | 147,241                          |
| Balances due on purchase of investments   | 107,054                   | 141,462                          |
| Senior notes  | 498,738                   | 498,682                          |
| Accounts payable and accrued liabilities  | 31,208                    | 45,020                           |
| <b>Total liabilities</b>  | <b>\$ 6,090,550</b>       | <b>\$ 5,659,266</b>              |
| <b>SHAREHOLDERS EQUITY:</b>   |                           |                                  |
|   | 1,469                     | 1,462                            |

Common shares, par value \$0.03 per share, issued and outstanding 2008:

48,977,635 shares and 2007: 48,741,927 shares

|   |              |              |
|---|--------------|--------------|
| Additional paid-in capital  | 1,298,375    | 1,281,832    |
| Retained earnings   | 1,039,154    | 820,334      |
| Accumulated other comprehensive income: net unrealized gains on investments, net of tax | 39,048       | 136,214      |
| Total shareholders' equity  | 2,378,046    | 2,239,842    |
| Total liabilities and shareholders' equity  | \$ 8,468,596 | \$ 7,899,108 |

See accompanying notes to the unaudited condensed consolidated financial statements.

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**ALLIED WORLD ASSURANCE COMPANY HOLDINGS, LTD**  
**UNAUDITED CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS**  
**AND COMPREHENSIVE INCOME**

for the three and six months ended June 30, 2008 and 2007

(Expressed in thousands of United States dollars, except share and per share amounts)

|  | <b>Three Months Ended</b> |                  | <b>Six Months Ended</b> |                   |
|--|---------------------------|------------------|-------------------------|-------------------|
|  | <b>June 30,</b>           |                  | <b>June 30,</b>         |                   |
|  | <b>2008</b>               | <b>2007</b>      | <b>2008</b>             | <b>2007</b>       |
| <b>REVENUES:</b>   |                           |                  |                         |                   |
| Gross premiums written   | \$ 446,784                | \$ 530,549       | \$ 843,657              | \$ 968,955        |
| Premiums ceded   | (126,534)                 | (143,962)        | (196,835)               | (224,524)         |
| Net premiums written   | 320,250                   | 386,587          | 646,822                 | 744,431           |
| Change in unearned premiums  | (51,374)                  | (83,468)         | (104,874)               | (154,746)         |
| Net premiums earned  | 268,876                   | 303,119          | 541,948                 | 589,685           |
| Net investment income  | 72,345                    | 73,937           | 149,276                 | 146,585           |
| Net realized investment losses   | (4,393)                   | (1,481)          | (928)                   | (7,965)           |
|  | 336,828                   | 375,575          | 690,296                 | 728,305           |
| <b>EXPENSES:</b>   |                           |                  |                         |                   |
| Net losses and loss expenses   | 178,084                   | 176,225          | 321,581                 | 342,220           |
| Acquisition costs  | 26,265                    | 31,872           | 53,105                  | 61,068            |
| General and administrative expenses  | 46,380                    | 34,432           | 89,651                  | 67,635            |
| Interest expense   | 9,513                     | 9,482            | 19,023                  | 18,856            |
| Foreign exchange (gain) loss   | (399)                     | 532              | 77                      | 564               |
|  | 259,843                   | 252,543          | 483,437                 | 490,343           |
| Income before income taxes   | 76,985                    | 123,032          | 206,859                 | 237,962           |
| Income tax (recovery) expense  | (2,220)                   | (255)            | (3,291)                 | 754               |
| <b>NET INCOME</b>  | <b>79,205</b>             | <b>123,287</b>   | <b>210,150</b>          | <b>237,208</b>    |
| Other comprehensive loss   |                           |                  |                         |                   |
| Unrealized losses on investments arising during the period net of applicable deferred income tax recovery for three months 2008: \$493; 2007: \$1,475; and six months 2008: \$242; 2007: \$2,292 | (101,589)                 | (58,625)         | (59,966)                | (40,092)          |
| Reclassification adjustment for net realized losses (gains) included in net income   | 5,012                     | 1,481            | (10,938)                | 7,965             |
| Other comprehensive loss   | (96,577)                  | (57,144)         | (70,904)                | (32,127)          |
| <b>COMPREHENSIVE (LOSS) INCOME</b>   | <b>\$ (17,372)</b>        | <b>\$ 66,143</b> | <b>\$ 139,246</b>       | <b>\$ 205,081</b> |

PER SHARE DATA

|   |            |            |            |            |
|---|------------|------------|------------|------------|
| Basic earnings per share  | \$ 1.62    | \$ 2.04    | \$ 4.33    | \$ 3.95    |
| Diluted earnings per share  | \$ 1.56    | \$ 1.96    | \$ 4.12    | \$ 3.81    |
| Weighted average common shares outstanding                              | 48,897,931 | 60,397,591 | 48,585,015 | 60,028,523 |
| Weighted average common shares and common share equivalents outstanding | 50,873,712 | 62,874,235 | 51,013,633 | 62,277,010 |
| Dividends declared per share  | \$ 0.18    | \$ 0.15    | \$ 0.36    | \$ 0.30    |

See accompanying notes to the unaudited condensed consolidated financial statements.

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**ALLIED WORLD ASSURANCE COMPANY HOLDINGS, LTD**  
**UNAUDITED CONDENSED CONSOLIDATED STATEMENTS OF SHAREHOLDERS' EQUITY**

for the six months ended June 30, 2008 and 2007

(Expressed in thousands of United States dollars)

|   | <b>Share<br/>Capital</b> | <b>Additional<br/>Paid-in<br/>Capital</b> | <b>Accumulated<br/>Other<br/>Comprehensive<br/>Income</b> | <b>Retained<br/>Earnings</b> | <b>Total</b> |
|---|--------------------------|---|---|------------------------------|--------------|
| December 31, 2007                                     | \$ 1,462                 | \$ 1,281,832                              | \$ 136,214  | \$ 820,334                   | \$ 2,239,842 |
| Cumulative effect adjustment upon adoption of FAS 159 |                          |   | (26,262)  | 26,262                       |              |
| Net income  |                          |   |   | 210,150                      | 210,150      |
| Dividends   |                          |   |   | (17,592)                     | (17,592)     |
| Other comprehensive loss                              |                          |   | (70,904)  |                              | (70,904)     |
| Stock compensation                                    | 7                        | 16,543                                    |   |                              | 16,550       |
| June 30, 2008   | \$ 1,469                 | \$ 1,298,375                              | \$ 39,048   | \$ 1,039,154                 | \$ 2,378,046 |

|                          | <b>Share<br/>Capital</b> | <b>Additional<br/>Paid-in<br/>Capital</b> | <b>Accumulated<br/>Other<br/>Comprehensive<br/>Income<br/>(Loss)</b> | <b>Retained<br/>Earnings</b> | <b>Total</b> |
|--------------------------|--------------------------|---|--|------------------------------|--------------|
| December 31, 2006        | \$ 1,809                 | \$ 1,822,607                              | \$ 6,464   | \$ 389,204                   | \$ 2,220,084 |
| Net income               |                          |   |  | 237,208                      | 237,208      |
| Dividends                |                          |   |  | (18,112)                     | (18,112)     |
| Other comprehensive loss |                          |   | (32,127)   |                              | (32,127)     |
| Stock compensation       | 3                        | 11,130                                    |  |                              | 11,133       |
| June 30, 2007            | \$ 1,812                 | \$ 1,833,737                              | \$ (25,663)  | \$ 608,300                   | \$ 2,418,186 |

See accompanying notes to the unaudited condensed consolidated financial statements.



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**ALLIED WORLD ASSURANCE COMPANY HOLDINGS, LTD**  
**UNAUDITED CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS**

for the six months ended June 30, 2008 and 2007

(Expressed in thousands of United States dollars)

|   | <b>Six Months Ended</b> |                  |
|---|-------------------------|------------------|
|   | <b>June 30,</b>         |                  |
|   | <b>2008</b>             | <b>2007</b>      |
| <b>CASH FLOWS PROVIDED BY OPERATING ACTIVITIES:</b>                           |                         |                  |
| Net income  | \$ 210,150              | \$ 237,208       |
| Adjustments to reconcile net income to cash provided by operating activities: |                         |                  |
| Net realized gains on sales of investments                                    | (48,215)                | (4,358)          |
| Impairment charges for other-than-temporary impairments on investments        | 37,277                  | 12,323           |
| Change in fair value of hedge fund investments                                | 11,866                  |                  |
| Amortization of premiums net of accrual of discounts on fixed maturities      | (3,787)                 | (1,970)          |
| Amortization and depreciation of fixed assets                                 | 4,518                   | 3,992            |
| Amortization of discount and expenses on senior notes                         | 225                     | 210              |
| Stock compensation expense  | 13,625                  | 11,763           |
| Insurance balances receivable   | (127,969)               | (146,351)        |
| Prepaid reinsurance   | (29,169)                | (49,803)         |
| Reinsurance recoverable   | (95,813)                | 9,907            |
| Accrued investment income   | 1,028                   | (5,243)          |
| Deferred acquisition costs  | (18,700)                | (31,042)         |
| Net deferred tax assets   | 3,091                   | 1,231            |
| Other assets  | (3,416)                 | (6,199)          |
| Reserve for losses and loss expenses  | 244,448                 | 106,683          |
| Unearned premiums   | 134,043                 | 204,550          |
| Unearned ceding commissions   | 3,525                   | 11,698           |
| Reinsurance balances payable  | 53,713                  | 40,132           |
| Accounts payable and accrued liabilities                                      | (13,812)                | (5,619)          |
| <b>Net cash provided by operating activities</b>                              | <b>376,628</b>          | <b>389,112</b>   |
| <b>CASH FLOWS USED IN INVESTING ACTIVITIES:</b>                               |                         |                  |
| Purchases of fixed maturity investments                                       | (1,866,738)             | (1,797,082)      |
| Purchases of other invested assets  | (34,461)                | (4,882)          |
| Sales of fixed maturity investments   | 1,738,412               | 1,203,750        |
| Sales of other invested assets  | 102,869                 | 48,967           |
| Net cash used for acquisition   | (44,052)                |                  |
| Changes in securities lending collateral received                             | (43,719)                | (198,775)        |
| Purchase of fixed assets  | (3,643)                 | (4,651)          |
| Change in restricted cash   | (16,606)                | 86,327           |
| <b>Net cash used in investing activities</b>                                  | <b>(167,938)</b>        | <b>(666,346)</b> |
| <b>CASH FLOWS PROVIDED BY FINANCING ACTIVITIES:</b>                           |                         |                  |
| Dividends paid  | (17,592)                | (18,112)         |
| Proceeds from the exercise of stock options                                   | 2,582                   |                  |
| Changes in securities lending collateral                                      | 43,719                  | 198,775          |

|  |            |            |
|--|------------|------------|
| Net cash provided by financing activities                | 28,709     | 180,663    |
| Effect of exchange rate changes on foreign currency cash | (48)       | 325        |
| NET INCREASE (DECREASE) IN CASH AND CASH EQUIVALENTS     | 237,351    | (96,246)   |
| CASH AND CASH EQUIVALENTS, BEGINNING OF PERIOD           | 202,582    | 366,817    |
| CASH AND CASH EQUIVALENTS, END OF PERIOD                 | \$ 439,933 | \$ 270,571 |
| Supplemental disclosure of cash flow information:        |            |            |
| Cash paid for income taxes                               | \$ 5,238   | \$ 2,808   |
| Cash paid for interest expense                           | 18,750     | 19,271     |
| Supplemental disclosure of non-cash flow information:    |            |            |
| Change in balance receivable on sale of investments      | (11,803)   | (36,544)   |
| Change in balance payable on purchase of investments     | (34,408)   | 21         |

See accompanying notes to the unaudited condensed consolidated financial statements.

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**ALLIED WORLD ASSURANCE COMPANY HOLDINGS, LTD**  
**NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS**

(Expressed in thousands of United States dollars, except share, per share and percentage information)

**1. GENERAL**

Allied World Assurance Company Holdings, Ltd ( Holdings ) was incorporated in Bermuda on November 13, 2001. Holdings, through its wholly-owned subsidiaries (collectively, the Company ), provides property and casualty insurance and reinsurance on a worldwide basis through operations in Bermuda, the United States, Ireland and the United Kingdom.

**2. BASIS OF PREPARATION AND CONSOLIDATION**

These unaudited condensed consolidated financial statements include the accounts of Holdings and its subsidiaries and have been prepared in accordance with accounting principles generally accepted in the United States of America ( U.S. GAAP ) for interim financial information and with Article 10 of Regulation S-X as promulgated by the U.S. Securities and Exchange Commission ( SEC ). Accordingly, they do not include all of the information and footnotes required by U.S. GAAP for complete financial statements. In the opinion of management, these unaudited condensed consolidated financial statements reflect all adjustments that are normal and recurring in nature and necessary for a fair presentation of financial position and results of operations as of 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.

The preparation of financial statements in conformity with U.S. GAAP requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates. The significant estimates reflected in the Company s financial statements include, but are not limited to:

The premium estimates for certain reinsurance agreements,

Recoverability of deferred acquisition costs,

The reserve for losses and loss expenses,

Valuation of ceded reinsurance recoverables,

Valuation of financial instruments, and

Determination of other-than-temporary impairment of investments.

Intercompany accounts and transactions have been eliminated on consolidation, and all entities meeting consolidation requirements have been included in the consolidation. Certain immaterial reclassifications in the unaudited condensed consolidated statements of cash flows have been made to the prior period s amounts to conform to the current period s presentation.

These unaudited condensed consolidated financial statements, including these notes, should be read in conjunction with the Company s audited consolidated financials statements, and related notes thereto, included in the Company s Annual Report on Form 10-K for the year ended December 31, 2007.

**3. NEW ACCOUNTING PRONOUNCEMENTS**

In February 2007, the Financial Accounting Standards Board ( FASB ) issued Statement of Financial Accounting Standards ( FAS ) No. 159 The Fair Value Option for Financial Assets and Financial Liabilities Including an amendment of FASB Statement No. 115 ( FAS 159 ). FAS 159 permits entities to choose to measure many financial instruments and certain other items at fair value. The objective is to improve financial reporting by providing entities with the opportunity to mitigate volatility in reported earnings caused by measuring related assets and liabilities differently without having to apply complex hedge accounting provisions. This statement is expected to expand the use of fair value measurement, which is consistent with the FASB s long-term measurement objectives for accounting for financial instruments. The fair value option will permit all entities to choose to measure eligible items at fair value

at specified election dates. An entity shall record unrealized gains and losses on items for which the fair value option has been elected through net income in the statement of operations at each subsequent reporting date. The Company adopted FAS 159 as of January 1, 2008. See Note 7 Fair Value of Financial Instruments regarding the Company's adoption of FAS 159.

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**ALLIED WORLD ASSURANCE COMPANY HOLDINGS, LTD**

**NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS**

(Expressed in thousands of United States dollars, except share, per share and percentage information)

In September 2006, the FASB issued FAS No. 157 Fair Value Measurements ( FAS 157 ). This statement defines fair value, establishes a framework for measuring fair value under U.S. GAAP, and expands disclosures about fair value measurements. FAS 157 applies under other accounting pronouncements that require or permit fair value measurements. FAS 157 is effective for financial statements issued for fiscal years beginning after November 15, 2007, and interim periods within those fiscal years. The Company adopted FAS 157 as of January 1, 2008. See Note 7 Fair Value of Financial Instruments regarding the Company's adoption of FAS 157.

In December 2007, the FASB issued FAS No. 141(R) Business Combinations ( FAS 141(R) ). FAS 141(R) replaces FAS No. 141 Business Combinations ( FAS 141 ), but retains the fundamental requirements in FAS 141 that the acquisition method of accounting be used for all business combinations and for an acquirer to be identified for each business combination. FAS 141(R) requires an acquirer to recognize the assets acquired, the liabilities assumed, and any noncontrolling interest in the acquiree at the acquisition date, measured at their fair values as of that date. FAS 141(R) also requires acquisition-related costs to be recognized separately from the acquisition, requires assets acquired and liabilities assumed arising from contractual contingencies to be recognized at their acquisition-date fair values and requires goodwill to be recognized as the excess of the consideration transferred plus the fair value of any noncontrolling interest in the acquiree at the acquisition date over the fair values of the identifiable net assets acquired. FAS 141(R) applies prospectively to business combinations for which the acquisition date is on or after the beginning of the first annual reporting period beginning on or after December 15, 2008 (January 1, 2009 for calendar year-end companies). The Company is currently evaluating the provisions of FAS 141(R) and its potential impact on future financial statements.

In December 2007, the FASB issued FAS No. 160 Noncontrolling Interests in Consolidated Financial Statements an amendment of ARB No. 51 ( FAS 160 ). FAS 160 amends ARB No. 51 to establish accounting and reporting standards for the noncontrolling interest in a subsidiary and for the deconsolidation of a subsidiary. FAS 160 clarifies that a noncontrolling interest in a subsidiary is an ownership interest in the consolidated entity that should be reported as equity in the consolidated financial statements. FAS 160 requires consolidated net income to be reported at the amounts that include the amounts attributable to both the parent and the noncontrolling interest. This statement also establishes a method of accounting for changes in a parent's ownership interest in a subsidiary that do not result in deconsolidation and for changes in a parent's ownership interest in a subsidiary that does result in deconsolidation. FAS 160 is effective for fiscal years, and interim periods within those fiscal years, beginning on or after December 15, 2008 (January 1, 2009 for calendar year-end companies). The presentation and disclosure requirements of FAS 160 shall be applied retrospectively for all periods presented. The Company is currently evaluating the provisions of FAS 160 and its potential impact on future financial statements.

In March 2008, the FASB issued FAS No. 161 Disclosures about Derivative Instruments and Hedging Activities an amendment of FASB Statement No. 133 ( FAS 161 ). FAS 161 requires enhanced interim and annual disclosures about an entity's derivative and hedging activities including how and why the entity uses derivative instruments, how the entity accounts for its derivatives under FAS Statement No. 133 ( Accounting for Derivative Instruments and Hedging Activities ), and how derivative instruments and related hedged items affect the entity's financial position, financial performance and cash flows. FAS 161 is effective for fiscal years and interim periods beginning after November 15, 2008 (January 1, 2009 for calendar year-end companies). The Company is currently evaluating the provisions of FAS 161 and its potential impact on future financial statements.

In May 2008, the FASB issued FAS No. 162 The Hierarchy of Generally Accepted Accounting Principles ( FAS 162 ). FAS 162 identifies the sources of accounting principles and the framework for selecting principles to be used in the preparation of financial statements of entities that are presented in conformity with U.S. GAAP. The current U.S. GAAP hierarchy is found in auditing literature and is focused on the auditor rather than the entity. FAS 162 shall be effective 60 days after the SEC's approval of the Public Accounting Oversight Board amendments to AU Section 411 *The Meaning of Present Fairly in Conformity with Generally Accepted Accounting Principles*. The Company does not anticipate any impact on future financial statements due to the adoption of FAS 162.

In May 2008, the FASB issued FAS No. 163 Accounting for Financial Guarantee Insurance Contracts an Interpretation of FASB Statement No. 60 ( FAS 163 ). FAS 163 clarifies how FAS 60 Accounting and Reporting by Insurance Enterprises applies to financial guarantee insurance contracts, including the recognition and measurement of premium revenue and claim liabilities. FAS 163 also requires expanded disclosures about financial guarantee insurance contracts. FAS 163 is effective for fiscal years beginning after December 15, 2008 (January 1, 2009 for calendar year-end companies), and interim periods within those fiscal years. The Company currently does not provide financial guarantee insurance, and as such does not anticipate any impact on future financial statements due to the adoption of FAS 163.

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(Expressed in thousands of United States dollars, except share, per share and percentage information)

**4. ACQUISITION OF FINIAL INSURANCE COMPANY**

In November 2007, Allied World Assurance Holdings (U.S.) Inc. entered into an agreement to purchase all of the outstanding stock of Finial Insurance Company (formerly known as Converium Insurance (North America) Inc.) from Finial Reinsurance Company, an affiliate of Berkshire Hathaway Inc. Finial Insurance Company was renamed Allied World Reinsurance Company, is currently licensed to write insurance and reinsurance in 49 states and the District of Columbia and has been used to launch the Company's new reinsurance operations in the United States. This transaction closed on February 29, 2008 for a purchase price of \$12,000 plus the Finial Insurance Company's policyholders' surplus of \$47,082 and an adjustment for the difference between the fair values of investments acquired under U.S. GAAP and statutory reporting of \$300. The total purchase price of \$59,382 was paid in cash from existing resources. As a part of the acquisition, the Company recorded \$12,000 of intangible assets with indefinite lives for the value of the insurance and reinsurance licenses acquired. The remaining assets and liabilities acquired were principally comprised of bonds, at fair value, of \$31,690, cash of \$15,330, other assets of \$1,176, deferred tax liabilities of \$4,344 and a reserve for losses and loss expenses of \$104,914, of which 100% were recorded as reinsurance recoverable as the entire reserve for losses and loss expenses is ceded to National Indemnity Company, an affiliate of Berkshire Hathaway Inc. The Company also recognized goodwill of \$3,530 related to this acquisition, which is included in goodwill and other intangible assets in the unaudited condensed consolidated balance sheets.

**5. INVESTMENTS**

The amortized cost, gross unrealized gains, gross unrealized losses and fair value of total investments by category as of June 30, 2008 and December 31, 2007 are as follows:

|  | <b>Cost</b>  | <b>Gross<br/>Unrealized<br/>Gains</b> | <b>Gross<br/>Unrealized<br/>Losses</b> | <b>Fair Value</b> |
|--|--------------|---------------------------------------|--|-------------------|
| June 30, 2008  |              |                                       |  |                   |
| U.S. government and government agencies              | \$ 2,046,132 | \$ 45,292                             | \$ (914)                               | \$ 2,090,510      |
| Non-U.S. government and government agencies          | 113,526      | 18,197                                | (398)                                  | 131,325           |
| Corporate  | 1,368,520    | 6,799                                 | (13,318)                               | 1,362,001         |
| States, municipalities and political subdivisions    | 63,409       |                                       |  | 63,409            |
| Mortgage backed                                      | 1,969,844    | 15,298                                | (22,998)                               | 1,962,144         |
| Asset backed   | 123,680      | 524                                   | (70)                                   | 124,134           |
| Total fixed maturity investments, available for sale | 5,685,111    | 86,110                                | (37,698)                               | 5,733,523         |
| Hedge funds  | 192,661      |                                       |  | 192,661           |
| Global high-yield bond fund                          | 81,241       |                                       | (3,797)                                | 77,444            |
|  | \$ 5,959,013 | \$ 86,110                             | \$ (41,495)                            | \$ 6,003,628      |
| December 31, 2007                                    |              |                                       |  |                   |
| U.S. government and government agencies              | \$ 1,987,577 | \$ 65,653                             | \$ (6)                                 | \$ 2,053,224      |
| Non-U.S. government and government agencies          | 100,440      | 18,694                                | (291)                                  | 118,843           |
| Corporate  | 1,248,338    | 10,114                                | (5,835)                                | 1,252,617         |
| Mortgage backed                                      | 2,095,561    | 22,880                                | (902)                                  | 2,117,539         |
| Asset backed   | 164,027      | 897                                   | (4)                                    | 164,920           |

|  |              |            |            |              |
|--|--------------|------------|------------|--------------|
| Total fixed maturity investments, available for sale | 5,595,943    | 118,238    | (7,038)    | 5,707,143    |
| Hedge funds  | 215,173      | 27,250     | (988)      | 241,435      |
| Global high-yield bond fund                          | 75,125       | 4,424      |            | 79,549       |
| Other invested asset                                 | 1,160        |            |            | 1,160        |
|  | \$ 5,887,401 | \$ 149,912 | \$ (8,026) | \$ 6,029,287 |

Due to the adoption of FAS 159 as of January 1, 2008, the Company's investment in hedge funds is included in other invested assets, at fair value on the unaudited condensed consolidated balance sheet. As of June 30, 2008, the Company's investment in the global high-yield bond fund is included in other invested assets available for sale, at fair value on the unaudited condensed consolidated balance sheet. As of December 31, 2007, the Company's investment in hedge funds, the global high-yield bond fund and other invested assets were included in other invested assets available for sale, at fair value on the unaudited condensed consolidated balance sheet.

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On a quarterly basis, the Company reviews the carrying value of its investments to determine if a decline in value is considered to be other than temporary. This review involves consideration of several factors including: (i) the significance of the decline in value and the resulting unrealized loss position; (ii) the time period for which there has been a significant decline in value; (iii) an analysis of the issuer of the investment, including its liquidity, business prospects and overall financial position; and (iv) the Company's intent and ability to hold the investment for a sufficient period of time for the value to recover. The identification of potentially impaired investments involves significant management judgment that includes the determination of their fair value and the assessment of whether any decline in value is other than temporary. If the decline in value is determined to be other than temporary, then the Company records a realized loss in the consolidated statements of operations and comprehensive income in the period that it is determined.

As of June 30, 2008, the Company's investment portfolio had gross unrealized losses of \$41,495, that were primarily the result of increases in market interest rates during 2008 for fixed maturity investments with similar duration to our fixed maturity investments, which caused the market price of our fixed maturity investments to decrease. Following the Company's review of the securities in its investment portfolio, 124 and 207 securities were considered to be other-than-temporarily impaired for the three and six months ended June 30, 2008, respectively. Consequently, the Company recorded an other-than-temporary impairment charge of \$25,907 and \$37,277 within net realized investment losses on the unaudited condensed consolidated statements of operations and comprehensive income for the three and six months ended June 30, 2008, respectively. The declines in market value of these securities were primarily due to the write-down of residential and commercial mortgage-backed securities due to the widening of credit spreads caused by the continued decline in the U.S. housing market. All of the residential and commercial mortgage-backed securities written down were AAA rated securities. Given the current market environment for mortgage-backed securities, it is difficult to determine when recovery will occur and as such the Company recorded an other-than-temporary charge. Also included in the other-than-temporary impairment charge during the three months ended June 30, 2008 was a write-down of \$1,000 related to the Company's investment in bonds issued by a commercial bank and a write down of \$1,160 of the other invested asset. The Company performed an analysis of the issuers, including their liquidity, business prospects and overall financial position and concluded that an other-than-temporary charge should be recognized.

During the three and six months ended June 30, 2007, 73 and 375 securities were considered to be other-than-temporarily impaired and as a result the Company recorded an other-than-temporary impairment charge of \$2,941 and \$12,323, within net realized investment losses on the unaudited condensed consolidated statements of operations and comprehensive income for the three and six months ended June 30, 2007, respectively.

During 2007, the Company submitted a redemption notice to sell its shares in the Goldman Sachs Global Equity Opportunities Fund, plc. The Company sold its shares on February 29, 2008 and recognized a loss on the sale of \$278, which is included in net realized investment losses in the unaudited condensed consolidated statements of operations and comprehensive income for the six months ended June 30, 2008.

