

HISCOX INSURANCE COMPANY (BERMUDA) LIMITED

Financial Statements
(With Independent Auditors' Report Thereon)

December 31, 2010 and 2009



CHIEF EXECUTIVE OFFICER'S REPORT

2010 was a tough year for natural catastrophes and it is very pleasing to be able to report that the Company still made a profit of \$134 million despite significant losses in the Chile and New Zealand earthquakes. Accordingly, our net assets have increased from \$808 million at the start of 2010 to \$942 million at the end.

2010 was the first year that we had substantial quota share support from a new client of the Group to whom we ceded a substantial book of US catastrophe business. I am glad to say that this client has renewed for the 2011 year and has been joined by three further clients, each of which will be participating in our reinsurance account in a tailored fashion.

The internal cessions that we assume from other parts of the Hiscox Group continue to perform adequately and we continue to actively manage this portfolio to ensure that each and every cession makes sense from the Company's perspective.

I reported last year that we had recruited a healthcare team in Bermuda. They began underwriting in 2010 although for 2011 they will be underwriting on behalf of Hiscox Syndicate 3624. Accordingly, the Company's balance sheet will not be at risk going forward.

We have continued to strengthen the business during 2010. Staff numbers have grown from 32 to 36 and we have attracted a number of very high quality young Bermudian recruits both in the front and back office. I am very proud that we were highly placed in Bermuda's 'Top 10 Employers that Stand Out in Bermuda' survey. It is pleasing to see the percentage of staff who are Bermudian continue to rise and to feel that our young insurance staff are fully benefitting from all the training resources of the Group.

Our Charities Committee continues to actively support a variety of causes throughout the Island. While our recipients are diverse, we strive to assist organizations that have difficulties raising funds. The Committee is especially keen in making sure that money goes directly to the front line. Apart from our charitable involvement, we are also involved in backing a number of community based initiatives and were delighted in February 2011 to be given an Appreciation Award by the Bermuda Government in recognition of our continued support for Under 11 Cricket on the Island.

The market for 2011 looks considerably tougher than that we enjoyed in 2010. In January we saw renewal rates fall by between 5% and 10% on our portfolio and we are expecting the market to be soft in the absence of a major event during the year. At the same time, the second horrific earthquake in New Zealand and the floods in Australia will both represent losses to the Company, although of a very containable nature. Despite this mildly gloomy outlook, we remain fully committed to continue underwriting in a disciplined fashion and to rely on the conservative investment strategy of the Group to ensure that the asset side of our balance sheet remains strong.

Charles Dupplin
Chief Executive Officer
March 9, 2011

Hiscox Bermuda
Wessex House 45 Reid Street
Hamilton HM 12, Bermuda
Postal Address
P.O. Box HM 192
Hamilton HM AX Bermuda

T +1 441 278 8300
F +1 441 278 8301
E enquiries@hiscox.bm
E submissions@hiscox.bm
www.hiscox.bm



KPMG
Crown House
4 Par-la-Ville Road
Hamilton HM 08, Bermuda
Mailing Address:
P.O. Box HM 906
Hamilton HM DX, Bermuda

Telephone 441 295 5063
Fax 441 295 9132
www.kpmg.bm

INDEPENDENT AUDITORS' REPORT

To the Board of Directors of
Hiscox Insurance Company (Bermuda) Limited

We have audited the accompanying balance sheets of Hiscox Insurance Company (Bermuda) Limited as of December 31, 2010 and December 31, 2009 and the statements of income, changes in shareholder's equity and cash flows for the years then ended. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audits to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes consideration of internal control over financial reporting as a basis for designing audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the Company's internal control over financial reporting. Accordingly, we express no such opinion. An audit also includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of Hiscox Insurance Company (Bermuda) Limited as of December 31, 2010 and 2009 and the results of its operations and its cash flows for the years then ended in conformity with accounting principles generally accepted in the United States of America.

