XL CAPITAL LTD
Form 10-Q
May 06, 2010

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-Q

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

For the quarterly period ended March 31, 2010

OR

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

For the transition period from ____ to ____

Commission file number 1-10804

XL CAPITAL LTD

(Exact name of registrant as specified in its charter)

Cayman Islands	98-0191089
(State or other jurisdiction of incorporation or organization)	(I.R.S. Employer Identification No.)

XL House, One Bermudiana Road, Hamilton, Bermuda HM 08
(Address of principal executive offices and zip code)
(441) 292-8515
(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 x No o

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

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

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

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

As of May 4, 2010, there were 342,083,631 outstanding Class A Ordinary Shares, $0.01 par value per share, of the registrant.

XL CAPITAL LTD

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PART I FINANCIAL INFORMATION

ITEM 1. FINANCIAL STATEMENTS

XL CAPITAL LTD

CONSOLIDATED BALANCE SHEETS

(U.S. dollars in thousands, except share amounts)	(Unaudited) March 31, 2010	December 31, 2009
A S S E T S		
Investments:		
Fixed maturities at fair value (amortized cost: 2010, $28,556,442; 2009, $28,798,504)	$ 27,825,508	$ 27,512,032
Equity securities, at fair value (cost: 2010, $21,696; 2009, $12,344)	29,230	17,779
Short-term investments, at fair value (amortized cost: 2010, $1,913,664; 2009, $1,767,197)	1,924,651	1,777,360
Total investments available for sale	29,779,389	29,307,171
Fixed maturities, held to maturity at amortized cost (fair value: 2010, $522,305; 2009, $530,319)	$ 516,470	$ 546,067
Investments in affiliates	1,143,137	1,185,604
Other investments	814,303	783,189
Total investments	32,253,299	31,822,031
Cash and cash equivalents	3,375,519	3,643,697
Accrued investment income	324,418	350,055
Deferred acquisition costs	638,409	654,065
Ceded unearned premiums	710,152	711,875
Premiums receivable	2,924,480	2,597,602
Reinsurance balances receivable	327,933	374,844
Unpaid losses and loss expenses recoverable	3,550,793	3,584,028
Net receivable from investments sold		84,617
Goodwill and other intangible assets	841,244	845,129
Deferred tax asset, net	135,678	193,868
Other assets	694,745	717,864
Total assets	$ 45,776,670	$ 45,579,675
L I A B I L I T I E S A N D S H A R E H O L D E R S E Q U I T Y		
Liabilities:		
Unpaid losses and loss expenses	$ 20,670,113	$ 20,823,524
Deposit liabilities	2,187,375	2,208,699
Future policy benefit reserves	5,115,700	5,490,119
Unearned premiums	3,938,736	3,651,310
Notes payable and debt	2,461,397	2,451,417
Reinsurance balances payable	419,331	378,887
Net payable for investments purchased	85,660	36,979
Other liabilities	784,895	923,650
Total liabilities	$ 35,663,207	$ 35,964,585
Commitments and Contingencies		
Redeemable Series C preference ordinary shares, 20,000,000 authorized, par value $0.01 Issued and outstanding: (2010, 2,876,000; 2009, 7,306,920)	$ 71,900	$ 182,673

Shareholders Equity:		
Noncontrolling interest in equity of consolidated subsidiaries	$ 2,305	$ 2,305
Series E preference ordinary shares, 1,000,000 authorized, par value $0.01 Issued and outstanding: (2010, 1,000,000; 2009, 1,000,000)	10	10
Class A ordinary shares, 999,990,000 authorized, par value $0.01 Issued and outstanding: (2010, 342,083,631; 2009, 342,118,986)	3,421	3,421
Additional paid in capital	10,482,229	10,474,688
Accumulated other comprehensive (loss)	(634,546)	(1,142,467)
Retained earnings	188,144	94,460
Total shareholders equity	$ 10,041,563	$ 9,432,417
Total liabilities, redeemable preference ordinary shares and shareholders equity	$ 45,776,670	$ 45,579,675

See accompanying Notes to Unaudited Consolidated Financial Statements

XL CAPITAL LTD

CONSOLIDATED STATEMENTS OF INCOME

	(Unaudited) Three Months Ended March 31, 2010	2009
(U.S. dollars in thousands, except per share amounts)		
Revenues:		
Net premiums earned	$ 1,368,485	$ 1,451,521
Net investment income	308,324	347,966
Realized investment gains (losses):		
Net realized gains (losses) on investments sold	4,021	33,103
Other-than-temporary impairments on investments	(60,514)	(285,040)
Other-than-temporary impairments on investments transferred to other comprehensive income	20,317	
Total net realized gains (losses) on investments	(36,176)	(251,937)
Net realized and unrealized gains (losses) on derivative instruments	(20,480)	(1,407)
Income (loss) from investment fund affiliates	8,178	(26,893)
Fee income and other	8,418	12,158
Total revenues	$ 1,636,749	$ 1,531,408
Expenses:		
Net losses and loss expenses incurred	$ 892,200	$ 790,283
Claims and policy benefits	123,743	157,959
Acquisition costs	201,137	218,219
Operating expenses	229,108	268,387
Exchange (gains) losses	(21,083)	(24,624)
Interest expense	49,070	61,341
Amortization of intangible assets	465	465
Total expenses	$ 1,474,640	$ 1,472,030
Income (loss) before income tax and income (loss) from operating affiliates	$ 162,109	$ 59,378
Provision for income tax	29,836	45,953
Income (loss) from operating affiliates	11,606	(10,328)
Net income	$ 143,879	$ 3,097
Non-controlling interest in net income (loss) of subsidiary	(1)	
Net income attributable to XL Capital Ltd	$ 143,880	$ 3,097
Preference share dividends	(32,500)	(36,534)
Gain on redemption of Series C Preference Ordinary Shares	16,616	211,816
Net income attributable to ordinary shareholders	$ 127,996	$ 178,379
Weighted average ordinary shares and ordinary share equivalents outstanding basic	342,148	336,217
Weighted average ordinary shares and ordinary share equivalents outstanding diluted	342,760	336,218
Earnings per ordinary share and ordinary share equivalent basic	$ 0.37	$ 0.53

Earnings per ordinary share and ordinary share equivalent diluted	$ 0.37	$ 0.53

See accompanying Notes to Unaudited Consolidated Financial Statements

XL CAPITAL LTD

CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME

(U.S. dollars in thousands)	(Unaudited) Three Months Ended March 31, 2010	2009
Net income attributable to XL Capital Ltd	$ 143,880	$ 3,097
Change in net unrealized gains (losses) on investments, net of tax	556,024	(788,685)
Change in OTTI losses recognized in other comprehensive income, net of tax	(16,458)	
Change in underfunded pension liability	3,482	(66)
Change in value of cash flow hedge	110	108
Foreign currency translation adjustments, net	(32,485)	(95,254)
Change in net unrealized gain (loss) on future policy benefit reserves	(2,752)	7,494
Comprehensive income (loss)	$ 651,801	$ (873,306)

See accompanying Notes to Unaudited Consolidated Financial Statements

XL CAPITAL LTD

CONSOLIDATED STATEMENTS OF SHAREHOLDERS EQUITY

	(Unaudited) Three Months Ended March 31,	
	2010	**2009**
(U.S. dollars in thousands)		
Noncontrolling Interest in Equity of Consolidated Subsidiaries:		
Balance beginning of year	$ 2,305	$ 1,598
Noncontrolling interest share in net income (loss) of subsidiary	(1)	$
Noncontrolling interest share in change in accumulated other comprehensive (income) loss	1	6
Balance end of period	$ 2,305	$ 1,604
Series E Preference Ordinary Shares:		
Balance beginning of year	$ 10	$ 10
Balance end of period	$ 10	$ 10
Class A Ordinary Shares:		
Balance beginning of year	$ 3,421	$ 3,308
Issuance of Class A ordinary shares		115
Exercise of stock options	1	
Repurchase of shares	(1)	(2)
Balance end of period	$ 3,421	$ 3,421
Additional Paid in Capital:		
Balance beginning of year	$ 10,474,688	$ 9,792,371
Issuance of Class A ordinary shares	8	741,947
Repurchase of Class A ordinary shares	(1,840)	
Dividends on Class A ordinary shares		(34,192)
Dividends on preference ordinary shares		(36,533)
Exercise of stock options, net of tax benefit	104	
Impact of share based compensation arrangements	1,447	
Stock option expense	2,759	1,776
Net change in deferred compensation	5,063	12,820
Balance end of period	$ 10,482,229	$ 10,478,189
Accumulated Other Comprehensive Income (Loss):		
Balance beginning of year	$ (1,142,467)	$ (3,364,927)
Change in net unrealized (losses) on investment portfolio, net of tax	542,109	(783,474)
Change in net unrealized (losses) gains on affiliate and other investments, net of tax	13,915	(5,211)
Change in OTTI losses recognized in other comprehensive income, net of tax	(16,458)	
Change in underfunded pension liability	3,482	(66)
Change in value of cash flow hedge	110	108
Foreign currency translation adjustments	(32,485)	(95,254)
Change in net unrealized gain (loss) on future policy benefit reserves	(2,752)	7,494
Balance end of period	$ (634,546)	$ (4,241,330)
Retained Earnings (Deficit):		