On June 30, 2007, the Company sold its shares in the Goldman Sachs Liquid Trading Opportunities Fund Offshore, Ltd. (the LTO Fund). The gain on the sale amounted to \$484, which has been included in net realized investment losses in the unaudited condensed consolidated statements of operations and comprehensive income for the three and six months ended June 30, 2007.

**6. DEBT AND FINANCING ARRANGEMENTS**

On July 21, 2006, the Company issued \$500,000 aggregate principal amount of 7.50% Senior Notes due August 1, 2016 (Senior Notes), with interest on the Senior Notes payable on August 1 and February 1 of each year, commencing on February 1, 2007. The Senior Notes were offered by the underwriters at a price of 99.71% of their principal amount, providing an effective yield to investors of 7.54%. The Company used a portion of the proceeds from the Senior Notes to repay the outstanding amount of its then existing credit agreement as well as to provide additional capital to its subsidiaries and for other general corporate purposes.

The Senior Notes can be redeemed by the Company prior to maturity subject to payment of a make-whole premium. The Company has no current expectations of calling the Senior Notes prior to maturity. The Senior Notes contain certain covenants that include: (i) limitations on liens on stock of designated subsidiaries; (ii) limitation as to the disposition of stock of designated subsidiaries; and (iii) limitations on mergers, amalgamations, consolidations or sale of assets. The Company was in compliance with all covenants related to its Senior Notes as of June 30, 2008 and December 31, 2007.

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Events of default include: (i) the default in the payment of any interest or principal on any outstanding notes, and the continuance of such default for a period of 30 days; (ii) the default in the performance, or breach, of any of the covenants in the indenture (other than a covenant added solely for the benefit of another series of debt securities) and continuance of such default or breach for a period of 60 days after the Company has received written notice specifying such default or breach; and (iii) certain events of bankruptcy, insolvency or reorganization. Where an event of default occurs and is continuing, either the trustee of the Senior Notes or the holders of not less than 25% in principal amount of the Senior Notes may have the right to declare that all unpaid principal amounts and accrued interest then outstanding be due and payable immediately.

In March 2007, the Company entered into a collateralized \$750,000 amended letter of credit facility (the Credit Facility ) with Citibank Europe plc. The Credit Facility will be used to issue standby letters of credit.

In November 2007, the Company entered into a \$800,000 five-year senior credit facility (the Facility ) with a syndication of lenders. The Facility consists of a \$400,000 secured letter of credit facility for the issuance of standby letters of credit (the Secured Facility ) and a \$400,000 unsecured facility for the making of revolving loans and for the issuance of standby letters of credit (the Unsecured Facility ). Both the Secured Facility and the Unsecured Facility have options to increase the aggregate commitments by up to \$200,000, subject to approval of the lenders. The Facility will be used for general corporate purposes and to issue standby letters of credit. The Facility contains representations, warranties and covenants customary for similar bank loan facilities, including a covenant to maintain a ratio of consolidated indebtedness to total capitalization as of the last day of each fiscal quarter or fiscal year of not greater than 0.35 to 1.0 and a covenant under the Unsecured Facility to maintain a certain consolidated net worth. In addition, each material insurance subsidiary must maintain a financial strength rating from A.M. Best Company of at least A- under the Unsecured Facility and of at least B++ under the Secured Facility. The Company is in compliance with all covenants under the Facility as of June 30, 2008 and December 31, 2007.

The Company currently has access to up to \$1,550,000 in letters of credit under the two letter of credit facilities described above. These facilities are used to provide security to reinsureds and are collateralized by the Company, at least to the extent of letters of credit outstanding at any given time. As of June 30, 2008 and December 31, 2007, there were outstanding letters of credit totaling \$887,018 and \$922,206, respectively, under the two facilities. Collateral committed to support the letter of credit facilities was \$1,188,937 as of June 30, 2008, compared to \$1,170,731 as of December 31, 2007.

At this time, the Company uses trust accounts primarily to meet security requirements for inter-company and certain related-party reinsurance transactions. The Company also has cash and cash equivalents and investments on deposit with various state or government insurance departments or pledged in favor of ceding companies in order to comply with relevant insurance regulations. As of June 30, 2008, total trust account deposits were \$735,807 compared to \$802,737 as of December 31, 2007.

**7. FAIR VALUE OF FINANCIAL INSTRUMENTS**

The Company adopted FAS 159 as of January 1, 2008, and has elected the fair value option for its hedge fund investments, which are classified as other invested assets, at fair value in the unaudited condensed consolidated balance sheets. At the time of adoption, the fair value and carrying value of the hedge fund investments were \$241,435 and the net unrealized gain was \$26,262. These funds are comprised of liquid portfolios that have no fixed maturity with the objective of achieving current income and capital appreciation. The Company has elected the fair value option for its hedge fund investments as the Company believes that recognizing changes in the fair value of the hedge funds in the consolidated statements of operations and comprehensive income each period better reflects the results of the Company's investment in the hedge funds rather than recognizing changes in fair value in accumulated other comprehensive income.

Upon adoption of FAS 159, the Company reclassified the net unrealized gain related to the hedge funds of \$26,262 from accumulated other comprehensive income and recorded a cumulative-effect adjustment in retained earnings. There was no net deferred tax liability associated with the net unrealized gain as the hedge fund investments are held

by Holdings Bermuda insurance subsidiary, which pays no income tax. Any subsequent change in unrealized gain or loss of other invested assets, at fair value will be recognized in the consolidated statements of operations and comprehensive income and included in net realized investment gains or losses. Prior to the adoption of FAS 159 any change in unrealized gain or loss was included in accumulated other comprehensive income in the unaudited condensed consolidated balance sheet. The net gain recognized for the change in fair value of the hedge fund investments in the unaudited condensed consolidated statements of operations and comprehensive income during the three months ended June 30, 2008 was \$621. The net loss recognized for the change in fair value of the hedge fund investments in the

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unaudited condensed consolidated statements of operations and comprehensive income during the six months ended June 30, 2008 was \$11,866.

The Company adopted FAS 157 as of January 1, 2008. This statement defines fair value and establishes a framework for measuring fair value under U.S. GAAP. FAS 157 defines fair value as the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date. FAS 157 also established a three-level valuation hierarchy for disclosure of fair value measurements. The valuation hierarchy is based upon whether the inputs to the valuation of an asset or liability are observable or unobservable in the market at the measurement date, with quoted market prices being the highest level (Level 1) and unobservable inputs being the lowest level (Level 3). A fair value measurement will fall within the level of the hierarchy based on the input that is significant to determining such measurement. The three levels are defined as follows:

**Level 1:** Observable inputs to the valuation methodology that are quoted prices (unadjusted) for identical assets or liabilities in active markets.

**Level 2:** Observable inputs to the valuation methodology other than quoted market prices (unadjusted) for identical assets or liabilities in active markets. Level 2 inputs include quoted prices for similar assets and liabilities in active markets, quoted prices for identical assets in markets that are not active and inputs other than quoted prices that are observable for the asset or liability, either directly or indirectly, for substantially the full term of the asset or liability.

**Level 3:** Inputs to the valuation methodology that are unobservable for the asset or liability.

The following table shows the fair value of the Company's financial instruments and where in the FAS 157 fair value hierarchy the fair value measurements are included as of June 30, 2008.

|   | Carrying<br>amount | Total fair<br>value | Fair value measurement using:   |   |  |
|---|--------------------|---------------------|---|---|--|
|   |                    |                     | Quoted<br>prices<br>in active<br>markets<br>for<br>identical<br>assets<br>(Level 1) | Significant<br>other<br>observable<br>inputs<br>(Level 2) | Significant<br>unobservable<br>inputs<br>(Level 3) |
| U.S. government and<br>government agencies              | \$ 2,090,510       | \$ 2,090,510        | \$ 957,331  | \$ 1,133,179  | \$   |
| Non-U.S. government and<br>government agencies          | 131,325            | 131,325             |   | 131,325   |  |
| Corporate   | 1,362,001          | 1,362,001           |   | 1,362,001   |  |
| States, municipalities and<br>political subdivisions    | 63,409             | 63,409              |   | 63,409  |  |
| Mortgage backed   | 1,962,144          | 1,962,144           |   | 1,962,144   |  |
| Asset backed  | 124,134            | 124,134             |   | 124,134   |  |
| Total fixed maturity<br>investments, available for sale | 5,733,523          | 5,733,523           |   |   |  |

|  |           |           |         |
|--|-----------|-----------|---------|
| Total other invested assets,<br>available for sale | 77,444    | 77,444    | 77,444  |
| Total other invested assets, fair<br>value         | 192,661   | 192,661   | 192,661 |
| Total investments                                  | 6,003,628 | 6,003,628 |         |
| Senior notes                                       | 498,738   | 474,700   | 474,700 |

The following describes the valuation techniques used by the Company to determine the fair value of financial instruments held as of June 30, 2008.

**U.S. government and U.S. government agencies:** Comprised primarily of bonds issued by the U.S. Treasury, the Federal Home Loan Bank, the Federal Home Loan Mortgage Corporation and the Federal National Mortgage Association. The fair values of the Company's U.S. government securities are based on quoted market prices in active markets, and are included in the Level 1 fair value hierarchy. The Company believes the market for U.S. Treasury securities is an actively traded market given the high level of daily trading volume. The fair values of U.S. government agency securities are priced using the spread above the risk-free yield curve. As

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the yields for the risk-free yield curve are observable market inputs, the fair values of U.S. government agency securities are included in the Level 2 fair value hierarchy.

**Non-U.S. government and government agencies:** Comprised of fixed income obligations of non-U.S. governmental entities. The fair values of these securities are based on broker-dealer quotes, and are included in the Level 2 fair value hierarchy.

**Corporate:** Comprised of bonds issued by corporations that on acquisition are rated BBB-/Baa3 or higher provided that, in aggregate, corporate bonds with ratings of BBB-/Baa3 do not constitute more than 5% of the market value of the Company's fixed income securities and are diversified across a wide range of issuers and industries. The fair values of corporate bonds that are short-term are priced using spread above the London Interbank Offering Rate yield curve, and the fair value of corporate bonds that are long-term are priced using the spread above the risk-free yield curve. The spreads are sourced from dealer quotes, trade prices and the new issue market. As the inputs used to price corporate bonds are observable market inputs, the fair values of corporate bonds are included in the Level 2 fair value hierarchy.

**States, municipalities and political subdivisions:** Comprised of fixed income obligations of U.S. domiciled state and municipality entities. The fair values of these securities are based on broker-dealer quotes and the new issue market, and are included in the Level 2 fair value hierarchy.

**Mortgage-backed:** Principally comprised of AAA-rated pools of residential and commercial mortgages originated by both agency (such as the Federal National Mortgage Association) and non-agency originators. The fair values of mortgage-backed securities originated by U.S. government agencies and non-U.S. government agencies are based on a pricing model that incorporates prepayment speeds and spreads to determine appropriate average life of mortgage-backed securities. The spreads are sourced from dealer quotes, trade prices and the new issue market. As the inputs used to price the mortgage-backed securities are observable market inputs, the fair values of these securities are included in the Level 2 fair value hierarchy.

**Asset-backed:** Comprised of primarily AAA-rated bonds backed by pools of automobile loan receivables, home equity loans and credit card receivables originated by a variety of financial institutions. The fair values of asset-backed securities are priced using prepayment speed and spread inputs that are sourced from the new issue market. As the inputs used to price the asset-backed securities are observable market inputs, the fair values of these securities are included in the Level 2 fair value hierarchy.

**Other invested assets available for sale:** Comprised of an open-end global high-yield bond fund that invests in non-investment grade bonds issued by various issuers and industries. The fair value of the global high-yield bond fund is based on the net asset value as reported by the fund manager. The net asset value is an observable input as it is quoted on a market exchange on a daily basis. The fair value of the global high-yield bond fund is included in the Level 2 fair value hierarchy.

**Other invested assets, at fair value:** Comprised of several hedge funds with objectives to seek attractive long-term returns with lower volatility by investing in a range of diversified investment strategies. The fair values of the hedge funds are based on the net asset value of the funds as reported by the fund manager less a liquidity discount where hedge fund investments contain lock-up provisions that prevent immediate dissolution. The Company considers these lock-up provisions to be obligations that market participants would assign a value to in determining the price of these hedge funds, and as such have considered these obligations in determining the fair value measurement of the related hedge funds. The liquidity discount was estimated by calculating the value of a protective put over the lock-up period. The protective put measures the risk of holding a restricted asset over a certain time period. The Company used the Black-Scholes option-pricing model to estimate the value of the protective put for each hedge fund. The aggregate liquidity discount recognized during the three and six months ended June 30, 2008 was \$54 and \$269, respectively. The net asset value and the liquidity discount are significant unobservable inputs, and as such the fair values of the Company's hedge funds are included in the Level 3 fair value hierarchy.

**Senior notes:** The fair value of the senior notes is based on the price as published by Bloomberg, which was 94.94% of their principal amount, providing an effective yield of 8.37% as of June 30, 2008. The fair value of the senior notes is included in the Level 2 fair value hierarchy.

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The following is a reconciliation of the beginning and ending balance of financial instruments using significant unobservable inputs (Level 3) for the three and six months ended June 30, 2008.

|  | Fair value measurement using significant unobservable inputs (Level 3):<br>hedge funds |                                   |
|--|--|-----------------------------------|
|  | Three months ended<br>June 30,<br>2008   | Six months ended<br>June 30, 2008 |
| Opening balance                                | \$ 191,195   | \$ 241,435                        |
| Total gains or losses included in earnings:    |  |                                   |
| Realized gains                                 | 4,884  | 6,113                             |
| Change in fair value of hedge fund investments | 621  | (11,866)                          |
| Purchases or sales                             | (4,039)  | (43,021)                          |
| Transfers in and/or out of Level 3             |  |                                   |
| Ending balance, June 30, 2008                  | \$ 192,661   | \$ 192,661                        |

**8. INCOME TAXES**

Certain subsidiaries of Holdings file U.S. federal income tax returns and various U.S. state income tax returns, as well as income tax returns in the U.K. and Ireland. The tax years open to examination by the U.S. Internal Revenue Service for the U.S. subsidiaries are the fiscal years from 2004 to the present. The tax years open to examination by the Inland Revenue for the U.K. branches are fiscal years from 2004 to the present. The tax years open to examination by Irish Revenue Commissioners for the Irish subsidiaries are the fiscal years from 2003 to the present. To the best of the Company's knowledge, there are no examinations pending by the U.S. Internal Revenue Service, the Inland Revenue or the Irish Revenue Commissioners.

Management has deemed all material tax provisions to have a greater than 50% likelihood of being sustained based on technical merits if challenged. The Company has not recorded any interest or penalties during the three and six months ended June 30, 2008 and 2007 and has not accrued any payment of interest and penalties as of June 30, 2008 and December 31, 2007.

The Company does not expect any material unrecognized tax benefits within 12 months of January 1, 2008.

**9. SHAREHOLDERS' EQUITY****a) Authorized shares**

The authorized share capital of Holdings as of June 30, 2008 and December 31, 2007 was \$10,000.

The issued share capital consists of the following:

|   | June 30, 2008 | December 31, 2007 |
|---|---------------|-------------------|
| Common shares issued and fully paid, par value \$0.03 per share | 48,977,635    | 48,741,927        |
| Share capital at end of period                                  | \$ 1,469      | \$ 1,462          |

As of June 30, 2008, there were outstanding 35,250,977 voting common shares and 13,726,658 non-voting common shares.

***b) Dividends***

In February 2008, the Company declared a quarterly dividend of \$0.18 per common share payable on April 3, 2008 to shareholders of record on March 18, 2008. The total dividend paid amounted to \$8,788. In May 2008, the Company declared a quarterly dividend of \$0.18 per common share, payable on June 12, 2008 to shareholders of record on May 27, 2008. The total dividend paid amounted to \$8,804.

In March 2007, the Company declared a quarterly dividend of \$0.15 per common share payable on April 5, 2007 to shareholders of record on March 20, 2007. The total dividend payable amounted to \$9,052. In May 2007, the Company declared a quarterly

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dividend of \$0.15 per common share that was paid on June 14, 2007 to shareholders of record on May 29, 2007. The total dividend paid amounted to \$9,060.

**10. EMPLOYEE BENEFIT PLANS****a) Employee option plan**

In 2001, the Company implemented the Allied World Assurance Company Holdings, Ltd Second Amended and Restated 2001 Employee Stock Option Plan (the Plan). Under the Plan, up to 4,000,000 common shares of Holdings may be issued. Holdings has filed a registration statement on Form S-8 under the Securities Act of 1933, as amended, to register common shares issued or reserved for issuance under the Plan. These options are exercisable in certain limited conditions, expire after 10 years, and generally vest pro-rata over four years from the date of grant. The exercise price of options issued are determined by the compensation committee of the Board of Directors but shall not be less than 100% of the fair market value of the common shares of Holdings on the date the option award is granted.

|                                    | <b>Six months ended June 30, 2008</b> |  |
|------------------------------------|---------------------------------------|--|
|                                    | <b>Options</b>                        | <b>Weighted<br/>Average<br/>Exercise Price</b> |
| Outstanding at beginning of period | 1,223,875                             | \$ 31.03                                       |
| Granted                            | 270,300                               | 43.15  |
| Exercised                          | (90,081)                              | 27.39  |
| Forfeited                          | (7,252)                               | 37.79  |
| Outstanding at end of period       | 1,396,842                             | \$ 33.57                                       |

Assumptions used in the option-pricing model for the options granted during the six months ended June 30, 2008:

|   | <b>Options<br/>granted during<br/>the six months<br/>ended<br/>June 30, 2008</b> |
|---|--|
| Expected term of option                   | 6.25 years   |
| Weighted average risk-free interest rate  | 2.52%  |
| Expected volatility                       | 23.46%   |
| Dividend yield                            | 1.66%  |
| Weighted average fair value on grant date | \$9.78   |

There is limited historical data available for the Company to base the expected term of the options. As these options are considered to have standard characteristics, the Company has used the simplified method to determine the expected life as set forth in the SEC's Staff Accounting Bulletins 107 and 110. Likewise, as the Company became a public company in July 2006, there is limited historical data available on which to base the volatility of its common shares. As such, the Company used the average of five volatility statistics from comparable companies, as well as the Company's volatility, in order to derive the volatility value above. The Company has assumed a forfeiture rate of 4.91% in determining the compensation expense over the service period.

Compensation expense of \$632 and \$627 relating to the options has been recognized in general and administrative expenses in the Company's unaudited condensed consolidated statements of operations and comprehensive income for the three months ended June 30, 2008 and 2007, respectively. Compensation expense of \$1,180 and \$1,316 relating to

the options has been recognized in general and administrative expenses in the Company's unaudited condensed consolidated statements of operations and comprehensive income for the six months ended June 30, 2008 and 2007, respectively. As of June 30, 2008 and December 31, 2007, the Company recorded in additional paid-in capital on the unaudited condensed consolidated balance sheets amounts of \$15,941 and \$11,840, respectively, in connection with all options granted.

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**b) Stock incentive plan**

In 2004, the Company implemented the Allied World Assurance Company Holdings, Ltd Second Amended and Restated 2004 Stock Incentive Plan (the "Stock Incentive Plan"). The Stock Incentive Plan provides for grants of restricted stock, restricted stock units ("RSUs"), dividend equivalent rights and other equity-based awards. A total of 2,000,000 common shares may be issued under the Stock Incentive Plan. To date only RSUs have been granted. These RSUs generally vest pro-rata over four years from the date of grant or in the fourth or fifth year from the original grant date.

|   | <b>Six months ended June 30, 2008</b> |   |
|---|---------------------------------------|---|
|   | <b>RSUs</b>                           | <b>Weighted<br/>Average<br/>Grant Date Fair<br/>Value</b> |
| Outstanding RSUs at beginning of period | 820,890                               | \$ 36.09  |
| RSUs granted                            | 242,979                               | 43.23   |
| RSUs fully vested                       | (139,664)                             | 37.27   |
| RSUs forfeited                          | (31,210)                              | 36.13   |
| Outstanding RSUs at end of period       | 892,995                               | \$ 37.85  |

Compensation expense of \$2,276 and \$1,859 relating to the issuance of the RSUs has been recognized in general and administrative expenses in the Company's unaudited condensed consolidated statements of operations and comprehensive income for the three months ended June 30, 2008 and 2007, respectively. Compensation expense of \$3,752 and \$3,846 relating to the issuance of the RSUs has been recognized in general and administrative expenses in the Company's unaudited condensed consolidated statements of operations and comprehensive income for the six months ended June 30, 2008 and 2007, respectively. The compensation expense for the RSUs is based on the fair market value of Holdings' common shares at the time of grant. The Company has assumed a forfeiture rate of 4.30% in determining the compensation expense over the service period. As of June 30, 2008 and December 31, 2007, the Company has recorded \$16,013 and \$12,337, respectively, in additional paid-in capital on the unaudited condensed consolidated balance sheets in connection with the RSUs awarded.

**c) Long-term incentive plan**

In 2006, the Company implemented the Allied World Assurance Company Holdings, Ltd Long-Term Incentive Plan ("LTIP"), which provides for performance based equity awards to key employees in order to promote the long-term growth and profitability of the Company. Each award represents the right to receive a number of common shares in the future, based upon the achievement of established performance criteria during the applicable performance period. A total of 2,000,000 common shares may be issued under the LTIP. The awards granted in 2008 will generally vest after the fiscal year ending December 31, 2010, or in the fourth or fifth year from the original grant date, subject to the achievement of the performance conditions and terms of the LTIP.

|  | <b>Six months ended June 30, 2008</b> |   |
|--|---------------------------------------|---|
|  | <b>LTIP</b>                           | <b>Weighted<br/>Average<br/>Grant Date Fair<br/>Value</b> |
| Outstanding LTIP awards at beginning of period | 590,834                               | \$ 40.09  |
| LTIP awards granted                            | 507,152                               | 43.27   |

|  |           |          |
|--|-----------|----------|
| LTIP awards subjected to accelerated vesting | (11,667)  | 34.00    |
| LTIP awards forfeited                        | (20,000)  | 43.40    |
| Outstanding LTIP awards at end of period     | 1,066,319 | \$ 41.61 |

Compensation expense of \$4,563 and \$2,960 relating to the LTIP has been recognized in general and administrative expenses in the Company's unaudited condensed consolidated statements of operations and comprehensive income for the three months ended June 30, 2008 and 2007, respectively. Compensation expense of \$8,693 and \$6,601 relating to the LTIP has been recognized in general and administrative expenses in the Company's unaudited condensed consolidated statements of operations and comprehensive income for the six months ended June 30, 2008 and 2007, respectively. The compensation expense for the LTIP is based on the fair market value of Holdings' common shares at the time of grant. As of June 30, 2008 and December 31, 2007, the

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(Expressed in thousands of United States dollars, except share, per share and percentage information)

Company has recorded \$25,079 and \$16,403, respectively, in additional paid-in capital on the unaudited condensed consolidated balance sheets in connection with the LTIP awards.

In calculating the compensation expense, and in the determination of share equivalents for the purpose of calculating diluted earnings per share, it is estimated for the LTIP awards granted in 2006 and 2007 that the maximum performance goals as set by the LTIP are likely to be achieved over the performance period. For the LTIP awards granted in 2008 it is estimated that the target performance goals as set by the LTIP are likely to be achieved over the performance period. Based on the target performance goals the LTIP awards granted in 2008 are expensed at 100% of the fair market value of Holdings common shares on the date of grant. The expense is recognized over the performance period.

The following table shows the stock compensation expense relating to the stock options, RSUs and LTIP awards for the three and six months ended June 30, 2008 and 2007.

|                                  | <b>Three Months Ended<br/>June 30,</b> |             | <b>Six Months Ended<br/>June 30,</b> |             |
|----------------------------------|--|-------------|--------------------------------------|-------------|
|                                  | <b>2008</b>                            | <b>2007</b> | <b>2008</b>                          | <b>2007</b> |
| Stock options                    | \$ 632                                 | \$ 627      | \$ 1,180                             | \$ 1,316    |
| RSUs                             | 2,276                                  | 1,859       | 3,752                                | 3,846       |
| LTIP                             | 4,563                                  | 2,960       | 8,693                                | 6,601       |
| Total stock compensation expense | \$ 7,471                               | \$ 5,446    | \$ 13,625                            | \$ 11,763   |

**11. EARNINGS PER SHARE**

The following table sets forth the comparison of basic and diluted earnings per share:

|   | <b>Three Months Ended<br/>June 30,</b> |             | <b>Six Months Ended<br/>June 30,</b> |             |
|---|--|-------------|--------------------------------------|-------------|
|   | <b>2008</b>                            | <b>2007</b> | <b>2008</b>                          | <b>2007</b> |
| Basic earnings per share                      |  |             |                                      |             |
| Net income                                    | \$ 79,205                              | \$ 123,287  | \$ 210,150                           | \$ 237,208  |
| Weighted average common shares<br>outstanding | 48,897,931                             | 60,397,591  | 48,585,015                           | 60,028,523  |
| Basic earnings per share                      | \$ 1.62                                | \$ 2.04     | \$ 4.33                              | \$ 3.95     |
|   |  |             |                                      |             |
|   | <b>Three Months Ended<br/>June 30,</b> |             | <b>Six Months Ended<br/>June 30,</b> |             |
|   | <b>2008</b>                            | <b>2007</b> | <b>2008</b>                          | <b>2007</b> |
| Diluted earnings per share                    |  |             |                                      |             |
| Net income                                    | \$ 79,205                              | \$ 123,287  | \$ 210,150                           | \$ 237,208  |
| Weighted average common shares<br>outstanding | 48,897,931                             | 60,397,591  | 48,585,015                           | 60,028,523  |
| Share equivalents:                            |  |             |                                      |             |
| Warrants and options                          | 1,125,506                              | 1,833,078   | 1,436,960                            | 1,651,842   |
| Restricted stock units                        | 327,128                                | 340,305     | 391,518                              | 351,913     |
| LTIP awards                                   | 523,147                                | 303,261     | 600,140                              | 244,732     |

|   |            |            |            |            |
|---|------------|------------|------------|------------|
| Weighted average common shares and common share equivalents outstanding diluted | 50,873,712 | 62,874,235 | 51,013,633 | 62,277,010 |
| Diluted earnings per share  | \$ 1.56    | \$ 1.96    | \$ 4.12    | \$ 3.81    |

For the three-month period ended June 30, 2008, a weighted average of 493,533 employee stock options were considered antidilutive and were therefore excluded from the calculation of the diluted earnings per share. For the six-month period ended June 30, 2008, a weighted average of 28,000 employee stock options were considered antidilutive and were therefore excluded from the calculation of the diluted earnings per share.

For the three-month period ended June 30, 2007, a weighted average of 6,500 employee stock options were considered antidilutive and were therefore excluded from the calculation of the diluted earnings per share. For the six-month period ended June 30, 2007, a weighted average of 3,250 employee stock options were considered antidilutive and were therefore excluded from the calculation of the diluted earnings per share.