Chartered Accountants
Hamilton, Bermuda
March 9, 2011

HISCOX INSURANCE COMPANY (BERMUDA) LIMITED

Balance Sheets

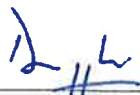
December 31, 2010 and 2009

(Expressed in Thousands of United States Dollars)

	<u>2010</u>	<u>2009</u>
Assets		
Cash and cash equivalents (Note 4)	\$ 179,203	\$ 114,099
Investments in marketable securities (Notes 3, 4 and 5)	1,075,702	884,271
Investments in catastrophe bonds (Note 3(e))	24,261	18,209
Reinsurance balances receivable	130,072	119,779
Losses recoverable (Note 6)	28,267	53,365
Prepaid reinsurance premiums	19,432	12,975
Accrued interest receivable	9,553	8,172
Deferred acquisition expenses	14,262	14,022
Other assets (Note 8)	<u>3,551</u>	<u>4,703</u>
Total assets	<u>\$ 1,484,303</u>	<u>\$ 1,229,595</u>
Liabilities		
Outstanding losses and loss expenses (Note 6)	\$ 331,819	\$ 240,889
Unearned premiums	165,820	152,206
Trades pending settlement	11,546	11,517
Reinsurance balances payable	23,943	5,762
Other liabilities (Note 8)	<u>9,405</u>	<u>11,349</u>
Total liabilities	<u>542,533</u>	<u>421,723</u>
Shareholder's equity		
Share capital		
Authorized, issued and fully paid		
100,000,000 shares of \$1 par value each	100,000	100,000
Contributed surplus (Note 9)	402,000	402,000
Retained earnings	<u>439,770</u>	<u>305,872</u>
Total shareholder's equity	<u>941,770</u>	<u>807,872</u>
Total liabilities and shareholder's equity	<u>\$ 1,484,303</u>	<u>\$ 1,229,595</u>

See accompanying notes to financial statements

Signed on behalf of the Board



Director



Director

HISCOX INSURANCE COMPANY (BERMUDA) LIMITED

Statements of Income

Years Ended December 31, 2010 and 2009
(Expressed in Thousands of United States Dollars)

	<u>2010</u>	<u>2009</u>
Income		
Premiums assumed	\$ 458,900	\$ 558,084
Change in unearned premiums	<u>(13,616)</u>	<u>(24,450)</u>
Premiums earned	445,284	533,634
Premiums ceded	80,667	84,586
Change in prepaid reinsurance premiums	<u>(6,457)</u>	<u>(12,058)</u>
Premiums ceded	74,210	72,528
Net premiums earned	371,074	461,106
Underwriting income – catastrophe bonds	1,979	644
Net investment income	<u>32,614</u>	<u>94,483</u>
Total income	405,667	556,233
Expenses		
Losses and loss expenses incurred	207,588	200,349
Reinsurance recoveries	<u>4,972</u>	<u>23,594</u>
Net losses and loss expenses incurred (Note 6)	212,560	223,943
Acquisition expenses	35,631	48,203
General and administrative expenses	15,978	35,884
Foreign exchange loss (gain)	<u>7,600</u>	<u>(5,884)</u>
Total expenses	271,769	302,146
Net income	<u>\$ 133,898</u>	<u>\$ 254,087</u>

See accompanying notes to financial statements

HISCOX INSURANCE COMPANY (BERMUDA) LIMITED

Statements of Changes in Shareholder's Equity

Years Ended December 31, 2010 and 2009
(Expressed in Thousands of United States Dollars)

	<u>2010</u>	<u>2009</u>
Share Capital		
Balance at beginning and end of year	\$ 100,000	\$ 100,000
Contributed surplus		
Balance at beginning of year	402,000	403,728
Stock based compensation	<u>—</u>	<u>(1,728)</u>
Balance at end of year	<u>402,000</u>	<u>402,000</u>
Retained earnings		
Balance at beginning of year	305,872	301,785
Net income for the year	133,898	254,087
Dividend paid during the year (Note 10)	<u>—</u>	<u>(250,000)</u>
Balance at end of year	<u>439,770</u>	<u>305,872</u>
Total shareholder's equity	<u>\$ 941,770</u>	<u>\$ 807,872</u>

See accompanying notes to financial statements

HISCOX INSURANCE COMPANY (BERMUDA) LIMITED

Statements of Cash Flows

Years Ended December 31, 2010 and 2009
(Expressed in Thousands of United States Dollars)