Balance beginning of year	$ 94,460	$ (315,529)
Net income attributable to XL Capital Ltd.	143,880	3,097
Dividends on Series E preference ordinary shares	(32,500)	
Dividends on Class A ordinary shares	(34,312)	
Gain on redemption of Series C preference ordinary shares	16,616	211,816
Balance end of period	$ 188,144	$ (100,616)
Total Shareholders Equity	$ 10,041,563	$ 6,141,278

See accompanying Notes to Unaudited Consolidated Financial Statements

XL CAPITAL LTD

CONSOLIDATED STATEMENTS OF CASH FLOWS

	(Unaudited) Three Months Ended March 31,	
	2010	2009
(U.S. dollars in thousands)		
Cash flows (used in) provided by operating activities:		
Net income attributable to XL Capital Ltd	$ 143,880	$ 3,097
Adjustments to reconcile net income to net cash (used in) provided by operating activities:		
Net realized losses on sales investments	36,176	251,937
Net realized and unrealized losses on derivative instruments	20,480	1,407
Amortization of (discounts) on fixed maturities	10,104	(15,243)
(Income) loss from investment and operating affiliates	(19,784)	37,221
Amortization of deferred compensation	6,280	10,511
Accretion of convertible debt	249	247
Accretion of deposit liabilities	21,860	11,726
Unpaid losses and loss expenses	52,377	(394,422)
Future policy benefit reserves	(76,245)	13,776
Unearned premiums	334,886	148,809
Premiums receivable	(372,830)	14,125
Unpaid losses and loss expenses recoverable	228	166,213
Ceded unearned premiums	(7,858)	(2,990)
Reinsurance balances receivable	43,101	(29,710)
Deferred acquisition costs	2,125	(26,785)
Reinsurance balances payable	48,446	64,174
Deferred tax asset	29,834	(3,138)
Other assets	20,947	(124,338)
Other liabilities	(133,651)	(181,627)
Other	46,216	(63,178)
Total adjustments	$ 62,941	$ (121,285)
Net cash provided by (used in) operating activities	$ 206,821	$ (118,188)
Cash flows provided by (used in) investing activities:		
Proceeds from sale of fixed maturities and short-term investments	$ 1,275,670	$ 3,405,917
Proceeds from redemption of fixed maturities and short-term investments	670,954	467,254
Proceeds from sale of equity securities	2,495	276,575
Purchases of fixed maturities and short-term investments	(2,340,341)	(3,400,142)
Purchases of equity securities	(11,127)	(18,369)
Net dispositions of investment affiliates	86,828	453,790
Other investments, net	61,749	48,766
Net cash provided by (used in) investing activities	$ (253,772)	$ 1,233,791
Cash flows (used in) financing activities:		
Proceeds from issuance of Class A ordinary shares	$	$ 745,000
Repurchase of Class A ordinary shares	(1,840)	(517)
Redemption of Series C preference ordinary shares	(94,157)	(104,718)
Dividends paid on Class A ordinary shares	(34,194)	(34,182)
Dividends paid on preference ordinary shares	(5,573)	(17,678)
Deposit liabilities	(47,999)	(83,465)
Repayment of debt		(745,000)
Collateral received on securities lending		92,488

Collateral returned on securities lending		(215,370)
Net cash (used in) financing activities	$ (183,763)	$ (363,442)
Effects of exchange rate changes on foreign currency cash	(37,464)	(39,800)
Increase (decrease) in cash and cash equivalents	(268,178)	712,361
Cash and cash equivalents beginning of period	3,643,697	4,353,826
Cash and cash equivalents end of period	$ 3,375,519	$ 5,066,187

See accompanying Notes to Unaudited Consolidated Financial Statements

XL CAPITAL LTD

NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS

1. Basis of Preparation and Consolidation

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

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

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

2. Significant Accounting Policies

(a) Recent Accounting Pronouncements

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

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

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

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NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

2. Significant Accounting Policies (Continued)

(a) Recent Accounting Pronouncements (Continued)

In March 2010, the FASB issued authoritative guidance relating to derivative accounting. Under this guidance, all entities that enter into contracts containing an embedded credit derivative feature related to the transfer of credit risk that is not only in the form of subordination of one financial instrument to another will be affected by the amendments in this guidance as it clarifies that the embedded credit derivative scope exception found in existing derivative guidance does not apply to such contracts. As a result, entities that have contracts containing an embedded credit derivative feature in a form other than such subordination may need to separately account for the embedded credit derivative feature. This guidance will be effective at the beginning of the Company s first fiscal quarter beginning after June 15, 2010. The Company is currently evaluating the potential impact of this guidance on its financial condition and results of operations.

3. Fair Value Measurements

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

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NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

3. Fair Value Measurements (Continued)

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

March 31, 2010 *(U.S. dollars in thousands)*	**Quoted Prices in Active Markets for Identical Assets (Level 1)**	**Significant Other Observable Inputs (Level 2)**	**Significant Unobservable Inputs (Level 3)**	**Collateral and Counterparty Netting**	**Balance as of March 31, 2010**
Assets					
U.S. Government and Government-Related/Supported	$	$ 2,454,313	$	$	$ 2,454,313
Corporate (1)		10,449,428	9,493		10,458,921
Residential mortgage-backed securities Agency		6,019,579			6,019,579
Residential mortgage-backed securities Non-Agency		1,378,352	30,000		1,408,352
Commercial mortgage-backed securities		1,210,604	41,655		1,252,259
Collateralized debt obligations		11,249	711,749		722,998
Other asset-backed securities		1,098,572	52,082		1,150,654
U.S. States and political subdivisions of the States		1,144,591			1,144,591
Non-U.S. Sovereign Government, Supranational and Government- Related		3,210,599	3,242		3,213,841
Total fixed maturities, at fair value	$	$ 26,977,287	$ 848,221	$	$ 27,825,508
Equity securities, at fair value	15,235	13,995			29,230
Short-term investments, at fair value (2)		1,918,085	6,566		1,924,651
Total investments available for sale	$ 15,235	$ 28,909,367	$ 854,787	$	$ 29,779,389
Cash equivalents (3)	1,451,251	669,931			2,121,182
Other investments (4)		366,532	83,088		449,620
Other assets (5)(6)		146,120	189,211	(233,160)	102,171
Total assets accounted for at fair value	$ 1,466,486	$ 30,091,950	$ 1,127,086	$ (233,160)	$ 32,452,362
Liabilities					
Financial instruments sold, but not yet purchased (7)	$	$ 32,264	$	$	$ 32,264
Other liabilities (5)(6)		22,458	84,737	(52,782)	54,413
Total liabilities accounted for at fair value	$	$ 54,722	$ 84,737	$ (52,782)	$ 86,677

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NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

3. Fair Value Measurements (Continued)

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

(1) Included within Corporate are certain floating rate medium term notes supported primarily by pools of European credit with varying degrees of leverage. The notes have a fair value of $587.2 million and $587.7 million and an amortized cost of $663.4 million and $707.9 million at March 31, 2010 and December 31, 2009, respectively. These notes allow the investor to participate in cash flows of the underlying bonds including certain residual values, which could serve to either decrease or increase the ultimate values of these notes.

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

(3) Cash equivalents balances subject to fair value measurement include certificates of deposit and money market funds. Operating cash balances are not subject to fair value measurement guidance.

(4) The Other investments balance excludes certain structured transactions including certain investments in project finance transactions, a payment obligation and liquidity financing provided to a structured credit vehicle as a part of a third party medium term note facility. These investments are carried at amortized cost that totaled $364.7 million at March 31, 2010 and $365.6 million at December 31, 2009.

(5) Other assets and other liabilities include derivative instruments.

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NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

3. Fair Value Measurements (Continued)

(6) The derivative balances included in each category above are reported on a gross basis by level with a netting adjustment presented separately in the Collateral and Counterparty Netting column. The Company often enters into different types of derivative contracts with a single counterparty and these contracts are covered under a netting agreement. In addition, the Company held net cash collateral related to derivative assets of approximately $195.3 million and $169.1 million at March 31, 2010 and December 31, 2009, respectively. This balance is included within cash and cash equivalents and the corresponding liability to return the collateral has been offset against the derivative asset within the balance sheet as appropriate under the netting agreement. The fair value of the individual derivative contracts are reported gross in their respective levels based on the fair value hierarchy.

(7) Financial instruments sold, but not yet purchased represent short sales and are included within Net payable for investments purchased on the balance sheet.

Level 3 Gains and Losses

The tables below present additional information about assets and liabilities measured at fair value on a recurring basis and for which Level 3 inputs were utilized to determine fair value. The table reflects gains and losses for the three month periods ended March 31, 2010 and March 31, 2009 for all financial assets and liabilities categorized as Level 3 as of March 31, 2010 and March 31, 2009, respectively. The tables do not include gains or losses that were reported in Level 3 in prior periods for assets that were transferred out of Level 3 prior to March 31, 2010 and March 31, 2009. Gains and losses for assets and liabilities classified within Level 3 in the table below may include changes in fair value that are attributable to both observable inputs (Levels 1 and 2) and unobservable inputs (Level 3). Further, it should be noted that the following tables do not take into consideration the effect of offsetting Level 1 and 2 financial instruments entered into by the Company that are either economically hedged by certain exposures to the Level 3 positions or that hedge the exposures in Level 3 positions.

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

There were no transfers between Level 1 and Level 2 during the three month periods ending March 31, 2010 and 2009.