**Table of Contents****ALLIED WORLD ASSURANCE COMPANY HOLDINGS, LTD****NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS**

(Expressed in thousands of United States dollars, except share, per share and percentage information)

**12. SEGMENT INFORMATION**

The determination of reportable segments is based on how senior management monitors the Company's underwriting operations. The Company measures the results of its underwriting operations under three major business categories, namely property insurance, casualty insurance and reinsurance. All product lines fall within these classifications.

The property segment provides direct coverage of physical property and energy-related risks. These risks generally relate to tangible assets and are considered "short-tail" in that the time from a claim being advised to the date when the claim is settled is relatively short. The casualty segment provides direct coverage of general liability risks, professional liability risks and healthcare risks. Such risks are "long-tail" in nature since the emergence and settlement of a claim can take place many years after the policy period has expired. The reinsurance segment includes any reinsurance of other companies in the insurance and reinsurance industries. The Company writes reinsurance on both a treaty and facultative basis.

Responsibility and accountability for the results of underwriting operations are assigned by major line of business on a worldwide basis. Because the Company does not manage its assets by segment, investment income, interest expense and total assets are not allocated to individual reportable segments.

Management measures results for each segment on the basis of the loss and loss expense ratio, acquisition cost ratio, general and administrative expense ratio and the combined ratio. The loss and loss expense ratio is derived by dividing net losses and loss expenses by net premiums earned. The acquisition cost ratio is derived by dividing acquisition costs by net premiums earned. The general and administrative expense ratio is derived by dividing general and administrative expenses by net premiums earned. The combined ratio is the sum of the loss and loss expense ratio, the acquisition cost ratio and the general and administrative expense ratio.

The following table provides a summary of the segment results for the three and six months ended June 30, 2008 and 2007.

| <b>Three Months Ended June 30, 2008</b>  | <b>Property</b> | <b>Casualty</b> | <b>Reinsurance</b> | <b>Total</b> |
|--|-----------------|-----------------|--------------------|--------------|
| Gross premiums written                   | \$ 131,973      | \$ 178,212      | \$ 136,599         | \$ 446,784   |
| Net premiums written                     | 54,289          | 129,335         | 136,626            | 320,250      |
| Net premiums earned                      | 44,164          | 105,604         | 119,108            | 268,876      |
| Net losses and loss expenses             | (62,593)        | (41,764)        | (73,727)           | (178,084)    |
| Acquisition costs                        | 2,976           | (5,229)         | (24,012)           | (26,265)     |
| General and administrative expenses      | (10,963)        | (24,286)        | (11,131)           | (46,380)     |
| Underwriting (loss) income               | (26,416)        | 34,325          | 10,238             | 18,147       |
| Net investment income                    |                 |                 |                    | 72,345       |
| Net realized investment losses           |                 |                 |                    | (4,393)      |
| Interest expense                         |                 |                 |                    | (9,513)      |
| Foreign exchange gain                    |                 |                 |                    | 399          |
| Income before income taxes               |                 |                 |                    | \$ 76,985    |
| Loss and loss expense ratio              | 141.7%          | 39.5%           | 61.9%              | 66.2%        |
| Acquisition cost ratio                   | (6.7)%          | 5.0%            | 20.2%              | 9.8%         |
| General and administrative expense ratio | 24.8%           | 23.0%           | 9.3%               | 17.2%        |
| Combined ratio                           | 159.8%          | 67.5%           | 91.4%              | 93.2%        |



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**ALLIED WORLD ASSURANCE COMPANY HOLDINGS, LTD**  
**NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS**  
(Expressed in thousands of United States dollars, except share, per share and percentage information)

**Three Months Ended June 30, 2007**

|  | <b>Property</b> | <b>Casualty</b> | <b>Reinsurance</b> | <b>Total</b> |
|--|-----------------|-----------------|--------------------|--------------|
| Gross premiums written                   | \$ 156,463      | \$ 188,091      | \$ 185,995         | \$ 530,549   |
| Net premiums written                     | 58,947          | 141,620         | 186,020            | 386,587      |
| Net premiums earned                      | 48,318          | 123,715         | 131,086            | 303,119      |
| Net losses and loss expenses             | (34,149)        | (60,908)        | (81,168)           | (176,225)    |
| Acquisition costs                        | (105)           | (5,033)         | (26,734)           | (31,872)     |
| General and administrative expenses      | (8,163)         | (16,711)        | (9,558)            | (34,432)     |
| Underwriting income                      | 5,901           | 41,063          | 13,626             | 60,590       |
| Net investment income                    |                 |                 |                    | 73,937       |
| Net realized investment losses           |                 |                 |                    | (1,481)      |
| Interest expense                         |                 |                 |                    | (9,482)      |
| Foreign exchange loss                    |                 |                 |                    | (532)        |
| Income before income taxes               |                 |                 |                    | \$ 123,032   |
| Loss and loss expense ratio              | 70.7%           | 49.2%           | 61.9%              | 58.1%        |
| Acquisition cost ratio                   | 0.2%            | 4.1%            | 20.4%              | 10.5%        |
| General and administrative expense ratio | 16.9%           | 13.5%           | 7.3%               | 11.4%        |
| Combined ratio                           | 87.8%           | 66.8%           | 89.6%              | 80.0%        |

**Six Months Ended June 30, 2008**

|  | <b>Property</b> | <b>Casualty</b> | <b>Reinsurance</b> | <b>Total</b> |
|--|-----------------|-----------------|--------------------|--------------|
| Gross premiums written                   | \$ 218,033      | \$ 299,274      | \$ 326,350         | \$ 843,657   |
| Net premiums written                     | 100,886         | 219,970         | 325,966            | 646,822      |
| Net premiums earned                      | 87,745          | 214,718         | 239,485            | 541,948      |
| Net losses and loss expenses             | (77,340)        | (114,879)       | (129,362)          | (321,581)    |
| Acquisition costs                        | 2,427           | (8,499)         | (47,033)           | (53,105)     |
| General and administrative expenses      | (21,457)        | (47,994)        | (20,200)           | (89,651)     |
| Underwriting (loss) income               | (8,625)         | 43,346          | 42,890             | 77,611       |
| Net investment income                    |                 |                 |                    | 149,276      |
| Net realized investment losses           |                 |                 |                    | (928)        |
| Interest expense                         |                 |                 |                    | (19,023)     |
| Foreign exchange loss                    |                 |                 |                    | (77)         |
| Income before income taxes               |                 |                 |                    | \$ 206,859   |
| Loss and loss expense ratio              | 88.1%           | 53.5%           | 54.0%              | 59.3%        |
| Acquisition cost ratio                   | (2.8)%          | 4.0%            | 19.6%              | 9.8%         |
| General and administrative expense ratio | 24.5%           | 22.4%           | 8.4%               | 16.5%        |
| Combined ratio                           | 109.8%          | 79.9%           | 82.0%              | 85.6%        |

| <b><u>Six Months Ended June 30, 2007</u></b> | <b>Property</b> | <b>Casualty</b> | <b>Reinsurance</b> | <b>Total</b> |
|--|-----------------|-----------------|--------------------|--------------|
| Gross premiums written                       | \$ 258,328      | \$ 313,280      | \$ 397,347         | \$ 968,955   |
| Net premiums written                         | 105,079         | 242,265         | 397,087            | 744,431      |
| Net premiums earned                          | 92,809          | 248,124         | 248,752            | 589,685      |
| Net losses and loss expenses                 | (41,014)        | (151,275)       | (149,931)          | (342,220)    |
| Acquisition costs                            | (437)           | (11,071)        | (49,560)           | (61,068)     |
| General and administrative expenses          | (15,920)        | (32,018)        | (19,697)           | (67,635)     |
| Underwriting income                          | 35,438          | 53,760          | 29,564             | 118,762      |
| Net investment income                        |                 |                 |                    | 146,585      |
| Net realized investment losses               |                 |                 |                    | (7,965)      |
| Interest expense                             |                 |                 |                    | (18,856)     |
| Foreign exchange loss                        |                 |                 |                    | (564)        |
| Income before income taxes                   |                 |                 |                    | \$ 237,962   |
| Loss and loss expense ratio                  | 44.2%           | 61.0%           | 60.3%              | 58.0%        |
| Acquisition cost ratio                       | 0.4%            | 4.4%            | 19.9%              | 10.4%        |
| General and administrative expense ratio     | 17.2%           | 12.9%           | 7.9%               | 11.5%        |
| Combined ratio                               | 61.8%           | 78.3%           | 88.1%              | 79.9%        |

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**Table of Contents****ALLIED WORLD ASSURANCE COMPANY HOLDINGS, LTD****NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS**

(Expressed in thousands of United States dollars, except share, per share and percentage information)

The following table shows an analysis of the Company's net premiums written by geographic location of the Company's subsidiaries for the three and six months ended June 30, 2008 and 2007. All inter-company premiums have been eliminated.

|                            | <b>Three Months Ended</b> |             | <b>Six Months Ended</b> |             |
|----------------------------|---------------------------|-------------|-------------------------|-------------|
|                            | <b>June 30,</b>           |             | <b>June 30,</b>         |             |
|                            | <b>2008</b>               | <b>2007</b> | <b>2008</b>             | <b>2007</b> |
| Bermuda                    | \$ 191,022                | \$ 302,480  | \$ 454,564              | \$ 593,082  |
| United States              | 79,238                    | 34,203      | 102,358                 | 57,113      |
| Europe                     | 49,990                    | 49,904      | 89,900                  | 94,236      |
| Total net premiums written | \$ 320,250                | \$ 386,587  | \$ 646,822              | \$ 744,431  |

**13. COMMITMENTS AND SUBSEQUENT EVENTS**

Holdings entered into a definitive agreement and plan of merger (the Merger Agreement) on June 27, 2008 with Allied World Merger Company, a newly formed Delaware corporation and an indirect wholly-owned subsidiary of the Company (Merger Sub), and Darwin Professional Underwriters, Inc. (Darwin), a Delaware corporation. The Merger Agreement provides for the merger of Merger Sub with and into Darwin, with Darwin continuing as the surviving corporation and an indirect wholly-owned subsidiary of Holdings. Darwin offers a wide array of specialty and primary professional lines coverages, including a healthcare professional liability franchise and a niche errors and omissions division.

Pursuant to the terms of the Merger Agreement, stockholders of Darwin will be entitled to receive \$32.00 in cash for each share of Darwin common stock in exchange for 100% of their interests in Darwin. Also, each outstanding Darwin stock option will fully vest and be converted into an amount in cash equal to (i) the excess, if any, of \$32.00 over the exercise price per share of the stock option, multiplied by (ii) the total number of shares of Darwin common stock subject to the stock option. In addition, each outstanding Darwin restricted share will fully vest and be converted into the right to receive \$32.00 in cash per restricted share, and each outstanding director share unit will be converted into the right to receive \$32.00 in cash per share unit. The total cash consideration to be paid by the Company will be approximately \$550,000. The \$32.00 per share purchase price is subject to a downward adjustment in the event that certain representations by Darwin in the Merger Agreement with respect to its capitalization are breached and, as a result of such breach, the aggregate consideration payable by the Company in the merger is increased by more than \$1,000. The transaction is expected to be completed during the fourth quarter of 2008 subject to customary closing conditions, including regulatory approvals. The transaction will be accounted for as a purchase. Under the purchase method of accounting for a business combination, the assets and liabilities of Darwin will be recorded at their fair values on the acquisition date.

On August 7, 2008, the Company declared a quarterly dividend of \$0.18 per common share, payable on September 11, 2008 to shareholders of record on August 26, 2008.

**Table of Contents****Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations.**

*The following discussion and analysis of our financial condition and results of operations should be read in conjunction with our condensed consolidated financial statements and related notes included elsewhere in this Form 10-Q. References in this Form 10-Q to the terms we, us, our, the company or other similar terms mean the consolidated operations of Allied World Assurance Company Holdings, Ltd and its subsidiaries, unless the context requires otherwise. References in this Form 10-Q to the term Holdings means Allied World Assurance Company Holdings, Ltd only.*

**Note on Forward-Looking Statement**

This Form 10-Q and other publicly available documents may include, and our officers and representatives may from time to time make, projections concerning financial information and statements concerning future economic performance and events, plans and objectives relating to management, operations, products and services, and assumptions underlying these projections and statements. These projections and statements are forward-looking statements within the meaning of The Private Securities Litigation Reform Act of 1995 and are not historical facts but instead represent only our belief regarding future events, many of which, by their nature, are inherently uncertain and outside our control. These projections and statements may address, among other things, our strategy for growth, product development, financial results and reserves. Actual results and financial condition may differ, possibly materially, from these projections and statements and therefore you should not place undue reliance on them. Factors that could cause our actual results to differ, possibly materially, from those in the specific projections and statements are discussed throughout this Management's Discussion and Analysis of Financial Condition and Results of Operations and in Risk Factors in Item 1A. of Part I of our 2007 Annual Report on Form 10-K filed with the U.S. Securities and Exchange Commission ( SEC ) on February 29, 2008. We are under no obligation (and expressly disclaim any such obligation) to update or revise any forward-looking statement that may be made from time to time, whether as a result of new information, future developments or otherwise.

**Overview****Our Business**

We write a diversified portfolio of property and casualty insurance and reinsurance lines of business internationally through our subsidiaries or branches based in Bermuda, the United States, Ireland and the United Kingdom. We manage our business through three operating segments: property, casualty and reinsurance. As of June 30, 2008, we had \$8.5 billion of total assets, \$2.4 billion of shareholders' equity and \$2.9 billion of total capital, which includes shareholders' equity and senior notes.

During the year ended December 31, 2007, we experienced rate declines from increased competition across all of our operating segments. This trend of increased competition and decreasing rates has continued during the six months ended June 30, 2008, and we expect this trend to continue during the remainder of 2008. Given this trend, we continue to be selective in the policies and reinsurance contracts we underwrite. Our consolidated gross premiums written decreased \$83.7 million, or 15.8%, for the three months ended June 30, 2008 compared to the three months ended June 30, 2007. Our consolidated gross premiums decreased \$125.3 million, or 12.9%, for the six months ended June 30, 2008 compared to the six months ended June 30, 2007. Our net income for the three months ended June 30, 2008 decreased \$44.1 million, or 35.8%, to \$79.2 million compared to \$123.3 million for the three months ended June 30, 2007. During the three months ended June 30, 2008, we were negatively impacted by net losses and loss expenses recognized of \$41.0 million related to both the floods in the U.S. Midwest and a gas pipeline explosion in Australia. Our net income for the six months ended June 30, 2008 decreased \$27.0 million, or 11.4%, to \$210.2 million compared to \$237.2 million for the six months ended June 30, 2007.

**Recent Developments**

On June 27, 2008, we entered into a definitive merger agreement to acquire Darwin Professional Underwriters, Inc. ( Darwin ). Darwin offers healthcare professional liability, errors and omissions and other specialty and primary professional liability coverages. Darwin had total gross premiums written for the year ended December 31, 2007 of \$280.3 million, which would have represented, on a pro-forma basis, approximately 16% of our total gross premiums written for the year ended December 31, 2007. Under the terms of the merger agreement, stockholders of Darwin will be entitled to receive \$32.00 per share in cash for each share of Darwin common stock in exchange for 100% of their

interests in Darwin. Also, each outstanding Darwin stock option will fully vest and be converted into an amount in cash equal to (i) the excess, if any, of \$32.00 over the exercise price per share of the stock option, multiplied by (ii) the total number of shares of Darwin common stock subject to the stock option. In addition, each outstanding Darwin restricted share

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will fully vest and be converted into the right to receive \$32.00 in cash per restricted share, and each outstanding director share unit will be converted into the right to receive \$32.00 in cash per share unit. The total cash consideration to be paid by us will be approximately \$550 million. The \$32.00 per share purchase price is subject to a downward adjustment in the event that certain representations by Darwin in the merger agreement with respect to its capitalization are breached and, as a result of such breach, the aggregate consideration payable by us in the merger is increased by more than \$1 million. The transaction is expected to be completed during the fourth quarter of 2008 subject to customary closing conditions, including regulatory approvals. The transaction will be accounted for as a purchase. Under the purchase method of accounting for a business combination, the assets and liabilities of Darwin will be recorded at their fair values on the acquisition date.

**Relevant Factors****Revenues**

We derive our revenues primarily from premiums on our insurance policies and reinsurance contracts, net of any reinsurance or retrocessional coverage purchased. Insurance and reinsurance premiums are a function of the amounts and types of policies and contracts we write, as well as prevailing market prices. Our prices are determined before our ultimate costs, which may extend far into the future, are known. In addition, our revenues include income generated from our investment portfolio, consisting of net investment income and net realized gains or losses. Investment income is principally derived from interest and dividends earned on investments, partially offset by investment management fees and fees paid to our custodian bank. Net realized gains or losses include (1) net realized investment gains or losses from the sale of investments, (2) write-downs related to declines in the market value of securities on our available for sale portfolio that were considered to be other than temporary and (3) the change in the fair value of investments that we mark-to-market in the consolidated statements of operations and comprehensive income.

**Expenses**

Our expenses consist largely of net losses and loss expenses, acquisition costs and general and administrative expenses. Net losses and loss expenses incurred are comprised of three main components:

losses paid, which are actual cash payments to insureds or losses payable to insureds, net of recoveries from reinsurers;

outstanding loss or case reserves, which represent management's best estimate of the likely settlement amount for known claims, less the portion that can be recovered from reinsurers; and

reserves for losses incurred but not reported, or IBNR, which are reserves established by us for claims that are not yet reported but can reasonably be expected to have occurred based on industry information, management's experience and/or actuarial evaluation. The portion recoverable from reinsurers is deducted from the gross estimated loss.

Acquisition costs are comprised of commissions, brokerage fees and insurance taxes. Commissions and brokerage fees are usually calculated as a percentage of premiums and depend on the market and line of business. Acquisition costs are reported after (1) deducting commissions received on ceded reinsurance, (2) deducting the part of acquisition costs relating to unearned premiums and (3) including the amortization of previously deferred acquisition costs.

General and administrative expenses include personnel expenses including stock-based compensation charges, rent expense, professional fees, information technology costs and other general operating expenses. We are experiencing increases in general and administrative expenses resulting from additional staff, increased stock-based compensation expense, increased rent expense for our U.S. offices, increased professional fees and additional amortization expense for building-related and infrastructure expenditures. We believe this trend will continue during the remainder of 2008 as we continue to hire additional staff and build our infrastructure.

**Ratios**

Management measures results for each segment on the basis of the loss and loss expense ratio, acquisition cost ratio, general and administrative expense ratio, expense ratio and the combined ratio. Because we do not manage our assets by segment, investment income, interest expense and total assets are not allocated to individual reportable segments. General and administrative expenses are allocated to segments based on various factors, including staff



count and each segment's proportional share of gross premiums written. The loss and loss expense ratio is derived by dividing net losses and loss expenses by net premiums earned. The acquisition cost ratio is derived by dividing acquisition costs by net premiums earned. The general and administrative expense ratio is derived by dividing general and administrative expenses by net premiums earned. The expense ratio is the sum of the acquisition cost ratio and the general and administrative expense ratio. The combined ratio is the sum of the loss and loss expense ratio, the acquisition cost ratio and the general and administrative expense ratio.

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### **Critical Accounting Policies**

It is important to understand our accounting policies in order to understand our financial position and results of operations. Our unaudited condensed consolidated financial statements reflect determinations that are inherently subjective in nature and require management to make assumptions and best estimates to determine the reported values. If events or other factors cause actual results to differ materially from management's underlying assumptions or estimates, there could be a material adverse effect on our financial condition or results of operations. We believe that some of the more critical judgments in the areas of accounting estimates and assumptions that affect our financial condition and results of operations are related to reserves for losses and loss expenses, reinsurance recoverables, premiums and acquisition costs, valuation of financial instruments and other-than-temporary impairment of investments. For a detailed discussion of our critical accounting policies please refer to our Annual Report on Form 10-K for the year ended December 31, 2007 filed with the SEC. There were no material changes in the application of our critical accounting estimates subsequent to that report, except as discussed below related to the valuation of financial instruments.

### **Fair Value of Financial Instruments**

Under existing accounting principles generally accepted in the United States ( U.S. GAAP ), we are required to recognize certain assets at their fair value in our condensed consolidated balance sheets. This includes our fixed maturity investments, global high-yield bond fund and hedge funds. Fair value, as defined in Financial Accounting Standard No. 157 Fair Value Measurements ( FAS 157 ), is the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date. FAS 157 also established a three-level valuation hierarchy for disclosure of fair value measurements. The valuation hierarchy is based upon whether the inputs to the valuation of an asset or liability are observable or unobservable in the market at the measurement date, with quoted market prices being the highest level (Level 1) and unobservable inputs being the lowest level (Level 3). A fair value measurement will fall within the level of the hierarchy based on the input that is significant to determining such measurement. The three levels are defined as follows:

**Level 1:** Observable inputs to the valuation methodology that are quoted prices (unadjusted) for identical assets or liabilities in active markets.

**Level 2:** Observable inputs to the valuation methodology other than quoted market prices (unadjusted) for identical assets or liabilities in active markets. Level 2 inputs include quoted prices for similar assets and liabilities in active markets, quoted prices for identical assets in markets that are not active and inputs other than quoted prices that are observable for the asset or liability, either directly or indirectly, for substantially the full term of the asset or liability.

**Level 3:** Inputs to the valuation methodology that are unobservable for the asset or liability.

At each measurement date, we estimate the fair value of the financial instruments using various valuation techniques. We utilize, to the extent available, quoted market prices in active markets or observable market inputs in estimating the fair value of our financial instruments. When quoted market prices or observable market inputs are not available, we utilize valuation techniques that rely on unobservable inputs to estimate the fair value of financial instruments. The following describes the valuation techniques used by us to determine the fair value of financial instruments held as of June 30, 2008 and what level within the FAS 157 fair value hierarchy the valuation technique resides.

**U.S. government and U.S. government agencies:** Comprised primarily of bonds issued by the U.S. Treasury, the Federal Home Loan Bank, the Federal Home Loan Mortgage Corporation and the Federal National Mortgage Association. The fair values of U.S. government securities are based on quoted market prices in active markets, and are included in the Level 1 fair value hierarchy. We believe the market for U.S. Treasury securities is an actively traded market given the high level of daily trading volume. The fair values of U.S. government agency securities are priced using the spread above the risk-free yield curve. As the yields for the risk-free yield curve are observable market inputs, the fair values of U.S. government agency securities are included in the Level 2 fair value hierarchy.

**Non-U.S. government and government agencies:** Comprised of fixed income obligations of non-U.S. governmental entities. The fair values of these securities are based on broker-dealer quotes, and are included in the Level 2 fair value hierarchy.

**Corporate:** Comprised of bonds issued by corporations that on acquisition are rated BBB-/Baa3 or higher provided that, in aggregate, corporate bonds with ratings of BBB-/Baa3 do not constitute more than 5% of the market value of our fixed income securities, and are diversified across a wide range of issuers and industries. The fair values of corporate bonds that are short-term are

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priced using spread above the London Interbank Offering Rate yield curve, and the fair value of corporate bonds that are long-term are priced using the spread above the risk-free yield curve. The spreads are sourced from dealer quotes, trade prices and the new issue market. As the inputs used to price corporate bonds are observable market inputs, the fair values of corporate bonds are included in the Level 2 fair value hierarchy.

**States, municipalities and political subdivisions:** Comprised of fixed income obligations of U.S. domiciled state and municipality entities. The fair values of these securities are based on broker-dealer quotes and the new issue market, and are included in the Level 2 fair value hierarchy.

**Mortgage-backed:** Principally comprised of AAA-rated pools of residential and commercial mortgages originated by both agency (such as the Federal National Mortgage Association) and non-agency originators. The fair values of mortgage-backed securities originated by U.S. government agencies and non-U.S. government agencies are based on a pricing model that incorporates prepayment speeds and spreads to determine appropriate average life of mortgage-backed securities. The spreads are sourced from dealer quotes, trade prices and the new issue market. As the inputs used to price the mortgage-backed securities are observable market inputs, the fair values of these securities are included in the Level 2 fair value hierarchy.

**Asset-backed:** Comprised of primarily AAA-rated bonds backed by pools of automobile loan receivables, home equity loans and credit card receivables originated by a variety of financial institutions. The fair values of asset-backed securities are priced using prepayment speed and spread inputs that are sourced from the new issue market. As the inputs used to price the asset-backed securities are observable market inputs, the fair values of these securities are included in the Level 2 fair value hierarchy.

**Other invested assets available for sale:** Comprised of an open-end global high-yield bond fund that invests in non-investment grade bonds issued by various issuers and industries. The fair value of the global high-yield bond fund is based on the net asset value as reported by the fund manager. The net asset value is an observable input as it is quoted on a market exchange on a daily basis. The fair value of the global high-yield bond fund is included in the Level 2 fair value hierarchy.

**Other invested assets, at fair value:** Comprised of several hedge funds with objectives to seek attractive long-term returns with lower volatility by investing in a range of diversified investment strategies. The fair values of the hedge funds are based on the net asset value of the funds as reported by the fund manager less a liquidity discount where hedge fund investments contain lock-up provisions that prevent immediate dissolution. We consider these lock-up provisions to be obligations that market participants would assign a value to in determining the price of these hedge funds, and as such have considered these obligations in determining the fair value measurement of the related hedge funds. The liquidity discount was estimated by calculating the value of a protective put over the lock-up period. The protective put measures the risk of holding a restricted asset over a certain time period. We used the Black-Scholes option-pricing model to estimate the value of the protective put for each hedge fund. The aggregate liquidity discount recorded during the three and six months ended June 30, 2008 was \$0.1 million and \$0.3 million, respectively. The net asset value and the liquidity discount are significant unobservable inputs, and as such the fair values of the hedge funds are included in the Level 3 fair value hierarchy. Our hedge funds are the only assets that have significant Level 3 inputs in determining fair value. The hedge funds represent 3.2% of our total investments.

There have been no material changes to any of our valuation techniques from what those used as of December 31, 2007. Since fair valuing a financial instrument is an estimate of what a willing buyer would pay for our asset if we sold it, we will not know the ultimate value of our financial instruments until they are sold. We believe the valuation techniques utilized provide us with the best estimate of the price that would be received to sell our assets in an orderly transaction between participants at the measurement date.