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NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

3. Fair Value Measurements (Continued)

Level 3 Gains and Losses (continued)

(U.S. dollars in thousands) (Unaudited)	Level 3 Assets and Liabilities Three Months Ended March 31, 2010 Corporate	Residential mortgage-backed securities Agency	Residential mortgage-backed securities Non Agency	Commercial mortgage-backed securities	Collateralized debt obligations
Balance, beginning of period	$ 10,311	$ 7,894	$ 42,190	$ 2,755	$ 190,663
Realized gains (losses)	(4,319)		(817)	(457)	(4,917)
Movement in unrealized gains (losses)	26		4,392	1,337	31,384
Purchases, sales issuances and settlements, net	(927)		(802)	(524)	(1,884)
Transfers into Level 3	8,158		117	38,544	496,503
Transfers out of Level 3	(2,600)	(7,894)	(15,080)		
Fixed maturities to short-term investments classification change	(1,156)				
Balance, end of period	$ 9,493	$	$ 30,000	$ 41,655	$ 711,749
Movement in total gains (losses) above relating to instruments still held at the reporting date	$ 165	$	$ 4,258	$ 888	$ 30,956

(U.S. dollars in thousands) (Unaudited)	Level 3 Assets and Liabilities Three Months Ended March 31, 2010 (Continued) Other asset backed securities	Non-U.S. Sovereign Government and Supranationals and Government Related	Short-term Investments	Other investments	Derivative Contracts - Net
Balance, beginning of period	$ 38,179	$ 3,217	$ 6,486	$ 75,584	$ 100,515
Realized gains (losses)	(6,351)		(2,848)		
Movement in unrealized gains (losses)	4,545	11	2,448	3,985	(1,390)
Purchases, sales issuances and settlements, net	22,257		(2,246)	3,519	5,349
Transfers into Level 3	204	14	1,570		
Transfers out of Level 3	(6,752)				
Fixed maturities to short-term investments classification change			1,156		
Balance, end of period	$ 52,082	$ 3,242	$ 6,566	$ 83,088	$ 104,474
Movement in total gains (losses) above relating to instruments still held at the reporting date	$ (1,820)	$ 11	$ 2,373	$ 3,985	$ (1,390)

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NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

3. Fair Value Measurements (Continued)

Level 3 Gains and Losses (continued)

(U.S. dollars in thousands) *(Unaudited)*	Fixed Maturities	Short-term Investments	Other Investments	Derivative Contracts Net
	Level 3 Assets and Liabilities Three Months Ended March 31, 2009			
Balance, beginning of period	$ 951,879	$ 20,746	$ 65,354	$ 226,818
Realized gains (losses)	(42,579)	(180)		
Movement in unrealized (losses) gains	(119,191)	(3,727)	(7,618)	(45,349)
Purchases, issuances and settlements	(4,497)	(3,009)	6,655	4,979
Transfers into Level 3	1,842			
Transfers out of Level 3	(165,132)			
Balance, end of period	$ 622,322	$ 13,830	$ 64,391	$ 186,448
Movement in total (losses) above relating to instruments still held at the reporting date	$ (132,016)	$ (4,546)	$ (7,618)	$ (45,349)

Fixed maturities and short-term investments

At March 31, 2010, certain collateralized debt obligations (CDOs) that were previously classified as Level 2 due to sufficient market data being available to allow a price to be determined and provided by third party pricing vendors, were transferred to Level 3 because third party vendor prices were no longer believed to be the most appropriate pricing source. Therefore, broker quotes are the primary source of the valuations for these CDOs.

During the fourth quarter of 2008, the Company determined that for certain of its CDOs (with a fair value of $483.2 million and a par value of $801.5 million as at December 31, 2008) the trading activity was considered to be stressed transactions. The markets for CDOs had become extremely illiquid due to a number of factors including risk aversion and reduction of purchases among institutional buyers. As a result, the Company believed that broker bids reflected loss expectations that did not reflect fair values at which willing buyers and sellers would transact. The Company determined that internal models were more appropriate and better representative of the fair value at which these securities would be sold in an orderly market. However, as a result of numerous recent market factors, including increased volumes of trading, the Company believed that transactions in this market were no longer distressed and, accordingly, reverted to third-party vendor pricing sources where available as of December 31, 2009, and, where not available, broker quotes. As noted above, during the quarter ended March 31, 2010 valuations for the majority of CDOs were once again sourced from broker quotes. Accordingly, as at March 31, 2010, the Company now carries these assets at a fair value of $560.5 million and a par value of $783.0 million within Level 3 of the fair value hierarchy.

At March 31, 2009, certain fixed maturity securities that were previously classified as Level 3, due to a lack of available third party vendor pricing, were transferred to Level 2 as prices for these securities were provided by third party pricing vendors.

The remainder of the Level 3 assets relate to private equity investments where the nature of the underlying assets held by the investee include positions such as private business ventures and are such that significant Level 3 inputs are utilized in the valuation, and certain derivative positions. The most significant of these transfers included $65.1 million of Non-U.S. Sovereign Government and Supranationals and Government Related, $28.4 million of Residential mortgage-backed securities-Non Agency, $27.0 of Other asset-backed securities and $16.6 million of Collateralized debt obligations.

Other investments

Included within the Other Investments component of the Company s Level 3 valuations are private investments and alternatives where the Company is not deemed to have significant influence over the investee. The fair value of these investments is based upon net asset values received from the investment manager or general partner of the respective entity. The nature of the underlying investments held by the investee which form the basis of the net asset value include assets such as private business ventures and are such that significant Level 3 inputs are utilized in the determination of the individual underlying holding values and accordingly the fair value of the Company s investment in each entity is classified within Level 3. The Company also incorporates factors such as the most recent financial information received, the values at which capital transactions with the investee take place, and management s judgment regarding whether any adjustments should be made to the net asset value in recording the fair value of each position.

Derivative instruments

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

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NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

3. Fair Value Measurements (Continued)

Level 3 Gains and Losses (continued)

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

Financial Instruments Not Carried at Fair Value

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

(U.S. dollars in thousands) *(Unaudited)*	As of March 31, 2010 Carrying Value	 Fair Value	As of December 31, 2009 Carrying Value	 Fair Value
Fixed maturities, held to maturity	$ 516,470	$ 522,305	$ 546,067	$ 530,319
Other investments structured transactions.	$ 364,683	$ 341,501	$ 365,600	$ 341,352
Financial Assets	$ 881,153	$ 863,806	$ 911,667	$ 871,671
Deposit liabilities	$ 2,187,375	$ 2,198,957	$ 2,208,699	$ 2,245,961
Notes payable and debt	2,461,397	2,445,982	2,451,417	2,504,386
Financial Liabilities	$ 4,648,772	$ 4,644,939	$ 4,660,116	$ 4,750,347
Redeemable series C preference ordinary shares	$ 71,900	$ 59,677	$ 182,673	$ 137,918

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

Deposit liabilities include obligations under structured insurance and reinsurance transactions as well as funding agreements issued. For purposes of fair value disclosures, the Company determines the fair value of the deposit liabilities by assuming a discount rate equal to the appropriate U.S. Treasury rate plus 108.1 basis points and the appropriate U.S. Treasury Rate plus 108.3 basis points at March 31, 2010 and December 31, 2009, respectively, to determine the present value of projected contractual liability payments through final maturity. The discount rate incorporates the Company s own credit risk into the determination of estimated fair value.

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

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

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

XL CAPITAL LTD

NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

4. Segment Information

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

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

Quarter ended March 31, 2010: *(U.S. dollars in thousands, except ratios)* *(Unaudited)*	**Insurance**	**Reinsurance**	**Total P&C**	**Life Operations**	**Corporate (6)**	**Total**
Gross premiums written	$ 1,131,890	$ 790,423	$ 1,922,313	$ 112,901	$	$ 2,035,214
Net premiums written	901,264	695,261	1,596,525	104,666		1,701,191
Net premiums earned	897,011	366,590	1,263,601	104,884		1,368,485
Net losses and loss expenses	648,319	243,881	892,200	123,743		1,015,943
Acquisition costs	110,142	72,605	182,747	18,390		201,137
Operating expenses (1)	153,236	42,028	195,264	3,008		198,272
Underwriting profit (loss)	$ (14,686)	8,076	(6,610)	(40,257)		(46,867)
Net investment income			203,914	80,344		284,258
Net results from structured products (2)	5,639	2,476	8,115		3,653	11,768
Net fee income and other (3)	(3,786)	319	(3,467)	40		(3,427)
Net realized gains (losses) on investments			(28,577)	(4,413)	(3,186)	(36,176)
Contribution from P&C, Life Operations and Corporate			173,375	35,714	467	209,556
Corporate & other:						
Net realized & unrealized gains (losses) on derivative instruments					(20,480)	(20,480)
Net income (loss) from financial, investments and other operating affiliates					19,784	19,784
Exchange (gains) losses					(21,083)	(21,083)
Corporate operating expenses					18,863	18,863
Interest expense (4)					36,900	36,900
Non-controlling interest in net income (loss) of subsidiary					(1)	(1)
Income taxes & other					30,301	30,301
Net income attributable to XL Capital Ltd						$ 143,880
Ratios P&C operations: (5)						
Loss and loss expense ratio	72.3%	66.5%	70.6%			
Underwriting expense ratio	29.3%	31.3%	29.9%			
Combined ratio	101.6%	97.8%	100.5%			

Notes:

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

(2) The net results from P&C and Corporate structured products include net investment income, interest expense and operating expenses of $19.7 million , $11.5 million and $0.1 million and $4.3 million, $0.6 million and $0.1 million, respectively.

(3) Net fee income and other includes operating expenses from the Company s loss prevention consulting services business and expenses related to the cost of an endorsement facility with National Indemnity Company.

(4) Interest expense excludes interest expense related to deposit liabilities recorded in the Insurance and Reinsurance segments and Corporate.

(5) Ratios are based on net premiums earned from P&C operations.

XL CAPITAL LTD

NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

4. Segment Information (Continued)

(6) Corporate includes institutional investment business with the Company s remaining funding agreements. These items were included in the Other Financial Lines segment prior to 2009.

Quarter ended March 31, 2009: *(U.S. dollars in thousands, except ratios)* *(Unaudited)*	**Insurance**	**Reinsurance**	**Total P&C**	**Life Operations**	**Corporate (6)**	**Total**
Gross premiums written	$ 1,091,245	$ 786,983	$ 1,878,228	$ 135,112	$	$ 2,013,340
Net premiums written	832,168	673,143	1,505,311	121,585		1,626,896
Net premiums earned	910,111	411,576	1,321,687	129,834		1,451,521
Net losses and loss expenses	615,214	175,069	790,283	157,959		948,242
Acquisition costs	105,412	95,724	201,136	17,083		218,219
Operating expenses (1)	179,328	47,088	226,416	3,841		230,257
Underwriting profit (loss) (7)	$ 10,157	93,695	103,852	(49,049)		54,803
Net investment income			242,166	77,522		319,688
Net results from structured products (2)	3,121	8,424	11,545		4,645	16,190
Net fee income and other (3)	(1,000)	2,051	1,051	51		1,102
Net realized gains (losses) on investments			(162,813)	(74,650)	(14,474)	(251,937)
Contribution from P&C, Life Operations and Corporate			195,801	(46,126)	(9,829)	139,846
Corporate & other:						
Net realized & unrealized gains (losses) on derivative instruments					(1,407)	(1,407)
Net income (loss) from financial, investments and other operating affiliates					(37,221)	(37,221)
Exchange (gains) losses					(24,624)	(24,624)
Corporate operating expenses					26,712	26,712
Interest expense (4)					49,615	49,615
Non-controlling interest in net income (loss) of subsidiary						
Income taxes & other					46,418	46,418
Net income attributable to XL Capital Ltd						$ 3,097
Ratios P&C operations: (5)						
Loss and loss expense ratio	67.6%	42.5%	59.8%			
Underwriting expense ratio	31.3%	34.7%	32.3%			
Combined ratio	98.9%	77.2%	92.1%			

Notes:

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

(2) The net results from P&C and Corporate structured products include net investment income, interest expense and operating expenses of $20.3 million, $8.8 million and $nil and $8.0 million, $3.0 million and $0.4 million, respectively.

(3) Net fee income and other includes operating expenses from the Company s loss prevention consulting services business and expenses related to the cost of an endorsement facility with National Indemnity Company.

(4) Interest expense excludes interest expense related to deposit liabilities recorded in the Insurance and Reinsurance segments and Corporate.

(5) Ratios are based on net premiums earned from P&C operations.

(6) Corporate includes institutional investment business with guaranteed investment contracts and funding agreements. These items were included in the Other Financial Lines segment prior to 2009.

(7) Certain reclassifications have been made to conform to current year presentation.

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NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

4. Segment Information (Continued)

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

Quarter ended March 31, 2010 *(U.S. dollars in thousands)* *(Unaudited)*	Insurance	Reinsurance	Life Operations	Total
P&C Operations:				
Casualty professional lines	$ 337,058	$ 55,720	$	$ 392,778
Casualty other lines	162,548	64,133		226,681
Property catastrophe	116	84,634		84,750
Other property	97,539	113,263		210,802
Marine, energy, aviation and satellite	140,770	20,190		160,960
Other specialty lines (1)	152,508			152,508
Other (2)	3,946	28,997		32,943
Structured indemnity	2,526	(347)		2,179
Total P&C Operations	$ 897,011	366,590	$	$ 1,263,601
Life Operations:				
Other Life	$	$	$ 73,453	$ 73,453
Annuity			31,431	31,431
Total Life Operations	$	$	$ 104,884	$ 104,884
Total	$ 897,011	$ 366,590	$ 104,884	$ 1,368,485

Quarter ended March 31, 2009: *(U.S. dollars in thousands)* *(Unaudited)*	Insurance	Reinsurance	Life Operations	Total
P&C Operations:				
Casualty professional lines	$ 315,616	$ 61,994	$	$ 377,610
Casualty other lines	154,505	62,783		217,288
Property catastrophe	114	70,696		70,810
Other property	109,436	142,760		252,196
Marine, energy, aviation and satellite	147,648	21,281		168,929
Other specialty lines (1)	169,984			169,984
Other (2)	7,946	52,093		60,039
Structured indemnity	4,862	(31)		4,831
Total P&C Operations	$ 910,111	$ 411,576	$	$ 1,321,687
Life Operations:				
Other Life	$	$	$ 100,408	$ 100,408
Annuity			29,426	29,426
Total Life Operations	$	$	$ 129,834	$ 129,834
Total	$ 910,111	$ 411,576	$ 129,834	$ 1,451,521

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

(2) Other includes credit and surety, whole account contracts and other lines.

XL CAPITAL LTD

NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

5. Investments

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

		Included in Accumulated Other Comprehensive Income (AOCI)			
			Gross Unrealized Losses		
March 31, 2010 *(U.S. dollars in thousands) (Unaudited)*	**Cost or Amortized Cost**	**Gross Unrealized Gains**	**Related to changes in estimated fair value**	**OTTI included in other comprehensive income (Loss)(1)**	**Fair Value**
Fixed maturities					
U.S. Government and Government-Related/Supported (2)	$ 2,402,485	$ 74,562	$ (22,734)	$	$ 2,454,313
Corporate (3) (4)	10,514,351	319,015	(267,008)	(107,437)	10,458,921
Residential mortgage-backed securities Agency	5,907,163	125,513	(13,097)		6,019,579
Residential mortgage-backed securities Non-Agency	1,908,056	13,621	(291,284)	(222,041)	1,408,352
Commercial mortgage-backed securities	1,259,234	27,874	(21,063)	(13,786)	1,252,259
Collateralized debt obligations	1,022,982	12,390	(303,101)	(9,273)	722,998
Other asset-backed securities	1,192,116	18,091	(40,234)	(19,319)	1,150,654
U.S. States and political subdivisions of the States	1,143,278	17,746	(16,433)		1,144,591
Non-U.S. Sovereign Government, Supranational and Government-Related (2)	3,206,777	78,011	(70,947)		3,213,841
Total fixed maturities	$ 28,556,442	$ 686,823	$ (1,045,901)	$ (371,856)	$ 27,825,508
Total short-term investments	$ 1,913,664	$ 22,621	$ (11,634)	$	$ 1,924,651
Total equity securities	$ 21,696	$ 7,567	$ (33)	$	$ 29,230

(1) Represents the amount of OTTI losses in AOCI, which from April 1, 2009 was not included in earnings under authoritative accounting guidance.

(2) U.S. Government and Government-Related/Supported and Non U.S. Sovereign Government, Supranationals and Government-Related includes government-related securities with an amortized cost of $2,216.3 million and fair value of $2,256.2 million and U.S. Agencies with an amortized cost of $1,227.6 million and fair value of $1,275.3 million.

(3) Included within Corporate are certain medium term notes supported primarily by pools of European credit leveraged by a factor of 0.30 (i.e. $130 of Bonds held for every $100 of note). The notes have a fair value of $587.2 million and an amortized cost of $663.4 million. These notes allow the investor to participate in cash flows of the underlying bonds including certain residual values, which could serve to either decrease or increase the ultimate values of these notes.

(4) Included in the table above are Tier One and Upper Tier Two securities, representing committed term debt and hybrid instruments senior to the common and preferred equities of the financial institutions. These securities have a fair value of $872.2 million and an amortized cost of $993.8 million as at March 31, 2010.

XL CAPITAL LTD

NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

5. Investments (Continued)

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

(1) Represents the amount of OTTI losses in AOCI, which from April 1, 2009 was not included in earnings under authoritative accounting guidance.

(2) U.S. Government and Government-Related/Supported and Non U.S. Sovereign Government, Supranationals and Government-Related includes government-related securities with an amortized cost of $2,325.4 million and fair value of $2,326.6 million and U.S. Agencies with an amortized cost of $1,361.6 million and fair value of $1,395.0 million.

(3) Included within Corporate are certain medium term notes supported primarily by pools of European credit leveraged by a factor of 0.44 (i.e. $144 of Bonds held for every $100 of note). The notes have a fair value of $587.7 million and an amortized cost of $707.9 million. These notes allow the investor to participate in cash flows of the underlying bonds including certain residual values, which could serve to either decrease or increase the ultimate values of these notes.

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

31, 2009.

The Company had gross unrealized losses totaling $1.4 billion at March 31, 2010 on its available for sale portfolio, which it considers to be temporarily impaired. Individual security positions comprising this balance have been evaluated by management, based on specified criteria, to determine if these impairments should be considered other than temporary. These criteria include an assessment of the severity of impairment along with management s assessment as to whether it is likely to sell these securities, among other factors included below.