**Table of Contents****Results of Operations**

The following table sets forth our selected consolidated statement of operations data for each of the periods indicated.

|                                     | <b>Three Months<br/>Ended June 30,</b> |             | <b>Six Months<br/>Ended June 30,</b> |             |
|-------------------------------------|--|-------------|--------------------------------------|-------------|
|                                     | <b>2008</b>                            | <b>2007</b> | <b>2008</b>                          | <b>2007</b> |
|                                     | (\$ in millions)                       |             |                                      |             |
| Gross premiums written              | \$ 446.8                               | \$ 530.5    | \$ 843.7                             | \$ 969.0    |
| Net premiums written                | \$ 320.3                               | \$ 386.6    | \$ 646.8                             | \$ 744.4    |
| Net premiums earned                 | 268.9                                  | 303.1       | 541.9                                | 589.7       |
| Net investment income               | 72.4                                   | 73.9        | 149.3                                | 146.6       |
| Net realized investment losses      | (4.4)                                  | (1.5)       | (0.9)                                | (8.0)       |
|                                     | \$ 336.9                               | \$ 375.5    | \$ 690.3                             | \$ 728.3    |
| Net losses and loss expenses        | \$ 178.1                               | \$ 176.2    | \$ 321.6                             | \$ 342.2    |
| Acquisition costs                   | 26.3                                   | 31.9        | 53.1                                 | 61.1        |
| General and administrative expenses | 46.4                                   | 34.4        | 89.6                                 | 67.6        |
| Interest expense                    | 9.5                                    | 9.5         | 19.0                                 | 18.9        |
| Foreign exchange (gain) loss        | (0.4)                                  | 0.5         | 0.1                                  | 0.5         |
|                                     | \$ 259.9                               | \$ 252.5    | \$ 483.4                             | \$ 490.3    |
| Income before income taxes          | \$ 77.0                                | \$ 123.0    | \$ 206.9                             | \$ 238.0    |
| Income tax (recovery) expense       | (2.2)                                  | (0.3)       | (3.3)                                | 0.8         |
| Net income                          | \$ 79.2                                | \$ 123.3    | \$ 210.2                             | \$ 237.2    |

**Ratios**

|  |       |       |       |       |
|--|-------|-------|-------|-------|
| Loss and loss expense ratio              | 66.2% | 58.1% | 59.3% | 58.0% |
| Acquisition cost ratio                   | 9.8   | 10.5  | 9.8   | 10.4  |
| General and administrative expense ratio | 17.2  | 11.4  | 16.5  | 11.5  |
| Expense ratio                            | 27.0  | 21.9  | 26.3  | 21.9  |
| Combined ratio                           | 93.2  | 80.0  | 85.6  | 79.9  |

**Comparison of Three Months Ended June 30, 2008 and 2007****Premiums**

Gross premiums written decreased by \$83.7 million, or 15.8%, for the three months ended June 30, 2008 compared to the three months ended June 30, 2007. The decrease in gross premiums written was primarily the result of the following:

The non-renewal of business that did not meet our underwriting requirements (which included pricing and/or policy and contract terms and conditions), increased competition and decreasing rates for new and renewal business in each of our operating segments.

In our reinsurance segment, adjustments on estimated premiums were lower by \$17.0 million during the three months ended June 30, 2008 compared to the three months ended June 30, 2007. We recognized net

downward adjustments of \$5.9 million during the three months ended June 30, 2008 compared to net upward adjustments of \$11.1 million during the three months ended June 30, 2007. Given declining market rates, actual premiums are lower than the estimated premiums thus resulting in downward premium adjustments during the three months ended June 30, 2008. As our historical experience develops, we may have fewer or smaller adjustments to our estimated premiums. Gross premiums written also decreased in our reinsurance segment by approximately \$7.0 million because some cedents purchased less reinsurance.

In our property segment, we reduced the amount of gross premiums written in our energy line of business by \$12.8 million, or 40.6%, in response to deteriorating market conditions.

We also reduced the amount of gross premiums written for certain energy classes of business within our casualty segment by \$6.4 million in response to deteriorating market conditions.

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The table below illustrates our gross premiums written by geographic location for the three months ended June 30, 2008 and 2007.

|               | <b>Three Months</b>   |             | <b>Dollar</b> | <b>Percentage</b> |
|---------------|-----------------------|-------------|---------------|-------------------|
|               | <b>Ended June 30,</b> | <b>2007</b> |               |                   |
|               | <b>2008</b>           |             |               |                   |
|               | (\$ in millions)      |             |               |                   |
| Bermuda       | \$ 258.9              | \$ 392.4    | \$ (133.5)    | (34.0)%           |
| United States | 109.3                 | 56.5        | 52.8          | 93.5              |
| Europe        | 78.6                  | 81.6        | (3.0)         | (3.7)             |
|               | \$ 446.8              | \$ 530.5    | \$ (83.7)     | (15.8)%           |

The decrease in gross premiums written for our Bermuda operations, in addition to the factors discussed above, was due to the fact that certain policies and treaties that were previously written in Bermuda during the three months ended June 30, 2007 were renewed in our U.S. companies during the three months ended June 30, 2008. Our new U.S. reinsurance company commenced operations in April 2008 and renewed treaties previously written in Bermuda of \$34.9 million during the three months ended June 30, 2008.

Net premiums written decreased by \$66.3 million, or 17.1%, for the three months ended June 30, 2008 compared to the three months ended June 30, 2007. The difference between gross and net premiums written is the cost to us of purchasing reinsurance, both on a proportional and a non-proportional basis, including the cost of property catastrophe reinsurance coverage. We ceded 28.3% of gross premiums written for the three months ended June 30, 2008 compared to 27.1% for the same period in 2007. The increase in the cession percentage was primarily due to increased reinsurance utilization in our casualty segment and an increase in the property catastrophe reinsurance protection that we purchased. During the three months ended June 30, 2008, we made the following changes to our reinsurance program:

Renewed our property catastrophe reinsurance treaty from May 1, 2008 to April 30, 2009, which resulted in premiums ceded of \$26.1 million. The cost of the property catastrophe reinsurance treaty was higher than the expiring treaty by approximately \$7.0 million. The increased cost of the property catastrophe reinsurance treaty was principally due to the new treaty expanding earthquake coverage in the U.S. and increased exposure due to changes in our general property quota share reinsurance treaty.

Our international property catastrophe treaty was cancelled and rewritten effective May 1, 2008. This treaty covers worldwide losses, excluding the United States and Canada. The total ceded premiums written for the international property catastrophe treaty were \$2.0 million. There were no ceded premiums written related to the international catastrophe property treaty during the three months ended June 30, 2007.

Purchased an excess-of-loss reinsurance treaty for our general property business with a limit of \$15 million excess of \$10 million or 10 million excess of 10 million. The total ceded premiums written for the excess-of-loss treaty were \$3.4 million. There was no excess-of-loss treaty in place during the three months ended June 30, 2007.

Offsetting the increases in reinsurance protection was a reduction in the cession percentage on our general property quota share reinsurance treaty from 55% to 40%.

Net premiums earned decreased by \$34.2 million, or 11.3%, for the three months ended June 30, 2008 compared to the three months ended June 30, 2007 as a result of lower net premiums written. The percentage decrease in net premiums earned was lower than that of net premiums written due to the continued earning of higher net premiums that were written prior to the three months ended June 30, 2008.

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We evaluate our business by segment, distinguishing between property insurance, casualty insurance and reinsurance. The following chart illustrates the mix of our business on both a gross premiums written and net premiums earned basis.

|             | <b>Gross<br/>Premiums<br/>Written</b> |             | <b>Net<br/>Premiums<br/>Earned</b> |             |
|-------------|---------------------------------------|-------------|------------------------------------|-------------|
|             | <b>Three Months Ended June 30,</b>    |             |                                    |             |
|             | <b>2008</b>                           | <b>2007</b> | <b>2008</b>                        | <b>2007</b> |
| Property    | 29.5%                                 | 29.5%       | 16.4%                              | 15.9%       |
| Casualty    | 39.9                                  | 35.5        | 39.3                               | 40.8        |
| Reinsurance | 30.6                                  | 35.0        | 44.3                               | 43.3        |

The increase in the percentage of casualty gross premiums written reflects the continued growth of our U.S. operations, where casualty gross premiums written increased by \$9.9 million, or 32.3%, for the three months ended June 30, 2008 compared to the three months ended June 30, 2007.

**Net Investment Income and Realized Investment Losses**

Net investment income decreased by \$1.5 million, or 2.0%, for the three months ended June 30, 2008 compared to the three months ended June 30, 2007. The decrease was primarily the result of lower yields on our investment portfolio. The annualized period book yield of the investment portfolio for the three months ended June 30, 2008 and 2007 was 4.5% and 4.8%, respectively. Investment management fees of \$1.5 million and \$1.6 million were incurred during the three months ended June 30, 2008 and 2007, respectively.

Our aggregate invested assets grew due to positive operating cash flows partially offset by funds used to acquire our common shares from American International Group, Inc. ( AIG ) in December 2007. As of June 30, 2008, approximately 99% of our fixed income investments (which included individually held securities and securities held in a global high-yield bond fund) consisted of investment grade securities. The average credit rating of our fixed income portfolio was AA+ as rated by Standard & Poor's and Aa1 as rated by Moody's Investors Service, with an average duration of approximately 3.4 years as of June 30, 2008.

Net realized investment losses increased by \$2.9 million for the three months ended June 30, 2008 compared to the three months ended June 30, 2007. Net realized investment losses of \$4.4 million for the three months ended June 30, 2008 were comprised of the following:

A write-down of approximately \$25.9 million related to declines in the market value of securities in our available for sale portfolio that were considered to be other than temporary. The declines in market value of these securities were primarily due to the write-down of residential and commercial mortgage-backed securities due to the widening of credit spreads caused by the continued decline in the U.S. housing market. All of the residential and commercial mortgage-backed securities written down were AAA rated securities. Given the current market environment for mortgage-backed securities, it is difficult to determine when recovery will occur and as such we recorded an other-than-temporary charge. Also included in the other-than-temporary impairment charge during the three months ended June 30, 2008 was a write-down of \$1.0 million related to our investment in bonds issued by a commercial bank and a write down of \$1.2 million of other invested assets. We performed an analysis of the issuers, including their liquidity, business prospects and overall financial position and concluded that an other-than-temporary charge should be recognized.

Net realized investment gains of \$0.6 million related to the mark-to-market of our hedge fund investments. On January 1, 2008, we adopted Statement of Financial Accounting Standards No. 159 The Fair Value Option for Financial Assets and Financial Liabilities Including an amendment of FASB Statement No. 115 ( FAS 159 ) and elected to fair value our hedge fund investments. As a result, any change in the fair value of our hedge fund investments is recognized as realized investment gains or losses in the condensed consolidated statements of operations and comprehensive income at each reporting period. As we adopted FAS 159 in 2008, there were no realized investment gains or losses recognized from our hedge fund investments in the unaudited condensed consolidated statement of operations and comprehensive income during the three months ended June 30, 2007



as the change in fair value was included in accumulated other comprehensive income in the unaudited condensed consolidated balance sheet.

Net realized investment gains of \$20.9 million from the sale of securities. We sold a number of securities during the three months ended June 30, 2008 to fund the increased capitalization of our direct U.S. operations and our European operations.

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During the three months ended June 30, 2007, the net loss on fixed income investments included a write-down of approximately \$2.9 million related to declines in the market value of securities in our available for sale portfolio that were considered to be other than temporary solely due to changes in interest rates.

***Net Losses and Loss Expenses***

Net losses and loss expenses increased by \$1.9 million, or 1.1%, for the three months ended June 30, 2008 compared to the three months ended June 30, 2007. The increase in net losses and loss expenses was due to higher than expected loss activity in the current period, which included net losses and loss expenses incurred from the floods in the U.S. Midwest of \$11.0 million and a gas pipeline explosion in Australia of \$30.0 million. On June 3, 2008, a pipeline rupture and fire significantly reduced the supply of natural gas to Western Australia. While not directly exposed to the pipeline, we provide business interruption protection as part of our property coverage to other large institutional businesses that depend on the natural gas produced through the pipeline. The losses from the gas pipeline explosion are in the very early stages, and we will continue to monitor our reserve for losses and loss expenses for any new claims information and adjust our reserve for losses and loss expenses accordingly. The increased loss activity in the current period was partially offset by net favorable prior year loss development and lower earned premiums during the three months ended June 30, 2008 compared to the three months ended June 30, 2007. Because our net exposures tend to vary with net premiums earned, lower net premiums earned will reduce the ultimate loss reserve amount, and therefore, reduce the losses and loss expenses incurred.

We recorded net favorable reserve development related to prior years of approximately \$39.8 million and \$32.4 million during the three months ended June 30, 2008 and 2007, respectively. The following is a breakdown of the major factors contributing to the net favorable reserve development for the three months ended June 30, 2008:

Net favorable reserve development of \$38.0 million was recognized by our casualty segment primarily as a result of general casualty, professional liability and healthcare lines of business actual loss emergence being lower than the initial expected loss emergence for the 2002 through 2004 loss years. During the three months ended June 30, 2008, we adjusted our weighting on actuarial methods utilized for these lines of business and loss years from using the expected loss ratio method to a blend of the Bornhuetter-Ferguson reported loss method and the expected loss ratio method. Placing greater reliance on more responsive actuarial methods for certain lines of business and loss years within our casualty segment is a natural progression as we mature as a company and gain sufficient historical experience of our own that allows us to further refine our estimate of the reserve for losses and loss expenses.

Net favorable reserve development of \$2.0 million was recognized by our reinsurance segment due to favorable development in the 2007 loss year related to windstorm Kyrill and the floods in the U.K. and Australia.

The following is a breakdown of the major factors contributing to the net favorable reserve development for the three months ended June 30, 2007:

Net favorable reserve development of \$30.4 million for our casualty segment was primarily comprised of \$74.8 million of favorable reserve development related to low loss emergence in our professional liability and healthcare lines of business for the 2003, 2004 and 2006 loss years, and our general casualty line of business for the 2004 loss year. These favorable reserve developments were partially offset by \$46.7 million of unfavorable reserve development due to higher than anticipated loss emergence in our general casualty line of business for the 2003 and 2005 loss years.

Net unfavorable reserve development of \$2.9 million, excluding the 2004 and 2005 windstorms, for our property segment was comprised of \$16.0 million of unfavorable reserve development, which primarily related to higher loss emergence than expected in our general property line of business for the 2004 and 2005 loss years and in our energy line of business for the 2006 loss year, which was partially offset by \$13.1 million of favorable reserve development primarily in our general property line of business for the 2003 and 2006 loss years.

Net favorable reserve development of \$1.6 million for our European property business related to the 2004 windstorms. We had no prior year loss reserve development related to Hurricanes Katrina, Rita and Wilma

during the three months ended June 30, 2007.

Net favorable reserve development of \$3.3 million, excluding the 2004 and 2005 windstorms, for our reinsurance segment comprised of \$1.6 million related to low loss emergence in our property reinsurance lines of business for the 2004 and 2005

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loss years and \$1.7 million related to low loss emergence in our accident and health reinsurance line of business for the 2004 and 2005 loss years.

The loss and loss expense ratio for the three months ended June 30, 2008 was 66.2%, compared to 58.1% for the three months ended June 30, 2007. Net favorable reserve development recognized in the three months ended June 30, 2008 reduced the loss and loss expense ratio by 14.8 percentage points. Thus, the loss and loss expense ratio related to the current period's business was 81.0%. Net favorable reserve development recognized in the three months ended June 30, 2007 reduced the loss and loss expense ratio by 10.7 percentage points. Thus, the loss and loss expense ratio related to that period's business was 68.8%. The increase in the current year's loss and loss expense ratio for the current period was primarily due to net incurred losses and loss expenses related to the flooding in the U.S. Midwest and the gas pipeline explosion in Australia during the three months ended June 30, 2008.

We continue to review the impact of the subprime and credit related downturn on professional liability insurance policies and reinsurance contracts we write. We have high attachment points for our professional liability policies and contracts, which makes estimating whether losses will exceed our attachment point more difficult. Based on claims information received to date and our analysis, the average attachment point for our professional liability policies with potential subprime and credit related exposure is approximately \$131 million with average limits of \$12 million (gross of reinsurance). Our direct insurance policies with subprime and credit related loss notices may have the benefit of facultative reinsurance, treaty reinsurance or a combination of both. For our professional liability reinsurance contracts with potential subprime and credit related exposure, the average attachment point is approximately \$99 million with average limits of \$1.7 million. At this time we believe, based on the claims information received to date, that our current IBNR is adequate to meet any potential subprime and credit related losses. As of June 30, 2008, we have recorded case reserves of \$5.0 million and \$7.5 million in our casualty and reinsurance operating segments, respectively, for subprime and credit related losses. We will continue to monitor our reserve for losses and loss expenses for any new claims information and adjust our reserve for losses and loss expenses accordingly.

The following table shows the components of the increase in net losses and loss expenses of \$1.9 million for the three months ended June 30, 2008 compared to the three months ended June 30, 2007.

|                                      | <b>Three Months<br/>Ended<br/>June 30,</b> |             | <b>Dollar<br/>Change</b> |
|--------------------------------------|--|-------------|--------------------------|
|                                      | <b>2008</b>                                | <b>2007</b> |                          |
|                                      | <b>(\$ in millions)</b>                    |             |                          |
| Net losses paid                      | \$ 82.9                                    | \$ 107.9    | \$ (25.0)                |
| Net change in reported case reserves | 35.4                                       | 18.6        | 16.8                     |
| Net change in IBNR                   | 59.8                                       | 49.7        | 10.1                     |
| Net losses and loss expenses         | \$ 178.1                                   | \$ 176.2    | \$ 1.9                   |

Net losses paid have decreased \$25.0 million for the three months ended June 30, 2008 primarily due to lower claim payments relating to the 2004 and 2005 windstorms than the amount paid during the three months ended June 30, 2007 and due to lower claim payments for our casualty segment. During the three months ended June 30, 2008, \$12.6 million of net losses were paid in relation to the 2004 and 2005 windstorms compared to \$23.5 million during the three months ended June 30, 2007. During the three months ended June 30, 2008, we recovered \$3.7 million on our property catastrophe reinsurance protection in relation to losses paid as a result of the 2004 and 2005 windstorms compared to \$8.9 million for the three months ended June 30, 2007. The increase in reported case reserves is due to increased case reserves for our property and reinsurance segments partially offset by lower case reserves for our casualty segment. The increase in IBNR was primarily due to increased reserves for losses and loss expenses for our current period's business partially offset by higher net favorable loss reserve development.



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The table below is a reconciliation of the beginning and ending reserves for losses and loss expenses for the three months ended June 30, 2008 and 2007. Losses incurred and paid are reflected net of reinsurance recoverables.

|  | <b>Three Months<br/>Ended June 30,<br/>2008                      2007</b> |                   |
|--|---|-------------------|
|  | <b>(\$ in millions)</b>   |                   |
| Net reserves for losses and loss expenses, April 1   | \$ 3,289.5  | \$ 2,995.1        |
| Included related to:                                 |   |                   |
| Current period non-catastrophe                       | 176.9   | 208.6             |
| Current period property catastrophe                  | 41.0  |                   |
| Prior period non-catastrophe                         | (39.8)  | (30.8)            |
| Prior period property catastrophe                    |   | (1.6)             |
| <b>Total incurred</b>                                | <b>\$ 178.1</b>   | <b>\$ 176.2</b>   |
| Paid related to:                                     |   |                   |
| Current period non-catastrophe                       | 7.4   | 2.5               |
| Current period property catastrophe                  |   |                   |
| Prior period non-catastrophe                         | 62.9  | 81.9              |
| Prior period property catastrophe                    | 12.6  | 23.5              |
| <b>Total paid</b>                                    | <b>\$ 82.9</b>  | <b>\$ 107.9</b>   |
| Foreign exchange revaluation                         | 0.9   | 1.1               |
| Net reserve for losses and loss expenses, June 30    | 3,385.6   | 3,064.5           |
| Losses and loss expenses recoverable                 | 778.6   | 679.2             |
| <b>Reserve for losses and loss expenses, June 30</b> | <b>\$ 4,164.2</b>   | <b>\$ 3,743.7</b> |

**Acquisition Costs**

Acquisition costs decreased by \$5.6 million, or 17.6%, for the three months ended June 30, 2008 compared to the three months ended June 30, 2007. Acquisition costs as a percentage of net premiums earned were 9.8% for the three months ended June 30, 2008 compared to 10.5% for the same period in 2007. The decrease in this rate was primarily due to increased commissions received on ceded reinsurance in our casualty segment.

**General and Administrative Expenses**

General and administrative expenses increased by \$12.0 million, or 34.9%, for the three months ended June 30, 2008 compared to the same period in 2007. The following is a breakdown of the major factors contributing to the increase:

Salary and employee welfare costs increased by \$7.6 million primarily due to our average staff count increasing by approximately 13.3% as a result of the significant expansion of our U.S. operations as part of our ongoing U.S. strategic initiatives. The increase in salary and employee welfare costs of \$7.6 million included increased stock-based compensation costs of \$2.0 million.

Information technology costs increased by approximately \$1.9 million due to consulting costs required as part of the development of our technological infrastructure as well as an increase in the cost of hardware and software.

Professional fees increased by approximately \$1.5 million due to increased legal and other professional fees.

Rent and building-related costs increased by approximately \$0.7 million due to additional office space in New York and Chicago and increased amortization of furniture and fixtures.

Our general and administrative expense ratio was 17.2% for the three months ended June 30, 2008, which was higher than the 11.4% for the three months ended June 30, 2007. The increase was primarily due to the factors discussed above, while net premiums earned declined.

Our expense ratio was 27.0% for the three months ended June 30, 2008 compared to 21.9% for the three months ended June 30, 2007. The increase resulted from increased general and administrative expenses.

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**Table of Contents****Interest Expense**

During both the three months ended June 30, 2008 and 2007, interest expense incurred of \$9.5 million represented one quarter of the annual interest expense on the senior notes, which bear interest at an annual rate of 7.50%.

**Net Income**

Net income for the three months ended June 30, 2008 was \$79.2 million compared to net income of \$123.3 million for the three months ended June 30, 2007. The decrease was primarily the result of lower net premiums earned, increased general and administrative expenses and increased loss activity for the three months ended June 30, 2008. Net income for the three months ended June 30, 2008 included a net foreign exchange gain of \$0.4 million and income tax recovery of \$2.2 million. Net income for the three months ended June 30, 2007 included a net foreign exchange loss of \$0.5 million and an income tax recovery of \$0.3 million.

**Comparison of Six Months Ended June 30, 2008 and 2007****Premiums**

Gross premiums written decreased by \$125.3 million, or 12.9%, for the six months ended June 30, 2008 compared to the six months ended June 30, 2007. The decrease in gross premiums written was primarily the result of the following:

The non-renewal of business that did not meet our underwriting requirements (which included pricing and/or policy and contract terms and conditions), increased competition and decreasing rates for new and renewal business in each of our operating segments.

In our reinsurance segment, adjustments on estimated premiums were lower by \$18.0 million during the six months ended June 30, 2008 compared to the six months ended June 30, 2007. We recognized net downward adjustments of \$8.0 million during the six months ended June 30, 2008 compared to net upward adjustments of \$10.0 million during the six months ended June 30, 2007. Gross premiums written also decreased in our reinsurance segment by approximately \$12.0 million because some cedents purchased less reinsurance.

In our property segment, we reduced the amount of gross premiums written in our energy line of business by \$17.6 million, or 33.1%, in response to deteriorating market conditions.

We also reduced the amount of gross premiums written for certain energy classes of business within our casualty segment by \$6.6 million in response to deteriorating market conditions.

The table below illustrates our gross premiums written by geographic location for the six months ended June 30, 2008 and 2007.

|               | <b>Six Months Ended</b> |                          |                          |                              |
|---------------|-------------------------|--------------------------|--------------------------|------------------------------|
|               | <b>2008</b>             | <b>June 30,<br/>2007</b> | <b>Dollar<br/>Change</b> | <b>Percentage<br/>Change</b> |
|               | (\$ in millions)        |                          |                          |                              |
| Bermuda       | \$ 556.1                | \$ 726.6                 | \$ (170.5)               | (23.5)%                      |
| United States | 145.1                   | 89.1                     | 56.0                     | 62.9                         |
| Europe        | 142.5                   | 153.3                    | (10.8)                   | (7.0)                        |
|               | \$ 843.7                | \$ 969.0                 | \$ (125.3)               | (12.9)%                      |

The decrease in gross premiums written for our Bermuda operations, in addition to the factors discussed above, was due to the fact that certain policies and treaties that were previously written in Bermuda during the six months ended June 30, 2007 were renewed in our U.S. companies during the six months ended June 30, 2008. Our new U.S. reinsurance company commenced operations in April 2008 and renewed treaties previously written in Bermuda of \$34.9 million during the six months ended June 30, 2008.



Net premiums written decreased by \$97.6 million, or 13.1%, for the six months ended June 30, 2008 compared to the six months ended June 30, 2007. The difference between gross and net premiums written is the cost to us of purchasing reinsurance, both on a proportional and a non-proportional basis, including the cost of property catastrophe reinsurance coverage. We ceded 23.3% of gross premiums written for the six months ended June 30, 2008 compared to 23.2% for the same period in 2007.

Net premiums earned decreased by \$47.8 million, or 8.1%, for the six months ended June 30, 2008 compared to the six months ended June 30, 2007 as a result of lower net premiums written. The percentage decrease in net premiums earned was lower than that

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of net premiums written due to the continued earning of higher net premiums that were written prior to the six months ended June 30, 2008.

We evaluate our business by segment, distinguishing between property insurance, casualty insurance and reinsurance. The following chart illustrates the mix of our business on both a gross premiums written and net premiums earned basis.

|             | Gross<br>Premiums<br>Written |       | Net<br>Premiums<br>Earned |       |
|-------------|------------------------------|-------|---------------------------|-------|
|             | Six Months Ended June 30,    |       |                           |       |
|             | 2008                         | 2007  | 2008                      | 2007  |
| Property    | 25.8%                        | 26.7% | 16.2%                     | 15.7% |
| Casualty    | 35.5                         | 32.3  | 39.6                      | 42.1  |
| Reinsurance | 38.7                         | 41.0  | 44.2                      | 42.2  |

The increase in the percentage of casualty gross premiums written reflects the continued growth of our U.S. operations, where casualty gross premiums written increased by \$15.4 million, or 28.9%, for the six months ended June 30, 2008 compared to the six months ended June 30, 2007.

**Net Investment Income and Realized Investment Losses**

Net investment income increased by \$2.7 million, or 1.8%, for the six months ended June 30, 2008 compared to the six months ended June 30, 2007. The increase was primarily the result of an increase in the dividend received from our global high-yield bond fund of \$4.0 million, as well as an approximate 4.1% increase in our average aggregate invested assets from June 30, 2007 to June 30, 2008. The dividend from the global high-yield bond fund increased from \$2.1 million for the six months ended June 30, 2007 to \$6.1 million for the six months ended June 30, 2008. Our aggregate invested assets grew due to positive operating cash flows partially offset by funds used to acquire our common shares from AIG in December 2007. For both the six months ended June 30, 2008 and 2007, we incurred investment management fees of \$3.0 million.