XL CAPITAL LTD

NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

5. Investments (Continued)

At March 31, 2010 and December 31, 2009, approximately 3.9% and 3.6%, respectively, of the Company s fixed income investment portfolio excluding operating cash at fair value was invested in securities which were below investment grade or not rated. The increase in below investment grade or not rated securities is primarily due to rating agency action on non-Agency residential mortgage-backed securities. Approximately 35.3% and 30.1% of the gross unrealized losses in the Company s fixed income securities portfolio at March 31, 2010 and December 31, 2009, respectively, related to securities that were below investment grade or not rated.

The following is an analysis of how long the available for sale securities at March 31, 2010 had been in a continual unrealized loss position:

March 31, 2010 *(U.S. dollars in thousands)* *(Unaudited)*	**Less than 12 months**		**Equal to or greater than 12 months**	
	Fair Value	**Gross Unrealized Losses (1)**	**Fair Value**	**Gross Unrealized Losses (1)**
Fixed maturities and short-term investments:				
U.S. Government and Government Related/Supported	$ 706,375	$ 12,131	$ 87,008	$ 11,340
Corporate (2) (3)	1,654,986	26,666	2,700,504	352,850
Residential mortgage-backed securities Agency	1,623,489	11,817	13,920	1,280
Residential mortgage-backed securities Non-Agency	175,502	52,797	1,119,141	460,528
Commercial mortgage-backed securities	17,837	6,269	275,706	28,580
Collateralized debt obligations	86,649	25,200	617,739	287,174
Other asset-backed securities	82,896	628	485,907	59,516
U.S. States and political subdivisions of the States	570,328	8,092	41,286	8,341
Non-U.S. Sovereign Government, Supranational and Government-Related	601,678	21,347	418,797	54,835
Total fixed maturities and short-term investments	$ 5,519,740	$ 164,947	$ 5,760,008	$ 1,264,444
Total equity securities	$ 1,967	$ 33	$	$

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

(2) Included within Corporate are certain medium term notes supported primarily by pools of European credit leveraged by factor of 0.30 (i.e. $130 of Bonds held for every $100 of note). The notes have a fair value of $545.2 million and an amortized cost of $624.3 million. These notes allow the investor to participate in cash flows of the underlying bonds including certain residual values, which could serve to either decrease or increase the ultimate values of these notes.

(3) Included in the table above are Tier One and Upper Tier Two securities, representing committed term debt and hybrid instruments senior to the common and preferred equities of the financial institutions. These securities have a fair value of $872.2 million and an amortized cost of $993.8 million as at March 31, 2010.

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NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

5. Investments (Continued)

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

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

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

(2) Included within Corporate are certain medium term notes supported primarily by pools of European credit leveraged by factor of 0.44 (i.e. $144 of Bonds held for every $100 of note). The notes have a fair value of $587.7 million and an amortized cost of $707.9 million. These notes allow the investor to participate in cash flows of the underlying bonds including certain residual values, which could serve to either decrease or increase the ultimate values of these notes.

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

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

(U.S. dollars in thousands) *(Unaudited)*	**March 31, 2010 (1)** Amortized Cost	Fair Value	**December 31, 2009 (1)** Amortized Cost	Fair Value
Due after 1 through 5 years	$ 8,143,231	$ 8,258,981	$ 7,969,186	$ 8,010,078
Due after 5 through 10 years	4,092,478	4,175,102	3,936,489	3,962,993
Due after 10 years	5,031,182	4,837,583	5,152,860	4,805,800

	17,266,891	17,271,666	17,058,535	16,778,871
Residential mortgage-backed securities Agency	5,907,163	6,019,579	6,169,707	6,228,501
Residential mortgage-backed securities Non-Agency	1,908,056	1,408,352	2,015,593	1,421,315
Commercial mortgage-backed securities	1,259,234	1,252,259	1,276,602	1,216,799
Collateralized debt obligations	1,022,982	722,998	1,030,245	698,561
Other asset-backed securities	1,192,116	1,150,654	1,247,822	1,167,985
Total mortgage and asset-backed securities	11,289,551	10,553,842	11,739,969	10,733,161
Total	$ 28,556,442	$ 27,825,508	$ 28,798,504	$ 27,512,032

(1) Included in the table above are $872.2 million and $904.3 million in Tier One and Upper Tier Two securities, representing committed term debt and hybrid instruments senior to the common and preferred equities of the financial institutions, at fair value as at March 31, 2010 and December 31, 2009, respectively. These securities have been distributed in the table based on their call date and have net unrealized losses of $145.5 million and $225.2 million as at March 31, 2010 and December 31, 2009, respectively.

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NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

5. Investments (Continued)

Factors considered in determining that the remaining gross unrealized loss is not other-than-temporarily impaired include management s consideration of current and near term liquidity needs and other available sources, an evaluation of the factors and time necessary for recovery, and the results of on-going retrospective reviews of security sales and the basis for such sales.

Gross unrealized losses of $1.4 billion on available for sale assets at March 31, 2010 can be attributed to the following significant drivers:

§ gross unrealized losses of $272.5 million related to the Company s Life operations investment portfolio, which had a fair value of $6.3 billion as at March 31, 2010. Of this, $168.2 million of gross unrealized losses related to $1.7 billion of exposures to corporate financial institutions including $113.4 million of losses on $698.9 million of Tier One and Upper Tier Two securities. At March 31, 2010, this portfolio had an average interest rate duration of 8.7 years, primarily denominated in U.K. Sterling and Euros. As a result of the long duration, significant gross losses have arisen as the fair values of these securities are more sensitive to prevailing government interest rates and credit spreads. This portfolio is matched to corresponding long duration liabilities. A hypothetical parallel increase in interest rates and credit spreads of 50 and 25 basis points, respectively, would increase the unrealized losses related to this portfolio at March 31, 2010 by approximately $264.2 million and $112.9 million, respectively on both the available for sale and held to maturity portfolios. Given the long term nature of this portfolio, and the level of credit spreads as at March 31, 2010 relative to historical averages within the U.K. and Euro-zone as well as the Company s liquidity needs at March 31, 2010, the Company believes that these assets will continue to be held until such time as they mature, or credit spreads revert to levels more consistent with historical averages.

§ gross unrealized losses of $177.7 million related to the corporate holdings within the Company s non-life fixed income portfolios, which had a fair value of $7.7 billion as at March 31, 2010. During the quarter ended March 31, 2010, as a result of declining credit spreads, the gross unrealized losses on these holdings has declined. The Company continues to believe that the gross unrealized losses are a reflection of a premium being charged by the market for credit, rather than fundamental deterioration in the debt service capabilities of the issuers.

Of the gross unrealized losses noted above $75.1 million relate to medium term notes primarily supported by pools of investment grade European credit with varying degrees of leverage. These had a fair value of $562.5 million at March 31, 2010. Management believes that expected cash flows over the expected holding period from these bonds are sufficient to support the remaining reported amortized cost.

§ gross unrealized losses of $491.0 million related to non-Agency residential mortgage backed securities (RMBS) portfolio (which consists of the Company s holdings of sub-prime non-agency securities, second liens, ABS CDOs with sub-prime collateral, Alt-A mortgage exposures and Prime RMBS), which had a fair value of $1,219.9 million as at March 31, 2010. The Company undertook a security level review in conjunction with its investment manager service providers of these securities and recognized charges to the extent it believed the discounted cash flow value (to fair value in certain cases) of any security was below its amortized cost. The Company has recognized realized losses, consisting of charges for OTTI and realized losses from sales, of approximately $1.2 billion since the beginning of 2007 and through March 31, 2010 on these asset classes.

The Company purchased a number of these assets to support the previously written guaranteed investment contract (GIC) and funding agreement contracts and has reduced its exposure to this asset class as part of its strategic portfolio realignment. The Company believes that, based on market conditions and liquidity needs at March 31, 2010, this reduction will be realized through natural cash flows of the portfolio, and limited selective sales, rather than selling these assets into markets which continue to not be reflective of the intrinsic value of these assets. The weighted average life of the sub-prime and Alt-A residential holdings within this portfolio at March 31, 2010 were 4.4 years and 4.2 years, respectively. The Company, based on current market conditions and liquidity needs as well as its assessment of the holdings, believes it will continue to hold these securities until either maturity, or a return of liquidity and valuations more reflective of intrinsic value of these holdings.

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NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

5. Investments (Continued)

- gross unrealized losses of $308.3 million related to the non-Life portfolio of Core CDO holdings (defined by the Company as investments in non-subprime collateralized debt obligations), which consists primarily of CDOs and had a fair value of $725.1 million as of March 31, 2010. The Company undertook a security level review in conjunction with its investment manager service providers of these securities and recognized charges to the extent it believed the discounted cash flow value of the security was below the amortized cost. The Company believes that the level of impairment is primarily a function of historically wide spreads in the CDO market during the period, driven by the level of illiquidity in this market. The Company purchased a number of these assets to support the previously written GIC and funding agreement contracts and has announced its intention to reduce its exposure to this asset class over time as a part of its strategic portfolio realignment. The Company, based on current market conditions and liquidity needs as well as its assessment of the holdings, believes it is likely that the Company will continue to hold these securities until either maturity or a recovery of value, following which the Company intends to reduce its exposure to this asset class.

Management, in its assessment of whether securities in a gross unrealized loss position are temporarily impaired, considers the significance of the impairments. The Company had structured credit securities with gross unrealized losses of $274.3 million, with a fair value of $134.9 million, which at March 31, 2010 were impaired by greater than 50% of amortized costs. All of these are asset-backed securities. Of these gross unrealized losses, $76.5 million are rated investment grade. The Company has evaluated each of these securities in conjunction with its investment manager service providers and believes it is more likely than not that the issuer will be able to fund sufficient principal and interest payments to support the current amortized cost. These securities include gross unrealized losses of $169.3 million on Topical assets, $75.9 million on Core CDOs, $0.8 million on prime RMBS and $11.3 million on commercial mortgage backed securities (CMBS) holdings.

Included in the gross unrealized losses associated with the Company s corporate portfolio as of March 31, 2010 are gross unrealized losses of $7.2 million related to Tier One and Upper Tier Two securities that have been rated below investment grade by at least one major rating agency. Of this total, none have gross unrealized losses representing greater than 50% of amortized cost. The Company has completed its review of this portfolio and believes, at this time, that these impairments remain temporary in nature. The primary basis for this conclusion was the analysis of the fundamentals of these securities using a debt-based impairment model, which indicated that these securities continue to meet their obligations, and the issuer has the ability to call these obligations at their call date. In addition, as these securities are below investment grade, the Company considered these securities using an equity-impairment model. Factors that were considered and supported that these impairments were temporary included that the vast majority of these securities had been rated below investment grade beginning in first quarter of 2009, in certain cases alternative ratings were available that indicated these securities remained investment grade, or the securities were only slightly below investment grade. At March 31, 2010, the Company believes that it is likely that the fair values of these securities will ultimately increase to equal the cost basis over a reasonable period of time. However, there is a high degree of judgment in reaching this conclusion, including an assessment of how various governments will treat these securities in the event of governmental intervention in these institutions operations or management s decision to defer calls or coupons. Management will closely monitor the developments related to these securities.

The Company recorded net impairment charges of $40.2 million for the quarter ended March 31, 2010. The significant assumptions and inputs associated with these securities consist of:

- For structured credit securities, the Company recorded net impairments of $28.9 million for the quarter ended March 31, 2010. The Company determined that the likely recovery on these securities was below the amortized cost, and accordingly impaired the securities to the discounted value of the cash flows of these securities.

- For corporate securities, excluding medium term notes backed primarily by investment grade European credit, the Company recorded net impairments totaling $0.2 million for the quarter ended March 31, 2010. The impairment charges consisted of below investment grade securities and below investment grade hybrids, with respect to which the Company considered impairment factors consistent with an equity impairment model, along with a debt impairment model, and accordingly recorded impairment charges to fair value, or determined that the securities in an unrealized loss position would be sold.

  In addition the Company recorded impairments totaling $5.3 million for the quarter ended March 31, 2010 in relation to medium term notes backed primarily by investment grade European credit. Management has concluded that, following recent credit spread movements since 2009, future yields within the supporting collateral were not sufficient to support the previously reported amortized cost.

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NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

5. Investments (Continued)

§ For non-equity accounted alternative funds, the Company recorded impairments of $5.8 million for the quarter ended March 31, 2010 because the fund was impaired by more than 50% of amortized cost.

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

Quarter Ended March 31, 2010 *(U.S. dollars in thousands)* *(Unaudited)*	**OTTI related to Credit Losses recognized in earnings**
Balance, January 1, 2010	$ 537,121
Credit loss impairment recognized in the current period on securities not previously impaired	10,074
Credit loss impairments previously recognized on securities which matured, paid down, prepaid or were sold during the period	(15,975)
Credit loss impairments previously recognized on securities impaired to fair value during the period	
Additional credit loss impairments recognized in the current period on securities previously impaired	27,627
Accretion of credit loss impairments previously recognized due to an increase in cash flows expected to be collected	(7,099)
Balance, March 31, 2010	$ 551,748

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

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

(U.S. dollars in thousands) *(Unaudited)*	**Three Months Ended March 31, 2010 (Unaudited)**
Gross realized gains	$ 34,173
Gross realized losses	(70,349)
Net realized (losses) on investments	$ (36,176)

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NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

5. Investments (Continued)

Transfer of Available for Sale Securities to Held to Maturity

In November 2009, the Company formalized its intention to hold certain fixed income securities to maturity. Consistent with this intention, the Company has reclassified these securities from available for sale to held to maturity in the consolidated financial statements. As a result of this classification, these fixed income securities are reflected in the held to maturity portfolio and recorded at amortized cost in the consolidated balance sheet and not fair value. The held to maturity portfolio is comprised of long duration non-U.S. sovereign government and government-related securities which are primarily Euro denominated. The Company believes this held to maturity strategy is achievable due to the relatively stable and predictable cash flows of the Company s long-term liabilities within its Life operations along with its ability to substitute other assets at a future date in the event that liquidity was required due to changes in expected cash flows or other transactions entered into related to the long-term liabilities supported by the held to maturity portfolio. The unrealized appreciation at the date of the transfer continues to be reported as a separate component of shareholders equity and is being amortized over the remaining lives of the securities as an adjustment to yield in a manner consistent with the amortization of any premium or discount. The unrealized U.S. dollar equivalent appreciation on the date of transfer was $51.2 million and $46.6 million of this balance remains unamortized at March 31, 2010.

Fixed Maturities Held to Maturity

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

March 31, 2010 *(U.S. dollars in thousands)* *(Unaudited)*	**Cost or Amortized Cost**	**Gross Unrealized Gains**	**Gross Unrealized Losses**	**Fair Value**
Fixed maturities				
Non-U.S. Sovereign Government, Supranational and Government-Related	$ 516,470	$ 8,455	$ (2,620)	$ 522,305
Total fixed maturities held to maturity	$ 516,470	$ 8,455	$ (2,620)	$ 522,305

December 31, 2009 *(U.S. dollars in thousands)* *(Unaudited)*	**Cost or Amortized Cost**	**Gross Unrealized Gains**	**Gross Unrealized Losses**	**Fair Value**
Fixed maturities				
Non-U.S. Sovereign Government, Supranational and Government-Related	$ 546,067	$	$ (15,748)	$ 530,319
Total fixed maturities held to maturity	$ 546,067	$	$ (15,748)	$ 530,319

The Company had gross unrealized losses totaling $2.6 million and $15.7 million at March 31, 2010 and December 31, 2009, respectively, which it considers to be temporarily impaired. The Company s held to maturity portfolio consists entirely of Non-U.S. sovereign holdings and all held to maturity fixed maturity securities have a maturity distribution of due after 10 years at each of March 31, 2010 and December 31, 2009.

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NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

6. Derivative Instruments

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

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

(U.S. dollars in thousands) (Unaudited)	March 31, 2010				December 31, 2009			
	Asset Derivative Notional Amount	Asset Derivative Fair Value (1)	Liability Derivative Notional Amount	Liability Derivative Fair Value (1)	Asset Derivative Notional Amount	Asset Derivative Fair Value (1)	Liability Derivative Notional Amount	Liability Derivative Fair Value (1)
Derivatives designated as hedging instruments:								
Interest rate contracts (2)	$ 2,162,724	$ 254,098	$ 95,648	$ (8,543)	$ 2,169,642	$ 238,639	$ 95,948	$ (8,225)
Foreign exchange contracts	560,450	27,822			596,072	7,526		
Total derivatives designated as hedging instruments	$ 2,723,174	$ 281,920	$ 95,648	$ (8,543)	$ 2,765,714	$ 246,165	$ 95,948	$ (8,225)
Derivatives not designated as hedging instruments:								
Investment Related Derivatives:								
Interest rate exposure	$ 1,962,336	$ 572	$ 1,800	$ (4)	$ 111,875	$ 1,248	$ 1,800	$ (6)
Foreign exchange exposure	482,598	23,238	300,064	(12,653)	545,319	9,070	314,361	(8,226)
Credit exposure	219,650	8,748	342,000	(3,914)	214,650	13,244	741,388	(18,198)
Financial market exposure	300,310	1,617			306,464	1,983		
Financial Operations Derivatives: (3)								
Credit exposure			265,511	(22,386)			271,704	(18,386)
Other Non-Investment Derivatives:								
Contingent capital facility	350,000				350,000			
Guaranteed minimum income benefit contract			87,098	(21,296)			86,250	(22,909)
Modified coinsurance funds withheld contract			68,746	(285)			71,695	(266)
Foreign exchange exposure								
Total derivatives not designated as hedging instruments	$ 3,314,894	$ 34,175	$ 1,065,219	$ (60,538)	$ 1,528,308	$ 25,545	$ 1,487,198	$ (67,991)

(1) Derivative instruments in an asset or liability position are included within Other Assets or Other Liabilities, respectively, in the Balance Sheet.

(2) At March 31, 2010 and December 31, 2009, the Company held net cash collateral related to these derivative assets of $195.3 million and $169.1 million. The collateral balance is included within cash and cash equivalents and the corresponding liability to return the collateral has been offset against the derivative asset within the balance sheet as appropriate under the netting agreement.

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(3) Financial operations derivatives represent interests in variable interest entities as described in Note 10, Variable Interest Entities.

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NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

6. Derivative Instruments (Continued)

(a) Derivative Instruments Designated as Fair Value Hedges

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

At March 31, 2010, a portion of the Company s liabilities are hedged against changes in the applicable designated benchmark interest rate. Interest rate swaps are also used to hedge the changes in fair value of certain fixed rate liabilities and fixed income securities due to changes in the designated benchmark interest rate. In addition, the Company utilizes foreign exchange contracts to hedge the fair value of certain fixed income securities as well as to hedge certain net investments in foreign operations.