For both the six months ended June 30, 2008 and 2007, the annualized period book yield of the investment portfolio was 4.7%. As of June 30, 2008, approximately 99% of our fixed income investments (which included individually held securities and securities held in a global high-yield bond fund) consisted of investment grade securities. The average credit rating of our fixed income portfolio was AA+ as rated by Standard & Poor's and Aa1 as rated by Moody's Investors Service, with an average duration of approximately 3.4 years as of June 30, 2008.

Net realized investment losses decreased by \$7.1 million, or 88.8%, for the six months ended June 30, 2008 compared to the six months ended June 30, 2007. Net realized investment losses of \$0.9 million for the six months ended June 30, 2008 were comprised of the following:

A write-down of approximately \$37.3 million related to declines in the market value of securities in our available for sale portfolio that were considered to be other than temporary. The declines in market value of these securities were primarily due to the write-down of residential and commercial mortgage-backed securities due to the widening of credit spreads caused by the continued decline in the U.S. housing market. All of the residential and commercial mortgage-backed securities written down were AAA rated securities. Given the current market environment for mortgage-backed securities, it is difficult to determine when recovery will occur and as such we recorded an other-than-temporary charge. Also included in the other-than-temporary impairment charge during the six months ended June 30, 2008 was a write-down of \$1.0 million related to our investment in bonds issued by a commercial bank and a write down of \$1.2 million of other invested assets. We performed an analysis of the issuers, including their liquidity, business prospects and overall financial position and concluded that an other-than-temporary charge should be recognized.

Net realized investment losses of \$11.9 million related to the mark-to-market of our hedge fund investments. There were no realized investment gains or losses recognized from our hedge fund investments during the six months ended June 30, 2007.



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Net realized investment gains of \$48.3 million from the sale of securities. We sold a number of securities during the six months ended June 30, 2008 to capitalize the initial operations of our U.S. reinsurance platform and to fund the increased capitalization of our direct U.S. operations and our European operations.

During the six months ended June 30, 2007, the net loss on fixed income investments included a write-down of approximately \$12.3 million related to declines in the market value of securities in our available for sale portfolio that were considered to be other than temporary solely due to changes in interest rates.

***Net Losses and Loss Expenses***

Net losses and loss expenses decreased by \$20.6 million, or 6.0%, for the six months ended June 30, 2008 compared to the six months ended June 30, 2007. The primary reasons for the reduction in these expenses were net favorable prior year reserve development and lower earned premiums during the six months ended June 30, 2008 compared to the six months ended June 30, 2007, partially offset by higher than expected loss activity for the current period's business.

We recorded net favorable reserve development related to prior years of approximately \$92.9 million and \$58.5 million during the six months ended June 30, 2008 and 2007, respectively. The following is a breakdown of the major factors contributing to the net favorable reserve development for the six months ended June 30, 2008:

We recognized net favorable reserve development of \$33.2 million related to the 2005 windstorms, of which \$10.5 million was recognized by our property segment and \$22.7 million was recognized by our reinsurance segment. We recognized the net favorable reserve development for the 2005 windstorms due to less than anticipated reported loss activity over the past several quarters. Accordingly, as of June 30, 2008, we estimated our net losses related to Hurricanes Katrina, Rita and Wilma to be \$387.7 million, which was a reduction from our original estimate of \$456.0 million.

Net favorable reserve development of \$47.2 million was recognized by our casualty segment primarily as a result of general casualty, professional liability and healthcare lines of business actual loss emergence being lower than the initial expected loss emergence for the 2002 through 2004 loss years.

Net favorable reserve development of \$10.4 million, excluding the 2005 windstorms, was recognized by our property segment primarily as a result of general property business actual loss emergence being lower than the initial expected loss emergence for the 2003, 2006 and 2007 loss years.

Net favorable reserve development of \$2.1 million was recognized by our reinsurance segment primarily due to favorable development in the 2007 loss year related to windstorm Kyrill and the floods in the U.K. and Australia.

The following is a breakdown of the major factors contributing to the net favorable reserve development for the six months ended June 30, 2007:

Net favorable development of \$29.7 million for our casualty segment, which consisted of \$107.6 million of favorable reserve development primarily related to low loss emergence in our professional liability and healthcare lines of business for the 2003, 2004 and 2006 loss years and low loss emergence in our general casualty business for the 2004 loss year. These favorable reserve developments were partially offset by \$77.9 million of unfavorable reserve development due to higher than anticipated loss emergence in our general casualty line of business for the 2003 and 2005 loss years and our professional liability line of business for the 2002 loss year.

Net favorable reserve development of \$10.3 million, excluding the 2004 and 2005 windstorms, for our property segment which consisted of \$27.5 million in favorable reserve development that was primarily the result of general property business actual loss emergence being lower than the initial expected loss emergence for the 2003 and 2006 loss years, partially offset by unfavorable reserve development of \$17.2 million that was primarily the result of increased loss activity for our general property business for the 2004 and 2005 loss years and our energy business for the 2006 loss year.

Net favorable reserve development of \$12.6 million related to Hurricanes Katrina, Rita and Wilma. As of June 30, 2007, we estimated our net losses related to Hurricanes Katrina, Rita and Wilma to be \$443.4 million, which was a reduction from our original estimate of \$456.0 million.

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Net favorable reserve development of \$2.6 million related to the 2004 windstorms. This included \$1.0 million of additional recoveries under our property catastrophe reinsurance protection related to Hurricane Frances and \$1.6 million for our European property business related to the 2004 windstorms.

Net favorable reserve development of \$3.3 million, excluding the 2004 and 2005 windstorms, for our reinsurance segment comprised of \$1.6 million related to low loss emergence in our property reinsurance lines of business for the 2004 and 2005 loss years and \$1.7 million related to low loss emergence in our accident and health reinsurance line of business for the 2004 and 2005 loss years.

The loss and loss expense ratio for the six months ended June 30, 2008 was 59.3%, compared to 58.0% for the six months ended June 30, 2007. Net favorable reserve development recognized in the six months ended June 30, 2008 reduced the loss and loss expense ratio by 17.1 percentage points. Thus, the loss and loss expense ratio related to the current period's business was 76.4%. Net favorable reserve development recognized in the six months ended June 30, 2007 reduced the loss and loss expense ratio by 9.9 percentage points. Thus, the loss and loss expense ratio related to that period's business was 67.9%. The increase in the current year's loss and loss expense ratio for the current period was due to higher than expected reported loss activity and lower rates on new and renewal business for each of our operating segments. During the six months ended June 30, 2008, we had exposure to a number of property losses that were higher than normal, which included fires, tornadoes, hail storms and floods in various regions of the United States and in other parts of the world as well as the gas pipeline explosion in Australia.

The following table shows the components of the decrease in net losses and loss expenses of \$20.6 million for the six months ended June 30, 2008 compared to the six months ended June 30, 2007.

|                                      | <b>Six Months<br/>Ended<br/>June 30,</b> |             | <b>Dollar<br/>Change</b> |
|--------------------------------------|--|-------------|--------------------------|
|                                      | <b>2008</b>                              | <b>2007</b> |                          |
|                                      | <b>(\$ in millions)</b>                  |             |                          |
| Net losses paid                      | \$ 175.5                                 | \$ 227.2    | \$ (51.7)                |
| Net change in reported case reserves | 36.8                                     | (2.5)       | 39.3                     |
| Net change in IBNR                   | 109.3                                    | 117.5       | (8.2)                    |
| Net losses and loss expenses         | \$ 321.6                                 | \$ 342.2    | \$ (20.6)                |

Net losses paid have decreased \$51.7 million for the six months ended June 30, 2008 primarily due to lower claim payments relating to the 2004 and 2005 windstorms than the amount paid during the six months ended June 30, 2007 and due to lower claim payments for our casualty segment. During the six months ended June 30, 2008, \$26.3 million of net losses were paid in relation to the 2004 and 2005 windstorms compared to \$58.8 million during the six months ended June 30, 2007. During the six months ended June 30, 2008, we recovered \$8.3 million on our property catastrophe reinsurance protection in relation to losses paid as a result of the 2004 and 2005 windstorms compared to \$18.4 million for the six months ended June 30, 2007. The increase in reported case reserves is due to increased case reserves for our property and reinsurance segments partially offset by lower case reserves for our casualty segment. The decrease in IBNR was primarily due to net favorable loss reserve development and a reduction in business written, partially offset by increased loss reserves for our current period's business.

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The table below is a reconciliation of the beginning and ending reserves for losses and loss expenses for the six months ended June 30, 2008 and 2007. Losses incurred and paid are reflected net of reinsurance recoverables.

|  | <b>Six Months<br/>Ended June 30,</b> |             |
|--|--------------------------------------|-------------|
|  | <b>2008</b>                          | <b>2007</b> |
|  | <b>(\$ in millions)</b>              |             |
| Net reserves for losses and loss expenses, January 1 | \$ 3,237.0                           | \$ 2,947.9  |
| Incurred related to:                                 |                                      |             |
| Current period non-catastrophe                       | 373.5                                | 400.7       |
| Current period property catastrophe                  | 41.0                                 |             |
| Prior period non-catastrophe                         | (59.7)                               | (43.3)      |
| Prior period property catastrophe                    | (33.2)                               | (15.2)      |
| Total incurred                                       | \$ 321.6                             | \$ 342.2    |
| Paid related to:                                     |                                      |             |
| Current period non-catastrophe                       | 10.2                                 | 3.2         |
| Current period property catastrophe                  |                                      |             |
| Prior period non-catastrophe                         | 139.0                                | 165.2       |
| Prior period property catastrophe                    | 26.3                                 | 58.8        |
| Total paid   | \$ 175.5                             | \$ 227.2    |
| Foreign exchange revaluation                         | 2.5                                  | 1.6         |
| Net reserve for losses and loss expenses, June 30    | 3,385.6                              | 3,064.5     |
| Losses and loss expenses recoverable                 | 778.6                                | 679.2       |
| Reserve for losses and loss expenses, June 30        | \$ 4,164.2                           | \$ 3,743.7  |

**Acquisition Costs**

Acquisition costs decreased by \$8.0 million, or 13.1%, for the six months ended June 30, 2008 compared to the six months ended June 30, 2007. Acquisition costs as a percentage of net premiums earned were 9.8% for the six months ended June 30, 2008 compared to 10.4% for the same period in 2007. The decrease in this rate was primarily due to increased commissions received on ceded reinsurance in our casualty segment.

**General and Administrative Expenses**

General and administrative expenses increased by \$22.0 million, or 32.5%, for the six months ended June 30, 2008 compared to the same period in 2007. The following is a breakdown of the major factors contributing to the increase:

Salary and employee welfare costs increased by \$13.2 million due to our average staff count increasing by approximately 11.9%. This also included a one-time expense of \$3.8 million for the reimbursement of stock compensation and signing bonuses for new executives hired as a result of the continued expansion of our U.S. operations and increased stock-based compensation costs of \$1.9 million.

Information technology costs increased by approximately \$4.2 million due to consulting costs required as part of the development of our technological infrastructure as well as an increase in the cost of hardware and software.

Professional fees increased by approximately \$2.3 million due to increased legal and other professional fees.

Rent and related costs increased by approximately \$1.8 million due to additional office space in New York and Chicago and increased amortization of furniture and fixtures. There was a gain of \$0.6 million on the sale of

fixed assets from our previous office space in Bermuda during the six months ended June 30, 2007. No such gain on fixed assets occurred during the six months ended June 30, 2008.

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Our general and administrative expense ratio was 16.5% for the six months ended June 30, 2008, which was higher than the 11.5% for the six months ended June 30, 2007. The increase was primarily due to the factors discussed above, while net premiums earned declined.

Our expense ratio was 26.3% for the six months ended June 30, 2008 compared to 21.9% for the six months ended June 30, 2007. The increase resulted from increased general and administrative expenses.

**Interest Expense**

Interest expense increased by \$0.1 million, or 0.5%, for the six months ended June 30, 2008 compared to the six months ended June 30, 2007. Interest expense incurred during both the six months ended June 30, 2008 and 2007 represented half of the annual interest expense on the senior notes, which bear interest at an annual rate of 7.50%.

**Net Income**

Net income for the six months ended June 30, 2008 was \$210.2 million compared to net income of \$237.2 million for the six months ended June 30, 2007. The decrease was primarily the result of lower net premiums earned, increased general and administrative expenses and increased loss activity for the six months ended June 30, 2008. Net income for the six months ended June 30, 2008 included a net foreign exchange loss of \$0.1 million and income tax recovery of \$3.3 million. Net income for the six months ended June 30, 2007 included a net foreign exchange loss of \$0.5 million and an income tax expense of \$0.8 million.

**Underwriting Results by Operating Segments**

Our company is organized into three operating segments:

*Property Segment.* Our property segment provides direct coverage of physical property and business interruption coverage for commercial property and energy-related risks. We write solely commercial coverages and focus on the insurance of primary risk layers. This means that we are typically part of the first group of insurers that cover a loss up to a specified limit.

*Casualty Segment.* Our casualty segment provides direct coverage for general and product liability, professional liability and healthcare liability risks. We focus primarily on insurance of excess layers, where we insure the second and/or subsequent layers of a policy above the primary layer. Our direct casualty underwriters provide a variety of specialty insurance casualty products to large and complex organizations around the world.

*Reinsurance Segment.* Our reinsurance segment includes the reinsurance of property, general casualty, professional liability, specialty lines and property catastrophe coverages written by other insurance companies. We presently write reinsurance on both a treaty and a facultative basis, targeting several niche reinsurance markets including professional liability lines, specialty casualty, property for U.S. regional insurers, accident and health and to a lesser extent marine and aviation lines.

**Property Segment**

The following table summarizes the underwriting results and associated ratios for the property segment for the three months ended June 30, 2008 and 2007, and the six months ended June 30, 2008 and 2007.

|                                     | Three Months<br>Ended June 30, |          | Six Months<br>Ended June 30, |          |
|-------------------------------------|--------------------------------|----------|------------------------------|----------|
|                                     | 2008                           | 2007     | 2008                         | 2007     |
|                                     | (\$ in millions)               |          |                              |          |
| <b>Revenues</b>                     |                                |          |                              |          |
| Gross premiums written              | \$ 132.0                       | \$ 156.5 | \$ 218.0                     | \$ 258.3 |
| Net premiums written                | 54.3                           | 59.0     | 100.9                        | 105.1    |
| Net premiums earned                 | 44.2                           | 48.3     | 87.7                         | 92.8     |
| <b>Expenses</b>                     |                                |          |                              |          |
| Net losses and loss expenses        | \$ 62.6                        | \$ 34.1  | \$ 77.3                      | \$ 41.0  |
| Acquisition costs                   | (3.0)                          | 0.1      | (2.4)                        | 0.4      |
| General and administrative expenses | 11.0                           | 8.2      | 21.4                         | 15.9     |
| <b>Underwriting (loss) income</b>   | (26.4)                         | 5.9      | (8.6)                        | 35.5     |

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|  | Three Months<br>Ended June 30, |       | Six Months<br>Ended June 30, |       |
|--|--------------------------------|-------|------------------------------|-------|
|  | 2008                           | 2007  | 2008                         | 2007  |
| <b>Ratios</b>                            | (\$ in millions)               |       |                              |       |
| Loss and loss expense ratio              | 141.7%                         | 70.7% | 88.1%                        | 44.2% |
| Acquisition cost ratio                   | (6.7)                          | 0.2   | (2.8)                        | 0.4   |
| General and administrative expense ratio | 24.8                           | 16.9  | 24.5                         | 17.2  |
| Expense ratio                            | 18.1                           | 17.1  | 21.7                         | 17.6  |
| Combined ratio                           | 159.8                          | 87.8  | 109.8                        | 61.8  |

**Comparison of Three Months Ended June 30, 2008 and 2007**

*Premiums.* Gross premiums written decreased \$24.5 million, or 15.7%, for the three months ended June 30, 2008 compared to the same period in 2007. This decrease was primarily due to the non-renewal of business that did not meet our underwriting requirements (which included pricing and/or policy terms and conditions) and rate decreases from increased competition for new and renewal business. In addition, we continued to reduce the amount of gross premiums written in our energy line of business by \$12.8 million, or 40.6%, in response to deteriorating market conditions. We expect the trend of reducing our energy line of business to continue during the remainder of the year.

The table below illustrates our gross premiums written by line of business for the three months ended June 30, 2008 and 2007.

|                  | Three Months<br>Ended<br>June 30, |          | Dollar<br>Change | Percentage<br>Change |
|------------------|-----------------------------------|----------|------------------|----------------------|
|                  | 2008                              | 2007     |                  |                      |
|                  | (\$ in millions)                  |          |                  |                      |
| General property | \$ 113.2                          | \$ 124.6 | \$ (11.4)        | (9.1)%               |
| Energy           | 18.7                              | 31.5     | (12.8)           | (40.6)               |
| Other            | 0.1                               | 0.4      | (0.3)            | (75.0)               |
|                  | \$ 132.0                          | \$ 156.5 | \$ (24.5)        | (15.7)%              |

Net premiums written decreased by \$4.7 million, or 8.0%, for the three months ended June 30, 2008 compared to the three months ended June 30, 2007. Overall, we ceded 58.9% of gross premiums written for the three months ended June 30, 2008 compared to 62.3% for the three months ended June 30, 2007. The decrease in the percentage of premiums ceded was caused by a reduction in the cession percentage on our general property quota share reinsurance treaty from 55% to 40% and the non-renewal of our energy quota share reinsurance treaty, which expired June 1, 2007, partially offset by additional reinsurance protection purchased, which was as follows:

Renewed our property catastrophe reinsurance treaty, which resulted in ceded written premiums of \$26.1 million. The cost of the property catastrophe reinsurance treaty was higher than the expiring treaty by approximately \$7.0 million. The increased cost of the property catastrophe reinsurance treaty is principally due to the new treaty expanding earthquake coverage in the United States and increased exposure due to changes in our general property quota share reinsurance treaty.

Our international property catastrophe treaty was cancelled and rewritten effective May 1, 2008. This treaty covers worldwide losses, excluding the United States and Canada. The total ceded premiums written for the international property catastrophe treaty were \$2.0 million. There were no ceded premiums written related to the international catastrophe property treaty during the six months ended June 30, 2007.

Purchased an excess-of-loss reinsurance treaty for our general property treaty with a limit of \$15 million excess of \$10 million or 10 million excess of 10 million. The total ceded premiums written for the excess-of-loss treaty were \$3.4 million. There was no excess-of-loss treaty in place during the three months ended June 30, 2007.

Net premiums earned decreased \$4.1 million, or 8.5%, primarily due to lower net premiums written. The percentage decrease in net premiums earned was lower than that of net premiums written due to the continued earning of higher net premiums that were written prior to the three months ended June 30, 2008.

*Net losses and loss expenses.* Net losses and loss expenses increased by \$28.5 million, or 83.6%, for the three months ended June 30, 2008 compared to the three months ended June 30, 2007. The increase in net losses and loss expenses was primarily the result of higher than expected loss activity for the current period's business partially offset by lower net premiums earned. During the three

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months ended June 30, 2008 our property segment recognized losses and loss expenses of \$6.0 million related to the flooding in the U.S. Midwest and \$30.0 million related to a gas pipeline explosion in Australia. On June 3, 2008, a pipeline rupture and fire significantly reduced the supply of natural gas to Western Australia. While not directly exposed to the pipeline, we provide business interruption protection as part of our property coverage to other large institutional businesses that depend on the natural gas produced through the pipeline. The losses from the gas pipeline explosion are in the very early stages and we will continue to monitor our reserve for losses and loss expenses for any new claims information and adjust our reserve for losses and loss expenses accordingly.

Overall, our property segment recorded net unfavorable reserve development of \$0.2 million during the three months ended June 30, 2008 compared to net unfavorable reserve development of \$1.3 million for the three months ended June 30, 2007.

The \$1.3 million of net unfavorable reserve development during the three months ended June 30, 2007 included the following:

Net unfavorable reserve development of \$2.9 million, excluding the 2004 and 2005 windstorms, for our property segment was comprised of \$16.0 million of unfavorable reserve development, which primarily related to higher loss emergence than expected in our general property line of business for the 2004 and 2005 loss years and in our energy line of business for the 2006 loss year, and which was partially offset by \$13.1 million of favorable reserve development primarily in our general property line of business for the 2003 and 2006 loss years.

The net favorable reserve development of \$1.6 million for our European property business related to the 2004 windstorms.

The loss and loss expense ratio for the three months ended June 30, 2008 was 141.7% compared to 70.7% for the three months ended June 30, 2007. Net unfavorable reserve development recognized in the three months ended June 30, 2008 increased the loss and loss expense ratio by 0.5%. Thus, the loss and loss expense ratio for this period's business was 141.2%. In comparison, net unfavorable reserve development recognized in the three months ended June 30, 2007 increased the loss and loss expense ratio by 2.7 percentage points. Thus, the loss and loss expense ratio for that period's business was 68.0%. The increase in the loss and loss expense ratio for the current period's business was due to higher than expected reported loss activity in the current period primarily caused by \$6.0 million in net losses and loss expense recognized related to the U.S. Midwest floods and \$30.0 million in net losses and loss expenses recognized related to the gas pipeline explosion in Australia.

Net paid losses for the three months ended June 30, 2008 and 2007 were \$31.2 million and \$40.9 million, respectively. The decrease in paid losses was due to lower net paid losses related to the 2004 and 2005 windstorms. During the three months ended June 30, 2008, approximately \$2.0 million of net losses were paid in relation to the 2004 and 2005 windstorms compared to approximately \$14.9 million during the three months ended June 30, 2007.

The table below is a reconciliation of the beginning and ending reserves for losses and loss expenses for the three months ended June 30, 2008 and 2007. Losses incurred and paid are reflected net of reinsurance recoverables.

|  | <b>Three Months<br/>Ended June 30,<br/>2008      2007</b> |          |
|--|---|----------|
|  | <b>(\$ in millions)</b>                                   |          |
| Net reserves for losses and loss expenses, April 1 | \$ 325.8  | \$ 381.6 |
| Incurred related to:                               |   |          |
| Current period non-catastrophe                     | 26.4  | 32.8     |
| Current period property catastrophe                | 36.0  |          |
| Prior period non-catastrophe                       | 0.2   | 2.9      |
| Prior period property catastrophe                  |   | (1.6)    |
| Total incurred                                     | \$ 62.6   | \$ 34.1  |

|   |          |          |
|---|----------|----------|
| Paid related to:                                  |          |          |
| Current period non-catastrophe                    | 3.1      | 2.4      |
| Current period property catastrophe               |          |          |
| Prior period non-catastrophe                      | 26.1     | 23.6     |
| Prior period property catastrophe                 | 2.0      | 14.9     |
| Total paid  | \$ 31.2  | \$ 40.9  |
| Foreign exchange revaluation                      | 0.9      | 1.1      |
| Net reserve for losses and loss expenses, June 30 | 358.1    | 375.9    |
| Losses and loss expenses recoverable              | 361.8    | 431.5    |
| Reserve for losses and loss expenses, June 30     | \$ 719.9 | \$ 807.4 |

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*Acquisition costs.* Acquisition costs decreased by \$3.1 million for the three months ended June 30, 2008 compared to June 30, 2007. The decrease is primarily caused by an increase in ceding commission percentage on our general property quota share treaty and an adjustment for outstanding commissions payable. The acquisition cost ratio decreased to negative 6.7% for the three months ended June 30, 2008 from 0.2% for the same period in 2007. The factors that will determine the amount of acquisition costs going forward are the amount of brokerage fees and commissions incurred on policies we write less ceding commissions earned on reinsurance we purchase. We normally negotiate our reinsurance treaties on an annual basis, so the ceding commission rates and amounts ceded will vary from renewal period to renewal period.

*General and administrative expenses.* General and administrative expenses increased by \$2.8 million, or 34.1%, for the three months ended June 30, 2008 compared to three months ended June 30, 2007. The increase in general and administrative expenses was attributable to increased salary and employee welfare costs, increased building-related costs, increased professional fees and higher costs associated with information technology. The increase in the general and administrative expense ratio from 16.9% for the three months ended June 30, 2007 to 24.8% for the same period in 2008 was the result of the factors discussed above, while net premiums earned declined.

**Comparison of Six Months Ended June 30, 2008 and 2007**

*Premiums.* Gross premiums written decreased \$40.3 million, or 15.6%, for the six months ended June 30, 2008 compared to the same period in 2007. This decrease was primarily due to the non-renewal of business that did not meet our underwriting requirements (which included pricing and/or policy terms and conditions) and rate decreases from increased competition for new and renewal business. In addition, we have continued to reduce the amount of gross premiums written in our energy line of business by \$17.6 million, or 33.1%, in response to deteriorating market conditions. We expect the trend of reducing our energy line of business to continue during the remainder of the year.

The table below illustrates our gross premiums written by line of business for the six months ended June 30, 2008 and 2007.

|                  | <b>Six Months Ended</b> |             | <b>Dollar</b>           | <b>Percentage</b> |
|------------------|-------------------------|-------------|-------------------------|-------------------|
|                  | <b>June 30,</b>         | <b>2007</b> |                         |                   |
|                  | <b>2008</b>             | <b>2007</b> | <b>(\$ in millions)</b> |                   |
| General property | \$ 182.1                | \$ 204.5    | \$ (22.4)               | (10.9)%           |
| Energy           | 35.6                    | 53.2        | (17.6)                  | (33.1)            |
| Other            | 0.3                     | 0.6         | (0.3)                   | (50.0)            |
|                  | \$ 218.0                | \$ 258.3    | \$ (40.3)               | (15.6)%           |

Net premiums written decreased by \$4.2 million, or 4.0%, for the six months ended June 30, 2008 compared to the six months ended June 30, 2007. This was primarily the result of lower gross premiums written partially offset by the changes to our reinsurance program discussed in the comparison of the three months ended June 30, 2008. Overall, we ceded 53.7% of gross premiums written for the six months ended June 30, 2008 compared to 59.3% for the six months ended June 30, 2007.

Net premiums earned decreased \$5.1 million, or 5.5%, primarily due to lower net premiums written. The percentage decrease in net premiums earned was lower than that of net premiums written due to the continued earning of higher net premiums that were written prior to the three months ended June 30, 2008.

*Net losses and loss expenses.* Net losses and loss expenses increased by \$36.3 million, or 88.5%, for the six months ended June 30, 2008 compared to the six months ended June 30, 2007. The increase in net losses and loss expenses was primarily the result of higher than expected loss activity for the current period's business partially offset by lower net premiums earned. Loss activity in the current period's business included \$6.0 million and \$30.0 million in losses and loss expenses recognized related to the flooding in the U.S. Midwest and the gas pipeline explosion in Australia, respectively.

Overall, our property segment recorded net favorable reserve development of \$20.9 million during the six months ended June 30, 2008 compared to net favorable reserve development of \$24.4 million for the six months ended June 30, 2007.