The following table provides the total impact on earnings relating to derivative instruments formally designated as fair value hedges along with the impacts of the related hedged items for the three month periods ended March 31, 2010 and 2009:

At March 31, 2010
(U.S. dollars in thousands)
(Unaudited)

		Hedged Items Amount of Gain/(Loss) Recognized in Income Attributable to Risk			
Derivatives Designated as Fair Value Hedges:	**Gain/(Loss) Recognized in Income on Derivative**	**Deposit Liabilities**	**Fixed Maturity Investments**	**Notes Payable and Debt**	**Ineffective Portion of Hedging Relationship Gain/ (Loss)**
Interest rate exposure	$ 11,820		$		
Foreign exchange exposure	35,244				
Total	$ 47,064	(824)	(34,666)	(15,415)	(3,841)

At March 31, 2009
(U.S. dollars in thousands)
(Unaudited)

		Hedged Items Amount of Gain/(Loss) Recognized in Income Attributable to Risk			
Derivatives Designated as Fair Value Hedges:	**Gain/(Loss) Recognized in Income on Derivative**	**Deposit Liabilities**	**Fixed Maturity Investments**	**Notes Payable and Debt**	**Ineffective Portion of Hedging Relationship Gain/ (Loss)**
Interest rate exposure	$ (62,639)		$		
Foreign exchange exposure					
Total	$ (62,639)	64,804	(854)		1,311

The gains (losses) recorded on both the derivatives instruments and specific items designated as being hedged as part of the fair value hedging relationships outlined above are recorded through net realized and unrealized gains (losses) on derivative instruments in the income statement along with any associated ineffectiveness in the relationships. In addition, the periodic coupon settlements relating to the interest rate swaps are recorded as adjustments to net investment income for the hedges of fixed maturity investments and as adjustments to interest expense for the hedges of deposit liabilities and notes payable and debt. These coupon settlements resulted in increases to net investment income of $3.8

million and $2.5 million at March 31, 2010 and March 31, 2009, respectively. The coupon settlements also resulted in a decrease in interest expense of $9.2 million and $6.2 million at March 31, 2010 and March 31, 2009, respectively.

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NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

6. Derivative Instruments (Continued)

(b) Derivative Instruments Designated as Cash Flow Hedges

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

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

The Company utilizes foreign exchange contracts to hedge the fair value of certain net investments in foreign operations. During the three months ended March 31, 2010, the Company entered into foreign exchange contracts that were formally designated as hedges of the investment in foreign subsidiaries with functional currencies of U.K. Sterling and the Euro. The U.S. Dollar equivalent of foreign denominated net assets of $372.7 million was hedged which resulted in a derivative gain of $22.6 million being recorded in the cumulative translation adjustment account within AOCI. There was no ineffectiveness resulting from these transactions. The Company did not have any hedge of net investments in foreign operations in place during the quarter ended March 31, 2009.

(d) Derivative Instruments Not Formally Designated As Hedging Instruments

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

(U.S. dollars in thousands) *(Unaudited)*	Amount of Gain (Loss) Recognized in Income on Derivative	
	Three Months Ended March 31, 2010	Three Months Ended March 31, 2009
Derivatives not designated as hedging instruments:		
Investment Related Derivatives:		
Interest rate exposure	$ 1,997	$ 873
Foreign exchange exposure	(13,437)	(6,416)
Credit exposure	(1,271)	1,036
Financial market exposure	511	1,960
Financial Operations Derivatives:		
Credit exposure	(4,002)	5,585
Other Non-Investment Derivatives:		
Contingent capital facility	(2,030)	(2,030)
Guaranteed minimum income benefit contract	1,613	(3,963)
Modified coinsurance funds withheld contract	(20)	237
Total derivatives not designated as hedging instruments	(16,639)	(2,718)
Amount of gain (loss) recognized in income from ineffective portion of fair value hedges	(3,841)	1,311
Net realized and unrealized gains (losses) on derivative instruments	$ (20,480)	$ (1,407)

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

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NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

6. Derivative Instruments (Continued)

d)(i) Investment Related Derivatives

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

Investment Related Derivatives Interest Rate Exposure

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

Investment Related Derivatives Foreign Exchange Exposure

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

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

Investment Related Derivatives Credit Exposure

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

Investment Related Derivatives Financial Market Exposure

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

(d)(ii) Financial Operations Derivatives Credit Exposure

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

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NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

6. Derivative Instruments (Continued)

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

As of March 31, 2010 and December 31, 2009 the remaining credit derivative exposures outside of the Company s investment portfolio consisted of 2 contracts written by the Company that provide credit protection on senior tranches of structured finance transactions with total insured contractual payments outstanding of $265.5 million ($240.9 million principal and $24.6 million interest), and $271.7 million ($244.9 million principal and $26.8 million interest), weighted average contractual term to maturity of 5.7 years and 6.0 years, a total liability recorded of $22.4 million and $18.4 million, respectively, and underlying obligations with an average rating of A at March 31, 2010 and December 31, 2009. As of March 31, 2010, there were no reported events of default on the underlying obligations. Credit derivatives are recorded at fair values, which are determined using either models developed by the Company or third party prices and are dependent upon a number of factors, including changes in interest rates, future default rates, credit spreads, changes in credit quality, future expected recovery rates and other market factors. The change resulting from movements in credit and credit quality spreads is unrealized as the credit derivatives are not traded to realize this resultant value.

(d)(iii) Other Non-Investment Derivatives

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

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

(e) Contingent Credit Features

Certain derivatives agreements entered into by the Company or its subsidiaries contain rating downgrade provisions that permit early termination of the agreement by the counterparty if collateral is not posted following failure to maintain certain credit ratings from one or more of the principal credit rating agencies. If the Company were required to early terminate such agreements due to rating downgrade, it could potentially be in a net liability position at time of settlement. The aggregate fair value of all derivatives agreements containing such rating downgrade provisions that were in a liability position on March 31, 2010 and December 31, 2009 was $27.5 million and $30.8 million, respectively. The Company has not been required to post collateral under any of these agreements as of March 31, 2010.

7. Share Capital

(a) Authorized and Issued

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

(b) Redeemable Series C Preference Ordinary Shares

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

On March 26, 2009, the Company completed a cash tender offer for a portion of its outstanding Series C Preference Ordinary Shares that resulted in approximately 12.7 million Series C Preference Ordinary Shares with a liquidation value of $317.3 million being purchased by the

Company for approximately $104.7 million plus accrued and unpaid dividends, combined with professional fees totaling $0.8 million. As a result, a book value gain of approximately $211.8 million was recorded in the first quarter of 2009 to common shareholders.

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NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

7. Share Capital (Continued)

(c) Stock Plans

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

On February 28, 2010, the Company granted approximately 0.9 million stock options with a weighted-average grant date fair value of $9.32 per option. The fair value of the options issued was estimated on the date of grant using the Black-Scholes option pricing model using the following weighted average assumptions:

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

On February 28, 2010, the Company granted approximately 1.1 million restricted stock units to officers of the Company and its subsidiaries with an aggregate grant date fair value of approximately $20.2 million. Each restricted stock unit represents the Company s obligation to deliver to the holder one Class A Ordinary Share upon satisfaction of the three year vesting term. Restricted stock units are granted at the closing market price on the day of grant and entitle the holder to receive dividends declared and paid in the form of additional Class A Ordinary Shares contingent upon vesting.

On February 28, 2010, the Company granted approximately 1.5 million performance units (representing a potential maximum share payout of approximately 3.1 million Class A Ordinary Shares) to certain employees with an aggregate grant date fair value of approximately $26.3 million. The performance units vest after three years and entitle the holder to shares of the Company s stock. There are no dividend rights associated with the performance units. Each grant of performance units has a target number of shares, with final payouts ranging from 0% to 200% of the grant amount depending upon a combination of corporate and business segment performance along with each employee s continued service through the vest date. Performance targets are based on relative and absolute financial performance metrics.

8. XL Capital Finance (Europe) plc

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

XL CAPITAL LTD

NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

9. Related Party Transactions

At March 31, 2010 and December 31, 2009, the Company owned non-controlling stakes in eight and nine independent investment management companies (Investment Manager Affiliates) totaling $162.0 million and $210.7 million, respectively. The Company sought to develop relationships with specialty investment management organizations, generally acquiring an equity interest in the business. The Company also invests in certain of the funds and limited partnerships and other legal entities managed by these affiliates and through these funds and partnerships pay management and performance fees to the Company s Investment Manager Affiliates.

In the normal course of business, the Company enters into certain quota share reinsurance contracts with a subsidiary of one of its other strategic affiliates, ARX Holding Corporation. During the quarter ended March 31, 2010, these contracts resulted in reported net premiums of $31.1 million, net paid claims of $13.5 million and reported acquisition costs of $14.3 million. During the same period in 2009, these contracts resulted in reported net premiums of $10.3 million, net paid claims of $8.1 million and reported acquisition costs of $5.8 million. Management believes that these transactions are conducted at market rates consistent with negotiated arms-length contracts.

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

10. Variable Interest Entities

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

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

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

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

The credit exposures represent the most significant risks associated with the Company s involvement with variable interest entities and there have been no significant changes in the nature of the Company s involvement with variable interest entities during the three months ended March 31, 2010.