The \$20.9 million of net favorable reserve development during the six months ended June 30, 2008 included the following:

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Net favorable reserve development of \$10.5 million related to the 2005 windstorms due to less than anticipated reported loss activity over the past several quarters.

Net favorable reserve development of \$10.4 million, excluding the 2005 windstorms, primarily the result of general property business actual loss emergence being lower than the initial expected loss emergence for the 2003, 2006 and 2007 loss years.

The \$24.4 million of net favorable reserve development during the six months ended June 30, 2007 included the following:

Net favorable reserve development of \$10.3 million, excluding 2004 and 2005 windstorms, for our property segment which consisted of \$27.5 million in net favorable reserve development primarily the result of general property business actual loss emergence being lower than the initial expected loss emergence for the 2003 and 2006 loss years, partially offset by unfavorable reserve development of \$17.2 million primarily the result of increased loss activity for our general property business for the 2004 and 2005 loss years and our energy business for the 2006 loss year.

Net favorable reserve development of \$8.7 million for Hurricanes Katrina, Rita and Wilma.

Net favorable reserve development of \$5.4 million related to the 2004 windstorms.

The loss and loss expense ratio for the six months ended June 30, 2008 was 88.1% compared to 44.2% for the six months ended June 30, 2007. Net favorable reserve development recognized in the six months ended June 30, 2008 reduced the loss and loss expense ratio by 23.8 percentage points. Thus, the loss and loss expense ratio related to the current period's business was 111.9%. In comparison, net favorable reserve development recognized in the six months ended June 30, 2007 decreased the loss and loss expense ratio by 26.2 percentage points. Thus, the loss and loss expense ratio for that period's business was 70.4%. The increase in the loss and loss expense ratio for the current period's business was due to higher than expected reported loss activity in the current period as well as lower rates on new and renewal business. During the six months ended June 30, 2008, we had exposure to a number of property losses that were higher than normal, which included fires, tornadoes, hail storms and floods in various regions of the United States and in other parts of the world as well as the gas pipeline explosion in Australia.

Net paid losses for the six months ended June 30, 2008 and 2007 were \$82.3 million and \$90.6 million, respectively. The decrease in paid losses was due to lower net paid losses related to the 2004 and 2005 windstorms. During the six months ended June 30, 2008, approximately \$11.2 million of net losses were paid in relation to the 2004 and 2005 windstorms compared to approximately \$38.4 million during the six months ended June 30, 2007.

The table below is a reconciliation of the beginning and ending reserves for losses and loss expenses for the six months ended June 30, 2008 and 2007. Losses incurred and paid are reflected net of reinsurance recoverables.

|  | <b>Six Months<br/>Ended June 30,<br/>2008                  2007</b> |          |
|--|---|----------|
|  | <b>(\$ in millions)</b>   |          |
| Net reserves for losses and loss expenses, January 1 | \$ 360.6  | \$ 423.9 |
| Incurred related to:                                 |   |          |
| Current period non-catastrophe                       | 62.2  | 65.4     |
| Current period property catastrophe                  | 36.0  |          |
| Prior period non-catastrophe                         | (10.4)  | (10.3)   |
| Prior period property catastrophe                    | (10.5)  | (14.1)   |
| Total incurred                                       | \$ 77.3   | \$ 41.0  |
| Paid related to:                                     |   |          |
| Current period non-catastrophe                       | 4.4   | 3.1      |



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|   |          |          |
|---|----------|----------|
| Current period property catastrophe               |          |          |
| Prior period non-catastrophe                      | 66.7     | 49.1     |
| Prior period property catastrophe                 | 11.2     | 38.4     |
| Total paid  | \$ 82.3  | \$ 90.6  |
| Foreign exchange revaluation                      | 2.5      | 1.6      |
| Net reserve for losses and loss expenses, June 30 | 358.1    | 375.9    |
| Losses and loss expenses recoverable              | 361.8    | 431.5    |
| Reserve for losses and loss expenses, June 30     | \$ 719.9 | \$ 807.4 |

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*Acquisition costs.* Acquisition costs decreased by \$2.8 million for the six months ended June 30, 2008 compared to June 30, 2007 primarily due to an increase in ceding commission percentage on our general property quota share treaty and an adjustment for outstanding commissions payable. The acquisition cost ratio decreased to negative 2.8% for the six months ended June 30, 2008 from 0.4% for the same period in 2007.

*General and administrative expenses.* General and administrative expenses increased by \$5.5 million, or 34.6%, for the six months ended June 30, 2008 compared to six months ended June 30, 2007. The increase in general and administrative expenses was attributable to increased salary and employee welfare costs including a one-time expense of \$0.5 million for the reimbursement of stock compensation and signing bonuses for new executives hired as a result of the continued expansion of our U.S. operations, increased building-related costs, increased professional fees and higher costs associated with information technology. The increase in the general and administrative expense ratio from 17.2% for the six months ended June 30, 2007 to 24.5% for the same period in 2008 was the result of the factors discussed above, while net premiums earned declined.

**Casualty Segment**

The following table summarizes the underwriting results and associated ratios for the casualty segment for the three months ended June 30, 2008 and 2007, and the six months ended June 30, 2008 and 2007.

|  | <b>Three Months</b>   |             | <b>Six Months</b>     |             |
|--|-----------------------|-------------|-----------------------|-------------|
|  | <b>Ended June 30,</b> |             | <b>Ended June 30,</b> |             |
|  | <b>2008</b>           | <b>2007</b> | <b>2008</b>           | <b>2007</b> |
|  | (\$ in millions)      |             |                       |             |
| <b>Revenues</b>                          |                       |             |                       |             |
| Gross premiums written                   | \$ 178.2              | \$ 188.1    | \$ 299.3              | \$ 313.3    |
| Net premiums written                     | 129.3                 | 141.6       | 220.0                 | 242.3       |
| Net premiums earned                      | 105.6                 | 123.7       | 214.8                 | 248.1       |
| <b>Expenses</b>                          |                       |             |                       |             |
| Net losses and loss expenses             | \$ 41.8               | \$ 60.9     | \$ 114.9              | \$ 151.3    |
| Acquisition costs                        | 5.2                   | 5.0         | 8.5                   | 11.1        |
| General and administrative expenses      | 24.3                  | 16.7        | 48.0                  | 32.0        |
| <b>Underwriting income</b>               | <b>34.3</b>           | <b>41.1</b> | <b>43.4</b>           | <b>53.7</b> |
| <b>Ratios</b>                            |                       |             |                       |             |
| Loss and loss expense ratio              | 39.5%                 | 49.2%       | 53.5%                 | 61.0%       |
| Acquisition cost ratio                   | 5.0                   | 4.1         | 4.0                   | 4.4         |
| General and administrative expense ratio | 23.0                  | 13.5        | 22.4                  | 12.9        |
| Expense ratio                            | 28.0                  | 17.6        | 26.4                  | 17.3        |
| Combined ratio                           | 67.5                  | 66.8        | 79.9                  | 78.3        |

**Comparison of Three Months Ended June 30, 2008 and 2007**

*Premiums.* Gross premiums written decreased \$9.9 million, or 5.3%, for the three months ended June 30, 2008 compared to the same period in 2007. This decrease was primarily due to the non-renewal of business that did not meet our underwriting requirements (which included pricing and/or policy terms and conditions) and rate decreases from increased competition for new and renewal business. This was most noticeable for our Bermuda operations where gross premiums written decreased \$21.8 million, or 17.4%. We also reduced the amount of gross premiums written for certain energy classes of business by \$6.4 million in response to deteriorating market conditions. These reductions were partially offset by an increase in the amount of business written through our U.S. offices as a result of the continued expansion of our U.S. operations. Gross premiums written by our U.S. operations increased \$9.9 million, or 32.3%, for the three months ended June 30, 2008 compared to the three months ended June 30, 2007.

The table below illustrates our gross premiums written by line of business for the three months ended June 30, 2008 and 2007.

|                        | <b>Three Months<br/>Ended<br/>June 30,</b> |             | <b>Dollar<br/>Change</b> | <b>Percentage<br/>Change</b> |
|------------------------|--|-------------|--------------------------|------------------------------|
|                        | <b>2008</b>                                | <b>2007</b> |                          |                              |
|                        |  |             | <b>(\$ in millions)</b>  |                              |
| Professional liability | \$ 89.5                                    | \$ 89.1     | \$ 0.4                   | 0.0%                         |
| General casualty       | 66.6                                       | 83.6        | (17.0)                   | (20.3)                       |
| Healthcare             | 16.0                                       | 13.1        | 2.9                      | 22.1                         |
| Other                  | 6.1  | 2.3         | 3.8                      | 165.2                        |
|                        | \$ 178.2                                   | \$ 188.1    | \$ (9.9)                 | (5.3)%                       |

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Net premiums written decreased \$12.3 million, or 8.7%, for the three months ended June 30, 2008 compared to the three months ended June 30, 2007. The decrease in net premiums written was greater than the decrease in gross premiums written. This was due to an increase in reinsurance purchased on our casualty business for the three months ended June 30, 2008 compared to the same period in 2007. We ceded 27.4% of gross premiums written for the three months ended June 30, 2008 compared to 24.7% for the three months ended June 30, 2007. The percentage of premiums ceded were higher for each of our lines of business during the three months ended June 30, 2008 compared to the three months ended June 30, 2007. Net premiums earned decreased \$18.1 million, or 14.6%, due to lower gross premiums written and increased reinsurance utilization.

*Net losses and loss expenses.* Net losses and loss expenses decreased by \$19.1 million, or 31.4%, for the three months ended June 30, 2008 compared to the three months ended June 30, 2007. The decrease in net losses and loss expenses was primarily due to higher net favorable reserve development recognized and the reduction in net premiums earned. Overall, our casualty segment recorded net favorable reserve development of \$38.0 million during the three months ended June 30, 2008 compared to net favorable reserve development of \$30.4 million for the three months ended June 30, 2007.

The net favorable reserve development of \$38.0 million recognized during the three months ended June 30, 2008 was primarily as a result of general casualty, professional liability and healthcare lines of business actual loss emergence being lower than the initial expected loss emergence for the 2002 through 2004 loss years. During the three months ended June 30, 2008, we adjusted our weighting on actuarial methods utilized for these lines of business and loss years from using the expected loss ratio method to a blend of the Bornhuetter-Ferguson reported loss method and the expected loss ratio method. Placing greater reliance on more responsive actuarial methods for certain lines of business and loss years within our casualty segment is a natural progression as we mature as a company and gain sufficient historical experience of our own that allows us to further refine our estimate of the reserve for losses and loss expenses.

The \$30.4 million net favorable reserve development during the three months ended June 30, 2007 included the following:

Favorable reserve development of \$74.8 million primarily related to low loss emergence in our professional liability and healthcare lines of business for the 2003, 2004 and 2006 loss years and general casualty line of business for the 2004 loss year.

This was partially offset by \$46.7 million of unfavorable reserve development due primarily to higher than anticipated loss emergence in our general casualty line of business for the 2003 and 2005 loss years.

The loss and loss expense ratio for the three months ended June 30, 2008 was 39.5%, compared to 49.2% for the three months ended June 30, 2007. The net favorable reserve development recognized during the three months ended June 30, 2008 decreased the loss and loss expense ratio by 36.0 percentage points. Thus, the loss and loss expense ratio related to the current period's business was 75.5% for the three months ended June 30, 2008. Comparatively, the net favorable reserve development recognized during the three months ended June 30, 2007 decreased the loss and loss expense ratio by 24.6 percentage points. Thus, the loss and loss expense ratio related to that period's business was 73.8%. The increase in the loss and loss expense ratio for the current period's business was due to lower rates on new and renewal policies.

We continue to review the impact of the subprime and credit related downturn on professional liability insurance policies we write. We have high attachment points for our professional liability policies, which makes estimating whether losses will exceed our attachment point more difficult. Based on claims information received to date and our analysis, the average attachment point for our professional liability policies with potential subprime and credit related exposure is approximately \$131 million with average limits of \$12 million (gross of reinsurance). Our direct insurance policies with subprime and credit related loss notices may have the benefit of facultative reinsurance, treaty reinsurance or a combination of both. At this time we believe, based on the claims information received to date, that our current IBNR is adequate to meet any potential subprime and credit related losses. As of June 30, 2008, we have recorded a case reserve of \$5.0 million for subprime and credit related losses. We will continue to monitor our reserve for losses and loss expenses for any new claims information and adjust our reserve for losses and loss expenses

accordingly.

Net paid losses were \$19.6 million for the three months ended June 30, 2008 compared to \$37.0 million for the three months ended June 30, 2007. The decrease is due to the timing of payments of claims that have already been reserved for in prior periods.

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The table below is a reconciliation of the beginning and ending reserves for losses and loss expenses for the three months ended June 30, 2008 and 2007. Losses incurred and paid are reflected net of reinsurance recoverables.

|  | <b>Three Months<br/>Ended June 30,<br/>2008                      2007</b> |            |
|--|---|------------|
|  | <b>(\$ in millions)</b>   |            |
| Net reserves for losses and loss expenses, April 1 | \$ 1,937.4  | \$ 1,758.3 |
| Included related to:                               |   |            |
| Current period non-catastrophe                     | 79.8  | 91.3       |
| Current period catastrophe                         |   |            |
| Prior period non-catastrophe                       | (38.0)  | (30.4)     |
| Prior period catastrophe                           |   |            |
| Total incurred                                     | \$ 41.8   | \$ 60.9    |
| Paid related to:                                   |   |            |
| Current period non-catastrophe                     |   |            |
| Current period catastrophe                         |   |            |
| Prior period non-catastrophe                       | 19.6  | 37.0       |
| Prior period catastrophe                           |   |            |
| Total paid   | \$ 19.6   | \$ 37.0    |
| Foreign exchange revaluation                       |   |            |
| Net reserve for losses and loss expenses, June 30  | 1,959.6   | 1,782.2    |
| Losses and loss expenses recoverable               | 407.3   | 220.0      |
| Reserve for losses and loss expenses, June 30      | \$ 2,366.9  | \$ 2,002.2 |

*Acquisition costs.* Acquisition costs increased \$0.2 million, or 4.0%, for the three months ended June 30, 2008 compared to the three months ended June 30, 2007. The increase was primarily related to increased premium taxes and broker commissions partially offset by lower gross premiums written and an increase in ceding commission income with the increase in reinsurance we purchased. The increase in the acquisition cost ratio from 4.1% for the three months ended June 30, 2007 to 5.0% for the three months ended June 30, 2008 was due to the factors discussed above.

*General and administrative expenses.* General and administrative expenses increased \$7.6 million, or 45.5%, for the three months ended June 30, 2008 compared to the three months ended June 30, 2007. The increase in general and administrative expenses was attributable to increased salary and related costs, increased building-related costs, increased professional fees and higher costs associated with information technology. The 9.5 percentage point increase in the general and administrative expense ratio from 13.5% for the three months ended June 30, 2007 to 23.0% for the same period in 2008 was primarily a result of the factors discussed above, while net premiums earned declined.

**Comparison of Six Months Ended June 30, 2008 and 2007**

*Premiums.* Gross premiums written decreased \$14.0 million, or 4.5%, for the six months ended June 30, 2008 compared to the same period in 2007. This decrease was primarily due to the non-renewal of business that did not meet our underwriting requirements (which included pricing and/or policy terms and conditions) and rate decreases from increased competition for new and renewal business. This was most noticeable for our Bermuda operations where gross premiums written decreased \$27.1 million, or 13.8%. We also reduced the amount of gross premiums written for certain energy classes of business by \$6.6 million in response to deteriorating market conditions. These reductions were partially offset by an increase in the amount of business written through our U.S. offices as a result of the continued expansion of our U.S. operations. Gross premiums written by our U.S. operations increased

\$15.4 million, or 28.8%, for the six months ended June 30, 2008 compared to the six months ended June 30, 2007.

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The table below illustrates our gross premiums written by line of business for the six months ended June 30, 2008 and 2007.

|                        | <b>Six Months Ended</b>  |                          | <b>Dollar<br/>Change</b> | <b>Percentage<br/>Change</b> |
|------------------------|--------------------------|--------------------------|--------------------------|------------------------------|
|                        | <b>June 30,<br/>2008</b> | <b>June 30,<br/>2007</b> |                          |                              |
|                        | (\$ in millions)         |                          |                          |                              |
| Professional liability | \$ 140.6                 | \$ 145.3                 | \$ (4.7)                 | (3.2)%                       |
| General casualty       | 108.0                    | 134.2                    | (26.2)                   | (19.5)                       |
| Healthcare             | 39.9                     | 30.3                     | 9.6                      | 31.7                         |
| Other                  | 10.8                     | 3.5                      | 7.3                      | 208.6                        |
|                        | \$ 299.3                 | \$ 313.3                 | \$ (14.0)                | (4.5)%                       |

Net premiums written decreased \$22.3 million, or 9.2%, for the six months ended June 30, 2008 compared to the six months ended June 30, 2007. The decrease in net premiums written was greater than the decrease in gross premiums written. This was due to an increase in reinsurance purchased on our casualty business for the six months ended June 30, 2008 compared to the same period in 2007. We ceded 26.5% of gross premiums written for the six months ended June 30, 2008 compared to 22.7% for the six months ended June 30, 2007. The percentage of premiums ceded were higher for each of our lines of business during the six months ended June 30, 2008 compared to the six months ended June 30, 2007. Net premiums earned decreased \$33.3 million, or 13.4%, due to lower gross premiums written and increased reinsurance utilization.

*Net losses and loss expenses.* Net losses and loss expenses decreased by \$36.4 million, or 24.1%, for the six months ended June 30, 2008 compared to the six months ended June 30, 2007. The decrease in net losses and loss expenses was primarily due to higher net favorable reserve development recognized and the reduction in net premiums earned. Overall, our casualty segment recorded net favorable reserve development of \$47.2 million during the six months ended June 30, 2008 compared to net favorable reserve development of \$29.7 million for the six months ended June 30, 2007.

The net favorable reserve development of \$47.2 million recognized during the six months ended June 30, 2008 was primarily as a result of general casualty, professional liability and healthcare lines of business actual loss emergence being lower than the initial expected loss emergence for the 2002 through 2004 loss years.

The \$29.7 million net favorable reserve development during the six months ended June 30, 2007 included the following:

Favorable reserve development of \$107.6 million related to low loss emergence primarily in our professional liability and healthcare lines of business for the 2003, 2004 and 2006 loss years and general casualty line of business for the 2004 loss year.

This was partially offset by \$77.9 million of unfavorable reserve development due to higher than anticipated loss emergence in our general casualty line of business for the 2003 and 2005 loss years and in our professional liability line for the 2002 loss year.

The loss and loss expense ratio for the six months ended June 30, 2008 was 53.5%, compared to 61.0% for the six months ended June 30, 2007. The net favorable reserve development recognized during the six months ended June 30, 2008 decreased the loss and loss expense ratio by 22.0 percentage points. Thus, the loss and loss expense ratio related to the current period's business was 75.5% for the six months ended June 30, 2008. Comparatively, the net favorable reserve development recognized during the six months ended June 30, 2007 decreased the loss and loss expense ratio by 12.0 percentage points. Thus, the loss and loss expense ratio related to that period's business was 73.0%. The increase in the loss and loss expense ratio for the current period's business was due to lower rates on new and renewal policies.



Net paid losses were \$33.5 million for the six months ended June 30, 2008 compared to \$60.3 million for the six months ended June 30, 2007. The decrease is due to the timing of payments of claims that have already been reserved for in prior periods.

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The table below is a reconciliation of the beginning and ending reserves for losses and loss expenses for the six months ended June 30, 2008 and 2007. Losses incurred and paid are reflected net of reinsurance recoverables.

|  | <b>Six Months<br/>Ended June 30,<br/>2008                      2007<br/>(\$ in millions)</b> |            |
|--|--|------------|
| Net reserves for losses and loss expenses, January 1 | \$ 1,878.2   | \$ 1,691.2 |
| Included related to:                                 |  |            |
| Current period non-catastrophe                       | 162.1  | 181.0      |
| Current period catastrophe                           |  |            |
| Prior period non-catastrophe                         | (47.2)   | (29.7)     |
| Prior period catastrophe                             |  |            |
| Total incurred                                       | \$ 114.9   | \$ 151.3   |
| Paid related to:                                     |  |            |
| Current period non-catastrophe                       |  |            |
| Current period catastrophe                           |  |            |
| Prior period non-catastrophe                         | 33.5   | 60.3       |
| Prior period catastrophe                             |  |            |
| Total paid   | \$ 33.5  | \$ 60.3    |
| Foreign exchange revaluation                         |  |            |
| Net reserve for losses and loss expenses, June 30    | 1,959.6  | 1,782.2    |
| Losses and loss expenses recoverable                 | 407.3  | 220.0      |
| Reserve for losses and loss expenses, June 30        | \$ 2,366.9   | \$ 2,002.2 |

*Acquisition costs.* Acquisition costs decreased \$2.6 million, or 23.4%, for the six months ended June 30, 2008 compared to the six months ended June 30, 2007. The decrease was primarily related to lower gross premiums written and an increase in ceding commission income with the increase in reinsurance we purchased. The decrease in the acquisition cost ratio from 4.4% for the six months ended June 30, 2007 to 4.0% for the six months ended June 30, 2008 was due to the increase in ceding commission received partially offset by increased premium taxes and broker commissions.

*General and administrative expenses.* General and administrative expenses increased \$16.0 million, or 50.0%, for the six months ended June 30, 2008 compared to the six months ended June 30, 2007. The increase in general and administrative expenses was attributable to increased salary and related costs including a one-time expense of \$2.1 million for the reimbursement of stock compensation and signing bonuses for new executives hired as a result of the continued expansion of our U.S. operations, increased building-related costs, increased professional fees and higher costs associated with information technology. The 9.5 percentage point increase in the general and administrative expense ratio from 12.9% for the six months ended June 30, 2007 to 22.4% for the same period in 2008 was primarily a result of the factors discussed above, while net premiums earned declined.

**Table of Contents****Reinsurance Segment**

The following table summarizes the underwriting results and associated ratios for the reinsurance segment for the three months ended June 30, 2008 and 2007, and for the six months ended June 30, 2008 and 2007.

|  | Three Months<br>Ended June 30, |          | Six Months<br>Ended June 30, |          |
|--|--------------------------------|----------|------------------------------|----------|
|  | 2008                           | 2007     | 2008                         | 2007     |
|  | (\$ in millions)               |          |                              |          |
| <b>Revenues</b>                          |                                |          |                              |          |
| Gross premiums written                   | \$ 136.6                       | \$ 186.0 | \$ 326.4                     | \$ 397.3 |
| Net premiums written                     | 136.6                          | 186.0    | 326.0                        | 397.1    |
| Net premiums earned                      | 119.1                          | 131.1    | 239.5                        | 248.8    |
| <b>Expenses</b>                          |                                |          |                              |          |
| Net losses and loss expenses             | \$ 73.7                        | \$ 81.2  | \$ 129.4                     | \$ 149.9 |
| Acquisition costs                        | 24.0                           | 26.7     | 47.0                         | 49.6     |
| General and administrative expenses      | 11.1                           | 9.6      | 20.2                         | 19.7     |
| <b>Underwriting income</b>               | 10.3                           | 13.6     | 42.9                         | 29.6     |
| <b>Ratios</b>                            |                                |          |                              |          |
| Loss and loss expense ratio              | 61.9%                          | 61.9%    | 54.0%                        | 60.3%    |
| Acquisition cost ratio                   | 20.2                           | 20.4     | 19.6                         | 19.9     |
| General and administrative expense ratio | 9.3                            | 7.3      | 8.4                          | 7.9      |
| Expense ratio                            | 29.5                           | 27.7     | 28.0                         | 27.8     |
| Combined ratio                           | 91.4                           | 89.6     | 82.0                         | 88.1     |

**Comparison of Three Months Ended June 30, 2008 and 2007**

*Premiums.* Gross premiums written decreased \$49.4 million, or 26.6%, for the three months ended June 30, 2008 compared to the same period in 2007. The decrease in gross premiums written was primarily due to non-renewal of business that did not meet our underwriting requirements (which included pricing and/or contract terms and conditions), rate decreases from increased competition for new and renewal business, net downward adjustments on estimated premiums and some cedents purchased less reinsurance. Adjustments on estimated premiums were lower by \$17.0 million during the three months ended June 30, 2008 compared to the three months ended June 30, 2007. We recognized net downward adjustments of \$5.9 million during the three months ended June 30, 2008 compared to net upward adjustments of \$11.1 million during the three months ended June 30, 2007. Given declining market rates, actual premiums are lower than the estimated premiums thus resulting in downward premium adjustments during the three months ended June 30, 2008. As our historical experience develops, we may have fewer or smaller adjustments to our estimated premiums. The impact of some cedents purchasing less reinsurance resulted in lower gross premiums written of approximately \$7.0 million. During the three months ended June 30, 2008, our Bermuda and U.S. reinsurance operations wrote gross premiums written of \$93.0 million and \$43.6 million, respectively. The gross premiums written by our U.S. reinsurance operations, which commenced business in April 2008, included the renewal of certain treaties previously written in Bermuda of \$34.9 million.

The table below illustrates our gross premiums written by line of business for the three months ended June 30, 2008 and 2007.

|                                    | Three Months<br>Ended<br>June 30, |         | Dollar<br>Change | Percentage<br>Change |
|------------------------------------|-----------------------------------|---------|------------------|----------------------|
|                                    | 2008                              | 2007    |                  |                      |
|                                    | (\$ in millions)                  |         |                  |                      |
| International reinsurance          | \$ 40.7                           | \$ 33.9 | \$ 6.8           | 20.1%                |
| Professional liability reinsurance | 30.4                              | 50.1    | (19.7)           | (39.3)               |

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|                              |          |          |           |         |
|------------------------------|----------|----------|-----------|---------|
| Property reinsurance         | 28.9     | 38.2     | (9.3)     | (24.3)  |
| General casualty reinsurance | 27.0     | 48.9     | (21.9)    | (44.8)  |
| Facultative reinsurance      | 4.4      | 9.9      | (5.5)     | (55.6)  |
| Other                        | 5.2      | 5.0      | 0.2       | 4.0     |
|                              | \$ 136.6 | \$ 186.0 | \$ (49.4) | (26.6)% |

Net premiums written decreased by \$49.4 million, or 26.6%, which was consistent with the decrease in gross premiums written. Net premiums earned decreased \$12.0 million, or 9.2%, primarily as a result of lower net premiums written. Premiums related to our

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reinsurance business earn at a slower rate than those related to our direct insurance business. Direct insurance premiums typically earn ratably over the term of a policy. Reinsurance premiums under a proportional contract are typically earned over the same period as the underlying policies, or risks, covered by the contract. As a result, the earning pattern of a proportional contract may extend up to 24 months, reflecting the inception dates of the underlying policies. Property catastrophe premiums and premiums for other treaties written on a losses occurring basis earn ratably over the term of the reinsurance contract.

*Net losses and loss expenses.* Net losses and loss expenses decreased by \$7.5 million, or 9.2%, for the three months ended June 30, 2008 compared to the three months ended June 30, 2007. The decrease in net losses and loss expenses was primarily due to lower net premiums earned partially offset by lower net favorable reserve development recognized during the three months ended June 30, 2008 compared to the three months ended June 30, 2007. During the three months ended June 30, 2008, we recognized net favorable reserve development of \$2.0 million due to favorable development in the 2007 loss year related to windstorm Kyrill and the floods in the U.K. and Australia. Comparatively, we recorded net favorable reserve development of approximately \$3.3 million during the three months ended June 30, 2007 consisting of \$1.6 million related to low loss emergence in our property reinsurance lines of business for the 2004 and 2005 loss years and \$1.7 million related to low loss emergence in our accident and health reinsurance line of business for the 2004 and 2005 loss years.

The loss and loss expense ratio was 61.9% for both the three months ended June 30, 2008 and 2007. Net favorable development recognized during the three months ended June 30, 2008 reduced the loss and loss expense ratio by 1.7 percentage points. Thus, the loss and loss expense ratio related to the current period's business was 63.6%. In comparison, net favorable loss development recognized in the three months ended June 30, 2007 reduced the loss and loss expense ratio by 2.5 percentage points. Thus, the loss and loss expense ratio related to that period's business was 64.4%. Included in the current period's business were net incurred losses and loss expenses of \$5.0 million related to the flooding in the U.S. Midwest. Comparatively during the three months ended June 30, 2007, we recognized net losses and loss expenses of \$9.0 million related to the floods in the U.K. and Australia.

We continue to review the impact of the subprime and credit related downturn on professional liability reinsurance contracts we write. We have high attachment points for our professional liability contracts, which makes estimating whether losses will exceed our attachment point more difficult. Based on claims information received to date and our analysis, the average attachment point for our professional liability reinsurance contracts with potential subprime and credit related exposure is approximately \$99 million with average limits of \$1.7 million. At this time we believe, based on the claims information received to date, that our current IBNR is adequate to meet any potential subprime and credit related losses. As of June 30, 2008, we have recorded a case reserve of \$7.5 million for subprime and credit related losses. We will continue to monitor our reserve for losses and loss expenses for any new claims information and adjust our reserve for losses and loss expenses accordingly.

Net paid losses were \$32.1 million for the three months ended June 30, 2008 compared to \$30.0 million for the three months ended June 30, 2007. The increase in paid losses was due to higher net paid losses related to the 2004 and 2005 windstorms. During the three months ended June 30, 2008, approximately \$10.6 million of net losses were paid in relation to the 2004 and 2005 windstorms compared to approximately \$8.6 million during the three months ended June 30, 2007.

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The table below is a reconciliation of the beginning and ending reserves for losses and loss expenses for the three months ended June 30, 2008 and 2007. Losses incurred and paid are reflected net of reinsurance recoverables.

|  | <b>Three Months June 30,<br/>Ended</b> |             |
|--|--|-------------|
|  | <b>2008</b>                            | <b>2007</b> |
|  | <b>(\$ in millions)</b>                |             |
| Net reserves for losses and loss expenses, April 1 | \$ 1,026.3                             | \$ 855.2    |
| Included related to:                               |  |             |
| Current period non-catastrophe                     | 70.7                                   | 84.5        |
| Current period property catastrophe                | 5.0                                    |             |
| Prior period non-catastrophe                       | (2.0)                                  | (3.3)       |
| Prior period property catastrophe                  |  |             |
| Total incurred                                     | \$ 73.7                                | \$ 81.2     |
| Paid related to:                                   |  |             |
| Current period non-catastrophe                     | 4.2                                    | 0.1         |
| Current period property catastrophe                |  |             |
| Prior period non-catastrophe                       | 17.3                                   | 21.3        |
| Prior period property catastrophe                  | 10.6                                   | 8.6         |
| Total paid   | \$ 32.1                                | \$ 30.0     |
| Foreign exchange revaluation                       |  |             |
| Net reserve for losses and loss expenses, June 30  | 1,067.9                                | 906.4       |
| Losses and loss expenses recoverable               | 9.4                                    | 27.7        |
| Reserve for losses and loss expenses, June 30      | \$ 1,077.3                             | \$ 934.1    |

*Acquisition costs.* Acquisition costs decreased by \$2.7 million, or 10.1%, for the three months ended June 30, 2008 compared to the three months ended June 30, 2007 primarily as a result of the related decrease in net premiums earned. The acquisition cost ratio of 20.2% for the three-month period ended June 30, 2008 was in line with the 20.4% acquisition cost ratio for the three-month period ended June 30, 2007.

*General and administrative expenses.* General and administrative expenses increased \$1.5 million, or 15.6%, for the three months ended June 30, 2008 compared to the three months ended June 30, 2007. The increase in general and administrative expenses was attributable to increased salary and related costs including a one-time expense of \$0.5 million for the reimbursement of stock compensation for new executives hired as a result of the build-out of our U.S. reinsurance operations, increased building-related costs, increased professional fees and higher costs associated with information technology. The 2.0 percentage point increase in the general and administrative expense ratio from 7.3% for the three months ended June 30, 2007 to 9.3% for the three months ended June 30, 2008 was primarily a result of the factors discussed above, while net premiums earned declined.

**Comparison of Six Months Ended June 30, 2008 and 2007**

*Premiums.* Gross premiums written decreased \$70.9 million, or 17.8%, for the six months ended June 30, 2008 compared to the same period in 2007. The decrease in gross premiums written was primarily due to non-renewal of business that did not meet our underwriting requirements (which included pricing and/or contract terms and conditions), rate decreases from increased competition for new and renewal business, net downward adjustments on estimated premiums and some cedents purchased less reinsurance. Adjustments on estimated premiums were lower by \$18.0 million during the six months ended June 30, 2008 compared to the six months ended June 30, 2007. We recognized net downward adjustments of \$8.0 million during the six months ended June 30, 2008 compared to net upward adjustments of \$10.0 million during the six months ended June 30, 2007. The impact of some cedents

purchasing less reinsurance resulted in lower gross premiums written of approximately \$12.0 million.

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The table below illustrates our gross premiums written by line of business for the six months ended June 30, 2008 and 2007.

|                                    | <b>Six Months Ended</b>  |                          | <b>Dollar<br/>Change</b> | <b>Percentage<br/>Change</b> |
|------------------------------------|--------------------------|--------------------------|--------------------------|------------------------------|
|                                    | <b>June 30,<br/>2008</b> | <b>June 30,<br/>2007</b> |                          |                              |
|                                    | (\$ in millions)         |                          |                          |                              |
| Professional liability reinsurance | \$ 108.0                 | \$ 146.7                 | \$ (38.7)                | (26.4)%                      |
| General casualty reinsurance       | 71.2                     | 96.8                     | (25.6)                   | (26.4)                       |
| International reinsurance          | 71.0                     | 66.2                     | 4.8                      | 7.3                          |
| Property reinsurance               | 55.1                     | 63.6                     | (8.5)                    | (13.4)                       |
| Facultative reinsurance            | 11.0                     | 16.3                     | (5.3)                    | (32.5)                       |
| Other                              | 10.1                     | 7.7                      | 2.4                      | 31.2                         |
|                                    | \$ 326.4                 | \$ 397.3                 | \$ (70.9)                | (17.8)%                      |

Net premiums written decreased by \$71.1 million, or 17.9%, which was consistent with the decrease in gross premiums written. Net premiums earned decreased \$9.3 million, or 3.7%, as a result of lower net premiums written.

*Net losses and loss expenses.* Net losses and loss expenses decreased by \$20.5 million, or 13.7%, for the six months ended June 30, 2008 compared to the six months ended June 30, 2007. The decrease in net losses and loss expenses was primarily due to higher net favorable reserve development recognized during the six months ended June 30, 2008 compared to the six months ended June 30, 2007. During the six months ended June 30, 2008, we recognized net favorable reserve development of \$24.8 million, which included net favorable reserve development of \$22.7 million for the 2005 windstorms, and net favorable reserve development of \$2.1 million primarily due to favorable development in the 2007 loss year related to windstorm Kyrill and the floods in the U.K. and Australia. We recognized net favorable reserve development of approximately \$4.4 million during the six months ended June 30, 2007, which included net favorable reserve development of approximately \$1.1 million related to the 2004 and 2005 windstorms. The remaining net favorable reserve development of \$3.3 million was comprised of \$1.6 million related to low loss emergence in our property reinsurance lines of business for the 2004 and 2005 loss years and \$1.7 million related to low loss emergence in our accident and health reinsurance line of business for the 2004 and 2005 loss years.

The loss and loss expense ratio for the six months ended June 30, 2008 was 54.0% compared to 60.3% for the six months ended June 30, 2007. Net favorable reserve development recognized during the six months ended June 30, 2008 reduced the loss and loss expense ratio by 10.4 percentage points. Thus, the loss and loss expense ratio related to the current period's business was 64.4%. In comparison, net favorable reserve development recognized in the six months ended June 30, 2007 reduced the loss and loss expense ratio by 1.8 percentage points. Thus, the loss and loss expense ratio related to that period's business was 62.1%. The increase in the loss and loss expense ratio for the current period's business was due to lower rates on new and renewal contracts, and higher than expected reported loss activity including \$5.0 million in net losses and loss expenses recognized related to the floods in the U.S. Midwest.

Net paid losses were \$59.7 million for the six months ended June 30, 2008 compared to \$76.3 million for the six months ended June 30, 2007. The decrease reflects lower net losses paid in relation to the 2004 and 2005 windstorms from \$20.4 million for the six months ended June 30, 2007 to \$15.2 million for the six months ended June 30, 2008 and lower losses paid for our property treaty line of business.



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The table below is a reconciliation of the beginning and ending reserves for losses and loss expenses for the six months ended June 30, 2008 and 2007. Losses incurred and paid are reflected net of reinsurance recoverables.

|  | <b>Six Months Ended<br/>June 30,</b> |             |
|--|--------------------------------------|-------------|
|  | <b>2008</b>                          | <b>2007</b> |
|  | <b>(\$ in millions)</b>              |             |
| Net reserves for losses and loss expenses, January 1 | \$ 998.2                             | \$ 832.8    |
| Included related to:                                 |                                      |             |
| Current period non-catastrophe                       | 149.2                                | 154.3       |
| Current period property catastrophe                  | 5.0                                  |             |
| Prior period non-catastrophe                         | (2.1)                                | (3.3)       |
| Prior period property catastrophe                    | (22.7)                               | (1.1)       |
| Total incurred                                       | \$ 129.4                             | \$ 149.9    |
| Paid related to:                                     |                                      |             |
| Current period non-catastrophe                       | 5.8                                  | 0.1         |
| Current period property catastrophe                  |                                      |             |
| Prior period non-catastrophe                         | 38.7                                 | 55.8        |
| Prior period property catastrophe                    | 15.2                                 | 20.4        |
| Total paid   | \$ 59.7                              | \$ 76.3     |
| Foreign exchange revaluation                         |                                      |             |
| Net reserve for losses and loss expenses, June 30    | 1,067.9                              | 906.4       |
| Losses and loss expenses recoverable                 | 9.4                                  | 27.7        |
| Reserve for losses and loss expenses, June 30        | \$ 1,077.3                           | \$ 934.1    |

*Acquisition costs.* Acquisition costs decreased by \$2.6 million, or 5.2%, for the six months ended June 30, 2008 compared to the six months ended June 30, 2007 primarily as a result of the related decrease in net premiums earned. The acquisition cost ratio of 19.6% for the six-month period ended June 30, 2008 was in line with the 19.9% acquisition cost ratio for the six-month period ended June 30, 2007.

*General and administrative expenses.* General and administrative expenses increased \$0.5 million, or 2.5%, for the six months ended June 30, 2008 compared to the six months ended June 30, 2007. The increase was primarily the result of a one-time expense of \$1.2 million for the reimbursement of stock compensation and signing bonuses for new executives hired as a result of the continued expansion of our U.S. operations and increased building-related costs, increased professional fees and higher costs associated with information technology partially offset by lower salary and related costs. The 0.5 percentage point increase in the general and administrative expense ratio from 7.9% for the six months ended June 30, 2007 to 8.4% for the six months ended June 30, 2008 was primarily a result of the factors discussed above, while net premiums earned decreased.

**Reserves for Losses and Loss Expenses**

Reserves for losses and loss expenses as of June 30, 2008 and December 31, 2007 were comprised of the following:

| <b>Jun.<br/>30,<br/>2008</b> | <b>Property</b>          |                          | <b>Casualty</b>          |                          | <b>Reinsurance</b>       |                          | <b>Total</b>             |  |
|------------------------------|--------------------------|--------------------------|--------------------------|--------------------------|--------------------------|--------------------------|--------------------------|--|
|                              | <b>Dec. 31,<br/>2007</b> | <b>Jun. 30,<br/>2008</b> | <b>Dec. 31,<br/>2007</b> | <b>Jun. 30,<br/>2008</b> | <b>Dec. 31,<br/>2007</b> | <b>Jun. 30,<br/>2008</b> | <b>Dec. 31,<br/>2007</b> |  |
| (\$ in millions)             |                          |                          |                          |                          |                          |                          |                          |  |

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|  |          |          |            |            |            |          |            |            |
|--|----------|----------|------------|------------|------------|----------|------------|------------|
| Case reserves                                  | \$ 444.3 | \$ 480.0 | \$ 350.9   | \$ 270.7   | \$ 239.0   | \$ 212.7 | \$ 1,034.3 | \$ 963.4   |
| IBNR   | 275.6    | 280.7    | 2,016.0    | 1,872.0    | 838.3      | 803.7    | 3,129.9    | 2,956.4    |
| Reserve for losses<br>and loss expenses        | 719.9    | 760.7    | 2,366.9    | 2,142.7    | 1,077.3    | 1,016.4  | 4,164.2    | 3,919.8    |
| Reinsurance<br>recoverables                    | (361.8)  | (400.1)  | (407.3)    | (264.5)    | (9.4)      | (18.2)   | (778.6)    | (682.8)    |
| Net reserve for<br>losses and loss<br>expenses | \$ 358.1 | \$ 360.6 | \$ 1,959.6 | \$ 1,878.2 | \$ 1,067.9 | \$ 998.2 | \$ 3,385.6 | \$ 3,237.0 |

Included in the increase in reserves for losses and loss expenses for the casualty segment from December 31, 2007 to June 30, 2008 was the reserves for losses and loss expenses assumed in connection with the acquisition of Finial Insurance Company, now known as Allied World Reinsurance Company. As a part of the acquisition, we assumed case reserves of \$56.4 million and IBNR of \$48.5 million. The case reserves and IBNR assumed were 100% ceded to National Indemnity Company, an affiliate of Berkshire

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Hathaway Inc., resulting in an increase of \$104.9 million in reinsurance recoverables. Please refer to Note 4 of the notes to the unaudited condensed consolidated financial statements for additional information regarding the acquisition of Finial Insurance Company. As of June 30, 2008, the case reserves and IBNR assumed from Finial Insurance Company were \$56.4 million and \$44.8 million, respectively.

We participate in certain lines of business where claims may not be reported for many years. Accordingly, management does not solely rely upon reported claims on these lines for estimating ultimate liabilities. As such, we also use statistical and actuarial methods to estimate expected ultimate losses and loss expenses. Loss reserves do not represent an exact calculation of liability. Rather, loss reserves are estimates of what we expect the ultimate resolution and administration of claims will cost. These estimates are based on various factors including underwriters expectations about loss experience, actuarial analysis, comparisons with the results of industry benchmarks and loss experience to date. Loss reserve estimates are refined as experience develops and as claims are reported and resolved. Establishing an appropriate level of loss reserves is an inherently uncertain process. Ultimate losses and loss expenses may differ from our reserves, possibly by material amounts.

The following tables provide our ranges of loss and loss expense reserve estimates by business segment as of June 30, 2008:

|             | <b>Reserve for Losses and Loss Expenses<br/>Gross of Reinsurance Recoverable(1)</b> |                         |                          |
|-------------|---|-------------------------|--------------------------|
|             | <b>Carried<br/>Reserves</b>   | <b>Low<br/>Estimate</b> | <b>High<br/>Estimate</b> |
|             | (\$ in millions)  |                         |                          |
| Property    | \$ 719.9  | \$ 549.0                | \$ 881.5                 |
| Casualty    | 2,366.9   | 1,717.6                 | 2,680.4                  |
| Reinsurance | 1,077.3   | 784.7                   | 1,352.5                  |

|             | <b>Reserve for Losses and Loss Expenses<br/>Net of Reinsurance Recoverable(1)</b> |                         |                          |
|-------------|---|-------------------------|--------------------------|
|             | <b>Carried<br/>Reserves</b>   | <b>Low<br/>Estimate</b> | <b>High<br/>Estimate</b> |
|             | (\$ in millions)  |                         |                          |
| Property    | \$ 358.1  | \$ 266.4                | \$ 450.2                 |
| Casualty    | 1,959.6   | 1,388.8                 | 2,233.3                  |
| Reinsurance | 1,067.9   | 776.1                   | 1,343.0                  |

(1) For statistical reasons, it is not appropriate to add together the ranges of each business segment in an effort to determine the low and high range around the consolidated loss reserves.

Our range for each business segment was determined by utilizing multiple actuarial loss reserving methods along with various assumptions of reporting patterns and expected loss ratios by loss year. The various outcomes of these

techniques were combined to determine a reasonable range of required loss and loss expense reserves.

Our selection of the actual carried reserves has typically been above the midpoint of the range. We believe that we should be conservative in our reserving practices due to the lengthy reporting patterns and relatively large limits of net liability for any one risk of our direct excess casualty business and of our casualty reinsurance business. Thus, due to this uncertainty regarding estimates for reserve for losses and loss expenses, we have historically carried our consolidated reserve for losses and loss expenses, net of reinsurance recoverable, above the midpoint of the low and high estimates for the consolidated net losses and loss expenses. These long-tail lines of business include our entire casualty segment, as well as the general casualty, professional liability, facultative casualty and the international casualty components of our reinsurance segment. We believe that relying on the more conservative actuarial indications for these lines of business is prudent for a relatively new company. For a discussion of loss and loss expense reserve estimate, please see Management's Discussion and Analysis of Financial Condition and Results of Operations Critical Accounting Policies Reserve for Losses and Loss Expenses in our Annual Report on Form 10-K filed with the SEC on February 29, 2008.

**Table of Contents****Reinsurance Recoverable**

The following table illustrates our reinsurance recoverable as of June 30, 2008 and December 31, 2007:

|                         | <b>Reinsurance Recoverable</b>     |                                    |
|-------------------------|------------------------------------|------------------------------------|
|                         | <b>As of<br/>Jun. 30,<br/>2008</b> | <b>As of<br/>Dec. 31,<br/>2007</b> |
|                         | (\$ in millions)                   |                                    |
| Ceded case reserves     | \$ 320.8                           | \$ 289.2                           |
| Ceded IBNR reserves     | 457.8                              | 393.6                              |
| Reinsurance recoverable | \$ 778.6                           | \$ 682.8                           |

Included in the increase in ceded case reserves and ceded IBNR from December 31, 2007 to June 30, 2008 was the reinsurance recoverable recorded for the reserves assumed as a part of the acquisition of Finial Insurance Company. As a part of the acquisition, we assumed case reserves of \$56.4 million and IBNR of \$48.5 million. The case reserves and IBNR assumed were 100% ceded to National Indemnity Company, resulting in additional reinsurance recoverables of \$104.9 million. Please refer to Note 4 of the notes to the unaudited condensed consolidated financial statements for additional information regarding the acquisition of Finial Insurance Company. As of June 30, 2008, the reinsurance recoverables from National Indemnity Company were \$101.2 million. We remain obligated for amounts ceded in the event our reinsurers do not meet their obligations. Accordingly, we have evaluated the reinsurers that are providing reinsurance protection to us and will continue to monitor their credit ratings and financial stability. We generally have the right to terminate our treaty reinsurance contracts at any time, upon prior written notice to the reinsurer, under specified circumstances, including the assignment to the reinsurer by A.M. Best of a financial strength rating of less than A-. Approximately 98% of ceded case reserves as of June 30, 2008 were recoverable from reinsurers who had an A.M. Best rating of A- or higher.

**Liquidity and Capital Resources****General**

As of June 30, 2008, our shareholders' equity was \$2.4 billion, a 6.2% increase compared to \$2.2 billion as of December 31, 2007. The increase was primarily the result of net income for the six-month period ended June 30, 2008 of \$210.2 million partially offset by unrealized losses of \$70.9 million during the six months ended June 30, 2008. On January 1, 2008, we adopted FAS 159 and elected the fair value option for our hedge fund investments. Upon adoption of FAS 159, we reclassified the net unrealized gain related to the hedge funds of \$26.3 million from accumulated other comprehensive income and recorded a cumulative-effect adjustment in retained earnings. Any subsequent change in the fair value of our hedge fund investments will be recognized in the consolidated statements of operations and comprehensive income and included in net realized investment gains (losses). Please refer to Note 7 of the notes to our unaudited condensed consolidated financial statements regarding our adoption of FAS 159.

Holdings is a holding company and transacts no business of its own. Cash flows to Holdings may comprise dividends, advances and loans from its subsidiary companies. Holdings is therefore reliant on receiving dividends and other permitted distributions from its subsidiaries to make principal, interest and/or dividend payments on its senior notes and common shares.

**Restrictions and Specific Requirements**

The jurisdictions in which our insurance subsidiaries are licensed to write business impose regulations requiring companies to maintain or meet various defined statutory ratios, including solvency and liquidity requirements. Some jurisdictions also place restrictions on the declaration and payment of dividends and other distributions.

The payment of dividends from Holdings' Bermuda domiciled insurance subsidiary is, under certain circumstances, limited under Bermuda law, which requires our Bermuda insurance subsidiary to maintain certain measures of solvency and liquidity. Holdings



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U.S. domiciled subsidiaries are subject to significant regulatory restrictions limiting their ability to declare and pay dividends. In particular, payments of dividends by Allied World Assurance Company (U.S.) Inc., Allied World National Assurance Company and Allied World Reinsurance Company are subject to restrictions on statutory surplus pursuant to Delaware law, New Hampshire law and New Jersey law, respectively. Each state requires prior regulatory approval of any payment of extraordinary dividends. In addition, Allied World Assurance Company (Europe) Limited and Allied World Assurance Company (Reinsurance) Limited are subject to significant regulatory restrictions limiting their ability to declare and pay any dividends without the consent of the Irish Financial Services Regulatory Authority. We also have insurance subsidiaries that are the parent company for other insurance subsidiaries, which means that dividends and other distributions will be subject to multiple layers of regulations as funds are pushed up to Holdings. The inability of the subsidiaries of Holdings to pay dividends and other permitted distributions could have a material adverse effect on Holdings' cash requirements and ability to make principal, interest and dividend payments on its senior notes and common shares.

Holdings' insurance subsidiary in Bermuda, Allied World Assurance Company, Ltd, is neither licensed nor admitted as an insurer, nor is it accredited as a reinsurer, in any jurisdiction in the United States. As a result, it is required to post collateral security with respect to any reinsurance liabilities it assumes from ceding insurers domiciled in the United States in order for U.S. ceding companies to obtain credit on their U.S. statutory financial statements with respect to insurance liabilities ceded to them. Under applicable statutory provisions, the security arrangements may be in the form of letters of credit, reinsurance trusts maintained by trustees or funds-withheld arrangements where assets are held by the ceding company.

At this time, Allied World Assurance Company, Ltd uses trust accounts primarily to meet security requirements for inter-company and certain related-party reinsurance transactions. We also have cash and cash equivalents and investments on deposit with various state or government insurance departments or pledged in favor of ceding companies in order to comply with relevant insurance regulations. As of June 30, 2008, total trust account deposits were \$735.8 million compared to \$802.7 million as of December 31, 2007. In addition, Allied World Assurance Company, Ltd currently has access to up to \$1.55 billion in letters of credit under two letter of credit facilities, one with Citibank Europe plc and one with a syndication of lenders described below. These facilities are used to provide security to reinsureds and are collateralized by us, at least to the extent of letters of credit outstanding at any given time. As of June 30, 2008 and December 31, 2007, there were outstanding letters of credit totaling \$887.0 million and \$922.2 million, respectively, under the two facilities. Collateral committed to support the letter of credit facilities was \$1,188.9 million as of June 30, 2008, compared to \$1,170.7 million as of December 31, 2007.

In November 2007, we entered into a \$800 million five-year senior credit facility (the Facility) with a syndication of lenders. The Facility consists of a \$400 million secured letter of credit facility for the issuance of standby letters of credit (the Secured Facility) and a \$400 million unsecured facility for the making of revolving loans and for the issuance of standby letters of credit (the Unsecured Facility). Both the Secured Facility and the Unsecured Facility have options to increase the aggregate commitments by up to \$200 million, subject to approval of the lenders. The Facility will be used for general corporate purposes and to issue standby letters of credit. The Facility contains representations, warranties and covenants customary for similar bank loan facilities, including a covenant to maintain a ratio of consolidated indebtedness to total capitalization as of the last day of each fiscal quarter or fiscal year of not greater than 0.35 to 1.0 and a covenant under the Unsecured Facility to maintain a certain consolidated net worth. In addition, each material insurance subsidiary must maintain a financial strength rating from A.M Best Company of at least A- under the Unsecured Facility and of at least B++ under the Secured Facility. Concurrent with this new Facility, we terminated the Letter of Credit Facility with Barclays Bank PLC and all outstanding letters of credit issued thereunder were transferred to the Secured Facility. We were in compliance with all covenants under the Facility as of June 30, 2008.

Security arrangements with ceding insurers may subject our assets to security interests or require that a portion of our assets be pledged to, or otherwise held by, third parties. Both of our letter of credit facilities are fully collateralized by assets held in custodial accounts at the Bank of New York Mellon held for the benefit of the banks. Although the investment income derived from our assets while held in trust accrues to our benefit, the investment of these assets is governed by the terms of the letter of credit facilities or the investment regulations of the state or territory of domicile

of the ceding insurer, which may be more restrictive than the investment regulations applicable to us under Bermuda law. The restrictions may result in lower investment yields on these assets, which may adversely affect our profitability.

We participate in a securities lending program whereby the securities we own that are included in fixed maturity investments available for sale are loaned to third parties, primarily brokerage firms, for a short period of time through a lending agent. We maintain control over the securities we lend and can recall them at any time for any reason. We receive amounts equal to all interest and dividends associated with the loaned securities and receive a fee from the borrower for the temporary use of the securities. Collateral in the form of cash is required initially at a minimum rate of 102% of the market value of the loaned securities and may not

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decrease below 100% of the market value of the loaned securities before additional collateral is required. We had \$189.2 million and \$144.6 million in securities on loan as of June 30, 2008 and December 31, 2007, respectively, with collateral held against such loaned securities amounting to \$191.0 million and \$147.2 million, respectively.