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NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

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

(U.S. dollars and shares in thousands, except per share amounts) (Unaudited)	(Unaudited) Three Months Ended March 31, 2010	2009
Basic earnings per ordinary share:		
Net income	$ 143,880	$ 3,097
Less: preference share dividends	(32,500)	(36,534)
Add: gain on redemption of Series C Preference Ordinary Shares	16,616	211,816
Net income available to ordinary shareholders	$ 127,996	$ 178,379
Weighted average ordinary shares outstanding	342,148	336,217
Basic earnings per ordinary share	$ 0.37	$ 0.53
Diluted earnings per ordinary share:		
Net income	$ 143,880	$ 3,097
Less: preference share dividends	(32,500)	(36,534)
Add: gain on redemption of Series C Preference Ordinary Shares	16,616	211,816
Net income available to ordinary shareholders	$ 127,996	$ 178,379
Weighted average ordinary shares outstanding basic	342,148	336,217
Impact of share based compensation and certain conversion features	612	1
Weighted average ordinary shares outstanding diluted	342,760	336,218
Diluted earnings per ordinary share	$ 0.37	$ 0.53
Dividends per ordinary share	$ 0.10	$ 0.10

12. Commitments and Contingencies

Financial and Other Guarantee Exposures

As part of the Company s legacy financial guarantee business, which was put into run off in 2008, the Company s outstanding financial guarantee contracts as of March 31, 2010 included the reinsurance of 41 financial guarantee contracts with total insured contractual payments outstanding of $674.7 million ($544.3 million of principal and $130.4 million of interest) and having a remaining weighted-average contract period of 11.3 years. The total gross claim liability and unearned premiums recorded at March 31, 2010 were $14.5 million and $1.0 million, respectively. Of the contractual exposure existing at March 31, 2010, the Company has reinsured $373.9 million with subsidiaries of Syncora Holdings Ltd (Syncora), however, as of March 31, 2010 there are no gross claim liabilities or recoverables recorded relating to this exposure. Of the 41 contracts noted above, 3 contracts with total insured contractual payments outstanding of $15.7 million had experienced an event of default and were considered by the Company to be non-performing at March 31, 2010, while the remaining 38 contracts were considered to be performing at such date. As of December 31, 2009, the Company s outstanding financial guarantee contracts that were subject to the new accounting guidance included the reinsurance of 41 financial guarantee contracts with total insured contractual payments outstanding of $713.6 million ($568.2 million of principal and $145.4 million of interest) and having a remaining weighted-average contract period of 11.5 years. The total gross claim liability and unearned premiums recorded at December 31, 2009 were $14.5 million and $1.5 million, respectively. Of the contractual exposure existing at December 31, 2009, the Company had reinsured $401.9 million with subsidiaries of Syncora however as at December 31, 2009 no reinsurance balances recoverable from Syncora had been recorded. Of the 41 contracts noted above, 3 contracts with total insured contractual payments outstanding of $16.1 million had experienced an event of default and were considered by the Company to be non-performing at December 31, 2009, while the remaining 38 contracts were considered to be performing at such date. Surveillance procedures to track and monitor credit deteriorations in the insured financial obligations are performed by the primary obligors for each transaction on the Company s behalf. Information regarding the performance status and updated exposure values is provided to the Company on a quarterly basis and evaluated by management in recording claims reserves.

XL CAPITAL LTD

NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

12. Commitments and Contingencies (Continued)

The Company continues to be subject to guarantees provided in respect of financial guaranty policies issued by subsidiaries of Syncora to the European Investment Bank (the EIB Policies), subject to certain limitations, which have been accounted for under Accounting Standards Codification (ASC) section 460-10, *Guarantees* (previously FIN 45, Guarantor s Accounting and Disclosure Requirements for Guarantees, Including Indirect Guarantees of Indebtedness of Others.) These guarantees were provided for the benefit of EIB Policies relating to project finance transactions comprised of transportation, school and hospital projects with an average rating of BBB, written between 2001 and 2006 with anticipated maturities ranging between 2027 and 2038. As at March 31, 2010, the Company s exposures relating to the EIB Policies was approximately $869.3 million, as compared to $920.4 million at December 31, 2009, decreasing mainly due to the strengthening of the U.S. dollar against the currencies of the underlying obligations. As of March 31, 2010, there have been no reported events of default on the underlying obligations. Accordingly, no reserves have been recorded.

13. Taxation

During the first quarter of 2010, the Company revised its capital strategy such that it is no longer able to positively assert that all earnings arising within the United States will be permanently reinvested in that jurisdiction. As a result, the effective tax rate for the quarter includes a provision for withholding tax on certain earnings arising in the United States. The impact of this change on the estimated effective rate for the quarter is an increase of approximately 0.5%.

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

General

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

This Management s Discussion and Analysis of Financial Condition and Results of Operations contains forward-looking statements that involve inherent risks and uncertainties. Statements that are not historical facts, including statements about the Company s beliefs and expectations, are forward-looking statements. These statements are based upon current plans, estimates and projections. Actual results may differ materially from those included in such forward-looking statements, and therefore undue reliance should not be placed on them. See Cautionary Note Regarding Forward-Looking Statements below for a list of factors that could cause actual results to differ materially from those contained in any forward-looking statement.

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

Executive Overview

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

Results of Operations and Key Financial Measures

The following table presents an analysis of the Company s net income available to ordinary shareholders and other financial measures (described below) for the three months ended March 31, 2010 and 2009:

(U.S. dollars and shares in thousands, except per share amounts)	(Unaudited) Three Months Ended March 31, 2010	2009
Net income available to ordinary shareholders	$ 127,996	$ 178,379
Earnings per ordinary share basic	$ 0.37	$ 0.53
Earnings per ordinary share diluted	$ 0.37	$ 0.53
Weighted average number of ordinary shares and ordinary share equivalents basic	342,148	336,217
Weighted average number of ordinary shares and ordinary share equivalents diluted	342,760	336,218

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

(U.S. dollars and shares in thousands, except ratios and per share amounts)	(Unaudited) Three Months Ended March 31, 2010	2009
Underwriting profit (loss) property and casualty operations	$ (6,610)	$ 103,852
Combined ratio property and casualty operations	100.5%	92.1%
Net investment income property and casualty operations	$ 223,639	$ 262,460
Annualized return on average shareholders equity	5.9%	13.9%

	(Unaudited) March 31, 2010	December 31, 2009
Book value per ordinary share	$ 26.42	$ 24.64
Fully diluted book value per ordinary share (1)	$ 26.38	$ 24.60

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

Key Financial Measures

Underwriting profit property and casualty operations

One way that the Company evaluates the performance of its insurance and reinsurance operations is the underwriting profit or loss. The Company does not measure performance based on the amount of gross premiums written. Underwriting profit or loss is calculated from premiums earned less net losses incurred and expenses related to underwriting activities. The Company s underwriting profit for the three month period ended March 31, 2010 was primarily reflective of the combined ratio discussed below.

Combined ratio property and casualty operations

The combined ratio for Property and Casualty (P&C) operations is used by the Company and many other insurance and reinsurance companies as another measure of underwriting profitability. The combined ratio is calculated from the net losses incurred and underwriting expenses as a ratio of the net premiums earned for the Company s insurance and reinsurance operations. A combined ratio of less than 100% indicates an underwriting profit and greater than 100% reflects an underwriting loss. The Company s combined ratio for the three months ended March 31, 2010, is higher than the same period in the previous year, primarily as a result of an increase in the loss and loss expense ratio, partially offset by a decrease in the underwriting expense ratio. The loss and loss expense ratio has increased as a result of higher levels of catastrophe losses in both the insurance and reinsurance segments. The decreased underwriting expense ratio is reflective of the additional costs incurred in 2009 associated with the Company s restructuring activities.

Net investment income property and casualty operations

Net investment income related to P&C operations is an important measure that affects the Company s overall profitability. The largest liability of the Company relates to its unpaid loss reserves, and the Company s investment portfolio provides liquidity for claims settlements of these reserves as they become due. Thus, a significant part of the investment portfolio is invested in fixed income securities. Net investment income is influenced by a number of factors, including the amounts and timing of inward and outward cash flows, the level of interest rates and credit spreads and changes in overall asset allocation. Net investment income related to P&C operations decreased by $38.8 million during the first quarter of 2010 as compared to the same period in the prior year. Overall, portfolio yields have decreased as a result of the impact of declines in U.S. interest rates, and particularly the impact of decreased U.S. Dollar Libor on the Company s floating rate securities previously supporting the GIC and funding agreement business. In addition, the Company increased its holdings in lower-yielding cash, government and agency RMBS securities in connection with its investment portfolio de-risking efforts as the Company re-aligned its portfolio to one more typical of a P&C portfolio.

Book value per ordinary share

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

Book value per ordinary share increased by $1.78 in the three months ended March 31, 2010 as compared to a decrease of $0.44 during the first three months of 2009. During the first three months of 2010, there was a decrease in net unrealized losses of $0.6 billion, net of tax. The impact of improved credit spreads in certain asset classes combined with the benefit from declining interest rates near the end of the quarter resulted in overall increased book value. In addition, book value per ordinary share increased as a result of net income attributable to ordinary shareholders of $128.0 million which included a $16.6 million gain associated with the purchase of an additional portion of the Company s Redeemable Series C Preference Ordinary Shares.

As noted above, fully diluted book value per ordinary share represents book value per ordinary share combined with the impact from dilution of share based compensation including in-the-money stock options and certain other share bas