We do not anticipate that the restrictions on liquidity resulting from restrictions on the payments of dividends by our subsidiary companies or from assets committed in trust accounts or to collateralize the letter of credit facilities or by our securities lending program will have a material impact on our ability to carry out our normal business activities, including interest and dividend payments, respectively, on our senior notes and common shares.

**Sources and Uses of Funds**

Our sources of funds primarily consist of premium receipts net of commissions, investment income, net proceeds from capital raising activities that may include the issuance of common shares, senior notes and other debt or equity issuances, and proceeds from sales and redemption of investments. Cash is used primarily to pay losses and loss expenses, purchase reinsurance, pay general and administrative expenses and taxes, and pay dividends and interest, with the remainder made available to our investment managers for investment in accordance with our investment policy.

On December 31, 2007, we filed a shelf-registration statement on Form S-3 (No. 333-148409) with the SEC in which we may offer from time to time common shares, preference shares, depository shares representing common shares or preference shares, senior or subordinated debt securities, warrants to purchase common shares, preference shares and debt securities, share purchase contracts, share purchase units and units which may consist of any combination of the securities listed above. The proceeds from any issuance may be used for working capital, capital expenditures, acquisitions and other general corporate purposes.

Cash flows from operations for the six months ended June 30, 2008 were \$376.6 million compared to \$389.1 million for the six months ended June 30, 2007. The decrease in cash flows from operations was primarily due to lower net premiums written.

Cash flows from investing activities consist primarily of proceeds on the sale of investments and payments for investments acquired. We had cash flows used in investing activities of \$167.9 million for the six months ended June 30, 2008 compared to \$666.3 million for the six months ended June 30, 2007. The decrease in investing cash flows was due to higher proceeds on the sale of fixed maturity securities caused by selling securities to capitalize the initial operations of our U.S. reinsurance platform and to increase the capitalization of our U.S. and European operations, some of which have not yet been reinvested. Also included in the cash flows used in investing activities was the net cash paid for Finial Insurance Company of \$44.1 million. Please refer to Note 4 of our unaudited condensed consolidated financial statements regarding our acquisition of Finial Insurance Company.

Cash flows used in financing activities consist primarily of the payment of dividends and any capital raising activities, which would include the issuance of common shares or debt. During the six months ended June 30, 2008 we paid dividends of \$17.6 million compared to \$18.1 million during the six months ended June 30, 2007.

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On August 7, 2008, our board of directors declared a quarterly dividend of \$0.18 per share, or approximately \$8.8 million in aggregate, payable on September 11, 2008 to the shareholders of record as of August 26, 2008. We expect our operating cash flows, together with our existing capital base, to be sufficient to meet these requirements and to operate our business. Our funds are primarily invested in liquid, high-grade fixed income securities. As of June 30, 2008 and December 31, 2007, including a global high-yield bond fund, 99% of our fixed income portfolio consisted of investment grade securities. As of June 30, 2008 and December 31, 2007, net accumulated unrealized gains, net of income taxes, were \$39.0 million and \$136.2 million, respectively. This change reflected movements in interest rates partially offset by the recognition of approximately \$37.3 million of realized losses on securities that were considered to be impaired on an other-than-temporary-basis. The maturity distribution of our fixed income portfolio (on a market value basis) as of June 30, 2008 and December 31, 2007 was as follows:

|  | <b>June 30,<br/>2008</b> | <b>December<br/>31,<br/>2007</b> |
|--|--------------------------|----------------------------------|
|  | (\$ in millions)         |                                  |
| Due in one year or less                | \$ 468.3                 | \$ 474.1                         |
| Due after one year through five years  | 1,760.0                  | 1,982.1                          |
| Due after five years through ten years | 1,104.0                  | 869.0                            |
| Due after ten years                    | 315.0                    | 99.5                             |
| Mortgage-backed                        | 1,962.1                  | 2,117.5                          |
| Asset-backed                           | 124.1                    | 164.9                            |
| Total                                  | \$ 5,733.5               | \$ 5,707.1                       |

We have investments in various hedge funds, the market value of which was \$192.7 million as of June 30, 2008. Each of the hedge funds has redemption notice requirements. For those hedge funds that are in the form of limited partnerships, liquidity is allowed after the term of the partnership and could be extended at the option of the general partner. As of June 30, 2008, we had two hedge funds that were in the form of limited partnerships, which allow for liquidity in 2010 unless extended by the general partners. Our other hedge funds typically allow liquidity an average of three months after we give notice of redemption.

We do not believe that inflation has had a material effect on our consolidated results of operations. The potential exists, after a catastrophe loss, for the development of inflationary pressures in a local economy. The effects of inflation are considered implicitly in pricing. Loss reserves are established to recognize likely loss settlements at the date payment is made. Those reserves inherently recognize the effects of inflation. The actual effects of inflation on our results cannot be accurately known, however, until claims are ultimately resolved.

**Financial Strength Ratings**

Financial strength ratings and senior unsecured debt ratings represent the opinions of rating agencies on our capacity to meet our obligations. Some of our reinsurance treaties contain special funding and termination clauses that are triggered in the event that we or one of our subsidiaries is downgraded by one of the major rating agencies to levels specified in the treaties, or our capital is significantly reduced. If such an event were to happen, we would be required, in certain instances, to post collateral in the form of letters of credit and/or trust accounts against existing outstanding losses, if any, related to the treaty. In a limited number of instances, the subject treaties could be cancelled retroactively or commuted by the cedent and might affect our ability to write business.

The following were our financial strength ratings as of August 4, 2008:

|                   |   |
|-------------------|---|
| A.M. Best         | A/stable                                    |
| Moody s*          | A2/negative                                 |
| Standard & Poor s | A-/ under review with negative implications |

\* Moody's financial strength ratings are for the company's Bermuda and U.S. insurance and reinsurance subsidiaries.

The following were our senior unsecured debt ratings as of August 4, 2008:

|                   |   |
|-------------------|---|
| A.M. Best         | bbb/stable                                  |
| Moody's           | Baa1/negative                               |
| Standard & Poor's | BBB/under review with negative implications |

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**Table of Contents****Long-Term Debt**

On July 21, 2006, we issued \$500.0 million aggregate principal amount of 7.50% senior notes due August 1, 2016, with interest payable August 1 and February 1 each year, commencing February 1, 2007. We can redeem the senior notes prior to maturity, subject to payment of a make-whole premium, however, we currently have no intention of redeeming the notes. The senior notes include certain covenants that include:

Limitation on liens on stock of designated subsidiaries;

Limitation as to the disposition of stock of designated subsidiaries; and

Limitations on mergers, amalgamations, consolidations or sale of assets.

We were in compliance with all covenants related to our senior notes as of June 30, 2008.

**Off-Balance Sheet Arrangements**

As of June 30, 2008, we did not have any off-balance sheet arrangements.

**Item 3. Quantitative and Qualitative Disclosures About Market Risk.**

We believe that we are principally exposed to three types of market risk: interest rate risk, credit risk and currency risk.

The fixed income securities in our investment portfolio are subject to interest rate risk. Any change in interest rates has a direct effect on the market values of fixed income securities. As interest rates rise, the market values fall, and vice versa. We estimate that an immediate adverse parallel shift in the U.S. Treasury yield curve of 200 basis points would cause an aggregate decrease in the market value of our fixed maturity investments and cash and cash equivalents of approximately \$394.7 million, or 6.5%, as set forth in the following table:

|  | Interest Rate Shift in Basis Points |           |           |           |           |           |           |
|--|-------------------------------------|-----------|-----------|-----------|-----------|-----------|-----------|
|  | -200                                | -100      | -50       | 0         | +50       | +100      | +200      |
|  | (\$ in millions)                    |           |           |           |           |           |           |
| Total market value                                   | \$6,681.8                           | \$6,466.2 | \$6,361.2 | \$6,258.0 | \$6,156.6 | \$6,057.0 | \$5,863.3 |
| Market value change from base                        | 423.8                               | 208.2     | 103.2     | 0         | (101.4)   | (201.0)   | (394.7)   |
| Change in unrealized appreciation/<br>(depreciation) | 6.8%                                | 3.3%      | 1.6%      | 0.0%      | (1.6)%    | (3.3)%    | (6.5)%    |

As a holder of fixed income securities, we also have exposure to credit risk. In an effort to minimize this risk, our investment guidelines have been defined to ensure that the assets held are well diversified and are primarily high-quality securities. As of June 30, 2008, approximately 99% of our fixed income investments (which includes individually held securities and securities held in a global high-yield bond fund) consisted of investment grade securities. We were not exposed to any significant concentrations of credit risk.

As of June 30, 2008, we held \$1,962.1 million, or 30.1%, of our aggregate invested assets in mortgage-backed securities. These assets are exposed to prepayment risk, which occurs when holders of individual mortgages increase the frequency with which they prepay the outstanding principal before the maturity date to refinance at a lower interest rate cost. Given the proportion that these securities comprise of the overall portfolio, and the current interest rate environment, prepayment risk is not considered significant at this time. In addition, nearly all of our investments in mortgage-backed securities were rated Aaa by Moody's and AAA by Standard & Poor's as of June 30, 2008. As of June 30, 2008, our mortgage-backed securities that have exposure to subprime mortgages was limited to \$2.5 million, or 0.04%, of our fixed maturity investments.

As of June 30, 2008, we invested in various hedge funds with a market value of \$192.7 million. Investments in hedge funds involve certain risks related to, among other things, the illiquid nature of the fund shares, the limited operating history of the fund, as well as risks associated with the strategies employed by the managers of the funds. The funds' objectives are generally to seek attractive long-term returns with lower volatility by investing in a range of diversified investment strategies. As our reserves and capital continue to build, we may consider additional investments in these or other alternative investments.



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The U.S. dollar is our reporting currency and the functional currency of all of our operating subsidiaries. We enter into insurance and reinsurance contracts where the premiums receivable and losses payable are denominated in currencies other than the U.S. dollar. In addition, we maintain a portion of our investments and liabilities in currencies other than the U.S. dollar, primarily Euro, British Sterling and the Canadian dollar. Assets in non-U.S. currencies are generally converted into U.S. dollars at the time of receipt. When we incur a liability in a non-U.S. currency, we carry such liability on our books in the original currency. These liabilities are converted from the non-U.S. currency to U.S. dollars at the time of payment. As a result, we have an exposure to foreign currency risk resulting from fluctuations in exchange rates.

As of June 30, 2008 and December 31, 2007, 2.2% and 2.3%, respectively, of our aggregate invested assets were denominated in currencies other than the U.S. dollar. Of our business written in the six months ended June 30, 2008 and 2007, approximately 18% and 15% was written in currencies other than the U.S. dollar, respectively. Of our business written in the year ended December 31, 2007, approximately 14% was written in currencies other than the U.S. dollar. We utilize a hedging strategy whose objective is to minimize the potential loss of value caused by currency fluctuations by using foreign currency forward contract derivatives that expire in 90 days.

Our foreign exchange (loss) gain for the six months ended June 30, 2008 and 2007 and the year ended December 31, 2007 are set forth in the chart below.

|                                 | <b>Six Months<br/>Ended</b> |             | <b>Year<br/>Ended</b> |
|---------------------------------|-----------------------------|-------------|-----------------------|
|                                 | <b>June 30,</b>             |             | <b>December</b>       |
|                                 | <b>2008</b>                 | <b>2007</b> | <b>31</b>             |
|                                 | <b>(\$ in millions)</b>     |             |                       |
| Realized exchange (loss) gain   | \$ (0.2)                    | \$ (1.0)    | \$ 1.6                |
| Unrealized exchange gain (loss) | 0.1                         | 0.5         | (0.8)                 |
| Foreign exchange (loss) gain    | \$ (0.1)                    | \$ (0.5)    | \$ 0.8                |

**Item 4. Controls and Procedures.**

In connection with the preparation of this quarterly report, our management has performed an evaluation, with the participation of our Chief Executive Officer and Chief Financial Officer, of the effectiveness of our disclosure controls and procedures (as defined in Rule 13a-15(e) under the Securities Exchange Act of 1934 (the Exchange Act)) as of June 30, 2008. Disclosure controls and procedures are designed to ensure that information required to be disclosed in reports filed or submitted under the Exchange Act is recorded, processed, summarized and reported within the time periods specified by SEC rules and forms and that such information is accumulated and communicated to management, including our Chief Executive Officer and Chief Financial Officer, to allow for timely decisions regarding required disclosures. Based on their evaluation, our Chief Executive Officer and Chief Financial Officer concluded that, as of June 30, 2008, our company's disclosure controls and procedures were effective to ensure that information required to be disclosed in our reports filed under the Exchange Act is recorded, processed, summarized and reported within the time periods specified by SEC rules and forms and accumulated and communicated to management, including our Chief Executive Officer and Chief Financial Officer, as appropriate to allow for timely decisions regarding required disclosures.

Our management, including our Chief Executive Officer and Chief Financial Officer, does not expect that our disclosure controls and procedures or our internal control over financial reporting will prevent all error and all fraud. A control system, no matter how well conceived and operated, can provide only reasonable, not absolute, assurance that the objectives of the control system are met. Further, the design of a control system must reflect the fact that there are resource constraints, and the benefits of controls must be considered relative to their costs. Because of the inherent limitations in all control systems, no evaluation of controls can provide an absolute assurance that all control issues and instances of fraud, if any, within our company have been detected.

No changes were made in our internal controls over financial reporting, as such term is defined in Exchange Act Rule 13a-15(f), during the quarter ended June 30, 2008 that has materially affected, or is reasonably likely to materially affect, our internal control over financial reporting.

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**PART II  
OTHER INFORMATION**

**Item 1. Legal Proceedings.**

We are and in the future may become involved in various claims and legal proceedings that arise in the normal course of our business. While any claim or legal proceeding contains an element of uncertainty, we do not currently believe that any claim or legal proceeding to which we are presently a party to is likely to have a material adverse effect on our results of operations.

**Item 1A. Risk Factors.**

Our business is subject to a number of risks, including those identified in Item 1A. of Part I of our 2007 Annual Report on Form 10-K filed with the SEC, that could have a material effect on our business, results of operations, financial condition and/or liquidity and that could cause our operating results to vary significantly from period to period. The risks described in our Annual Report on Form 10-K are not the only risks we face. Additional risks and uncertainties not currently known to us or that we currently deem to be immaterial also could have a material effect on our business, results of operations, financial condition and/or liquidity.

On June 27, 2008, we entered into an Agreement and Plan of Merger (the Merger Agreement ) with Allied World Merger Company, an indirect wholly-owned subsidiary of ours, and Darwin. The Merger Agreement provides for the merger of Allied World Merger Company with and into Darwin, with Darwin continuing as the surviving corporation and an indirect wholly-owned subsidiary of ours. The following are a number of risks we face in connection with this proposed acquisition.

***The occurrence of any event, change or other circumstances that could give rise to the termination of the Merger Agreement could adversely affect our future business.***

There are significant risks and uncertainties associated with our proposed acquisition of Darwin. The occurrence of certain events, changes or any other circumstances could give rise to the termination of the Merger Agreement and cause the acquisition not to be completed. For instance, there is no assurance that we will receive the necessary state insurance regulatory approvals or Darwin will receive the approval of its stockholders. If either party fails to obtain such approvals or meet other conditions necessary to complete the acquisition set forth in the Merger Agreement, we would not be able to close this transaction. Failure to complete the acquisition would prevent us from realizing its anticipated benefits to our business.

***Our business could be adversely impacted by uncertainty related to the proposed acquisition, whether or not the acquisition is completed.***

Whether or not the acquisition is completed, the announcement and pendency of the acquisition could impact our business, which could have an adverse effect on our financial condition, results of operations and the success of the acquisition, including:

that the proposed acquisition disrupts our current business plans and operations;

our management's attention being directed toward the completion of the acquisition and transaction-related considerations and being diverted away from our day-to-day business operations and the execution of our current business plans;

current and prospective employees may experience uncertainty about their future roles with the company, which might adversely affect our ability to attract and retain employees who generate and service our business; and

incurring transaction costs, such as legal, financing and accounting fees, and other costs, fees, expenses and charges related to the acquisition, whether or not the acquisition is completed.



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***We must obtain several state regulatory approvals to complete the acquisition, which, if delayed, not granted or granted with unacceptable conditions may jeopardize or delay the acquisition, result in additional expense or reduce the anticipated benefits of the acquisition.***

We must obtain certain approvals from state regulatory authorities prior to the completion of the acquisition of Darwin and its insurance subsidiaries. State insurance laws generally require that, prior to the acquisition of an insurance company, the acquiring party must obtain approval from the insurance commissioner of the insurance company's state of domicile or, in certain jurisdictions, where such insurance company is commercially domiciled. The regulatory authorities from which we seek approvals have broad discretion in administering relevant laws and regulations. As a condition to the approval of the acquisition, regulatory authorities may impose requirements or limitations that could negatively affect the way Darwin conducts its business post-acquisition. If we agree to any material conditions or restrictions in order to obtain any approvals required to complete the acquisition, these conditions or restrictions could adversely affect our ability to integrate each company's businesses or reduce the anticipated benefits of the acquisition.

***The anticipated benefits of the acquisition may not be realized fully or at all or may take longer to realize than expected.***

The acquisition involves the integration of two companies that have previously operated independently. The two companies will devote significant management attention and resources to integrating the two companies. Delays in this process could adversely affect our business, results of operations, financial condition and share price after the completion of the acquisition. Achieving the anticipated benefits of the acquisition is subject to a number of uncertainties, including whether Darwin's and our businesses are integrated in an efficient and effective manner, and general competitive factors in the marketplace. We may experience unanticipated difficulties or expenses in connection with integrating these businesses, including:

retaining existing employees, clients, brokers, agents and program administrators of Darwin;

retaining and integrating management and other key employees of Darwin; and

potential charges to earnings resulting from the application of purchase accounting to the transaction.

Even if the business operations are integrated successfully, there can be no assurance that we will realize the full benefits of synergies, cost savings and operating efficiencies that we currently expect from this integration or that these benefits will be achieved within the anticipated time frame. Failure to achieve these anticipated benefits could result in increased costs, decreases in the amount of expected revenues and diversion of management's time and energy and could materially adversely affect our business, financial condition and results of operations.

**Item 2. *Unregistered Sale of Equity Securities and Use of Proceeds.***

None.

**Item 3. *Defaults Upon Senior Securities.***

None.

**Item 4. *Submission of Matters to a Vote of Security Holders.***

(a) On May 8, 2008, we held our 2008 Annual General Meeting of Shareholders (the "Annual General Meeting").

(b) Proxies were solicited by our management in connection with the Annual General Meeting at which the following matters were acted upon with the voting results indicated below. There was no solicitation of opposition to our nominees listed in the proxy statement. Our Class I directors were re-elected for a three-year term as described in (c) (1) below.

The other directors, whose term of office continued after the Annual General Meeting are:

Scott A. Carmilani

James F. Duffy

Bart Friedman

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Scott Hunter

Michael I.D. Morrison

(c) 1. Election of Directors

Our board of directors is divided into three classes: Class I, Class II and Class III, each of approximately equal size. In accordance with our Bye-laws, directors are elected by shareholders holding a plurality of the votes cast. At the Annual General Meeting, our shareholders elected our Class I directors to hold office until our company's Annual General Meeting of Shareholders in 2011, or until their successors are duly elected and qualified or their office is otherwise vacated.

| Name               | Votes For  | Withheld Authority |
|--------------------|------------|--------------------|
| Mark R. Patterson  | 14,219,537 | 14,584,555         |
| Samuel J. Weinhoff | 14,399,854 | 14,404,238         |

2. Approval of Eligible Subsidiary Directors

In accordance with our Bye-laws, no person may be elected as a director of our company's non-U.S. subsidiaries (excluding Allied World Assurance Company, Ltd) unless such person has been approved by our company's shareholders. At our Annual General Meeting, the following slates of nominees were approved as eligible subsidiary directors of our non-U.S. subsidiaries:

*Allied World Assurance Holdings (Ireland) Ltd* - the slate of Scott A. Carmilani, John Clifford, Wesley D. Dupont, Hugh Governey, Michael I.D. Morrison and John T. Redmond.

|                  |                      |                |
|------------------|----------------------|----------------|
| <b>Votes For</b> | <b>Votes Against</b> | <b>Abstain</b> |
| 28,476,139       | 321,279              | 6,416          |

*Allied World Assurance Company (Europe) Limited* - the slate of J. Michael Baldwin, Scott A. Carmilani, John Clifford, Hugh Governey, Michael I.D. Morrison and John T. Redmond.

|                  |                      |                |
|------------------|----------------------|----------------|
| <b>Votes For</b> | <b>Votes Against</b> | <b>Abstain</b> |
| 28,476,462       | 321,274              | 6,356          |

*Allied World Assurance Company (Reinsurance) Limited* - the slate of J. Michael Baldwin, Scott A. Carmilani, John Clifford, Hugh Governey, Michael I.D. Morrison and John T. Redmond.

|                  |                      |                |
|------------------|----------------------|----------------|
| <b>Votes For</b> | <b>Votes Against</b> | <b>Abstain</b> |
| 28,476,447       | 321,289              | 6,356          |

*Newmarket Administrative Services (Bermuda), Ltd*- the slate of Scott A. Carmilani, Joan H. Dillard, Wesley D. Dupont and Richard E. Jodoin.

|                  |                      |                |
|------------------|----------------------|----------------|
| <b>Votes For</b> | <b>Votes Against</b> | <b>Abstain</b> |
| 28,564,590       | 232,888              | 6,356          |

*Newmarket Administrative Services (Ireland) Limited*- the slate of Scott A. Carmilani, John Clifford, Hugh Governey and John T. Redmond.

|                  |                      |                |
|------------------|----------------------|----------------|
| <b>Votes For</b> | <b>Votes Against</b> | <b>Abstain</b> |
| 28,565,939       | 232,782              | 5,371          |

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**Table of Contents****3. Approval of Second Amended and Restated Stock Option Plan**

Our shareholders approved the Allied World Assurance Company Holdings, Ltd Second Amended and Restated 2001 Employee Stock Option Plan.

| <b>Votes For</b> | <b>Votes Against</b> | <b>Abstain</b> | <b>Broker<br/>Non-Votes</b> |
|------------------|----------------------|----------------|-----------------------------|
| 24,845,661       | 1,711,173            | 4,075          | 2,243,183                   |

**4. Approval of Second Amended and Restated Stock Incentive Plan**

Our shareholders approved the Allied World Assurance Company Holdings, Ltd Second Amended and Restated 2004 Stock Incentive Plan.

| <b>Votes For</b> | <b>Votes Against</b> | <b>Abstain</b> | <b>Broker<br/>Non-Votes</b> |
|------------------|----------------------|----------------|-----------------------------|
| 23,685,961       | 2,871,048            | 3,900          | 2,243,183                   |

**5. Approval of Employee Share Purchase Plan**

Our shareholders approved the Allied World Assurance Company Holdings, Ltd 2008 Employee Share Purchase Plan.

| <b>Votes For</b> | <b>Votes Against</b> | <b>Abstain</b> | <b>Broker<br/>Non-Votes</b> |
|------------------|----------------------|----------------|-----------------------------|
| 26,413,930       | 152,440              | 3,539          | 2,243,183                   |

**6. Approval and Adoption of Second Amended and Restated Bye-Laws**

Our shareholders approved and adopted the Second Amended and Restated Bye-Laws of Allied World Assurance Company Holdings, Ltd.

| <b>Votes For</b> | <b>Votes Against</b> | <b>Abstain</b> |
|------------------|----------------------|----------------|
| 28,573,125       | 217,945              | 13,022         |

**7. Appointment of Independent Auditors**

Our shareholders approved the appointment of Deloitte & Touche as our independent auditors to serve until our 2009 Annual General Meeting of Shareholders.

| <b>Votes For</b> | <b>Votes Against</b> | <b>Abstain</b> |
|------------------|----------------------|----------------|
| 28,785,575       | 18,377               | 140            |

**Item 5. *Other Information.***

None.

**Item 6. *Exhibits.*****Exhibit  
Number****Description**

- 2.1(1) Agreement and Plan of Merger, dated as of June 27, 2008, by and among Allied World Assurance Company Holdings, Ltd, Allied World Merger Company and Darwin Professional Underwriters, Inc.
- 2.2(1) Voting Agreement, dated as of June 27, 2008, by and among Allied World Assurance Company Holdings, Ltd, Allied World Merger Company, and Alleghany Insurance Holdings, LLC.

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| <b>Exhibit<br/>Number</b> | <b>Description</b>  |
|---------------------------|---|
| 10.1(2)                   | Discretionary Investment Management Agreement, dated as of May 14, 2008, by and between Allied World Reinsurance Company and Goldman Sachs Asset Management, L.P. |
| 10.2                      | Allied World Assurance Company (U.S.) Inc. Amended and Restated Supplemental Executive Retirement Plan.   |
| 31.1                      | Certification by Chief Executive Officer, as required by Section 302 of the Sarbanes-Oxley Act of 2002.   |
| 31.2                      | Certification by Chief Financial Officer, as required by Section 302 of the Sarbanes-Oxley Act of 2002.   |
| 32.1*                     | Certification by Chief Executive Officer, as required by Section 906 of the Sarbanes-Oxley Act of 2002.   |
| 32.2*                     | Certification by Chief Financial Officer, as required by Section 906 of the Sarbanes-Oxley Act of 2002.   |
| (1)                       | Incorporated by reference to the Current Report on Form 8-K of Allied World Assurance Company Holdings, Ltd, filed with the SEC on June 30, 2008.                 |
| (2)                       | Incorporated by reference to the Current Report on Form 8-K of Allied World Assurance Company Holdings, Ltd, filed with the SEC on May 16, 2008.                  |
|                           | Management contract or compensatory plan, contract or arrangement.  |
| *                         | These certifications are  |

being furnished  
solely pursuant  
to Section 906  
of the  
Sarbanes-Oxley  
Act of 2002  
(subsections  
(a) and (b) of  
Section 1350,  
chapter 63 of  
title 18 United  
States Code)  
and are not  
being filed as  
part of this  
report.

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**SIGNATURES**

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

ALLIED WORLD ASSURANCE COMPANY  
HOLDINGS, LTD

Dated: August 8, 2008

By: /s/ Scott A. Carmilani  
Name:

Title: Scott A. Carmilani  
President and Chief Executive  
Officer

Dated: August 8, 2008

By: /s/ Joan H. Dillard  
Name:

Title: Joan H. Dillard  
Senior Vice President and Chief  
Financial Officer

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**EXHIBIT INDEX**

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|---------------------------|--|
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Management contract or compensatory plan, contract or arrangement.

\* These certifications are being furnished solely pursuant to Section 906 of the Sarbanes-Oxley Act of 2002 (subsections (a) and (b) of Section 1350, chapter 63 of title 18 United States Code) and are not being filed as part of this report.

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