	<u>2010</u>	<u>2009</u>
Cash flows from operating activities		
Net income	\$ 133,898	\$ 254,087
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation	71	423
Loss on disposal of equipment	-	111
Share based compensation	688	408
Realized (gain) loss on marketable securities	(8,863)	5,596
Unrealized loss (gain) on marketable securities	945	(61,979)
Realized gain on catastrophe bonds	(142)	-
Unrealized gain on catastrophe bonds	(233)	(177)
Effect of exchange rate fluctuations on cash	1,709	(1,374)
Net purchase of investments	(183,513)	(455,435)
Net purchase of catastrophe bonds	(5,677)	(18,032)
Reinsurance balances receivable	(10,293)	144,306
Losses recoverable	25,098	62,664
Prepaid reinsurance premiums	(6,457)	4,997
Accrued interest receivable	(1,381)	(4,720)
Deferred acquisition expenses	(240)	3,148
Other assets	(435)	(1,853)
Outstanding losses and loss expenses	90,930	(121,416)
Unearned premiums	13,614	(67,234)
Trades pending settlement	29	(27,883)
Reinsurance balances payable	18,181	178
Other liabilities	<u>(2,632)</u>	<u>(756)</u>
Cash provided (used) by operating activities	<u>65,297</u>	<u>(284,941)</u>
Cash flows from investing activities		
Purchase of equipment	(78)	(1,388)
Sale of fixed assets	<u>1,594</u>	<u>-</u>
Cash provided by (used in) investing activities	<u>1,516</u>	<u>(1,388)</u>
Net increase (decrease) in cash and cash equivalents	66,813	(286,329)
Cash and cash equivalents at beginning of year	114,099	399,054
Effect of exchange rate fluctuations on cash and cash equivalents	<u>(1,709)</u>	<u>1,374</u>
Cash and cash equivalents at end of year	<u>\$ 179,203</u>	<u>\$ 114,099</u>

See accompanying notes to financial statements

HISCOX INSURANCE COMPANY (BERMUDA) LIMITED

Notes to Financial Statements

December 31, 2010 and 2009

(Expressed in Thousands of United States Dollars)

1. General

Hiscox Insurance Company (Bermuda) Limited (“Hiscox Bermuda” or the “Company”) was incorporated under the laws of Bermuda on October 21, 2005. The Company is a provider of property catastrophe and specialty reinsurance coverages to insurers and reinsurers on a worldwide basis. Hiscox Bermuda is registered as a Class 4 insurer under The Insurance Act 1978 (Bermuda). The Company is directly owned by Hiscox Ltd, a company incorporated in Bermuda and publicly traded on the London Stock Exchange.

2. Summary of significant accounting policies

The accompanying financial statements are prepared in accordance with accounting principles generally accepted in the United States of America which require management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates. The following are the significant accounting policies adopted by the Company:

(a) Premiums and related expenses

Premiums are recorded as written at the beginning of each policy based on contract and policy terms and information received from ceding companies and their brokers. For excess of loss contracts, the deposit premiums are contractually determined at inception and any subsequent premium adjustments resulting from changes in underlying exposures are recorded in the period in which they are determined. Premiums are earned on a pro-rata basis over the coverage period. For proportional treaties, the amount of premium is estimated at inception based on information from the ceding company or their broker. Initial premium estimates are updated by management as necessary when additional information is provided by the ceding company or their broker; revisions in estimates are recorded in the period in which they are determined. Proportional treaty premiums are earned over the exposure period. Unearned premiums represent the portion of premiums written applicable to unexpired terms of in-force policies.

Ceded reinsurance premiums are similarly recorded as written at the beginning of each policy and pro-rated over the term of the contract with the unexpired portion deferred in the balance sheet.

Where coverage is reinstated under pre-defined contract terms after the occurrence of a loss event, reinstatement premiums are recognized as written and are earned over the period of coverage. Accruals for reinstatement premiums are based on contractual terms applied to amounts of losses incurred, the only element of management judgment involved is with respect to the amount of loss reserves. Changes in estimates of reinstatement premiums are reflected in the period that changes in loss estimates are determined.

Acquisition costs, consisting principally of commissions and brokerage expenses incurred at the time a contract or policy is issued, are deferred and amortized over the period in which the related premiums are earned. Deferred policy acquisition costs are limited to their estimated realizable value based on the related unearned premiums, anticipated claims and associated investment income.

HISCOX INSURANCE COMPANY (BERMUDA) LIMITED

Notes to Financial Statements

December 31, 2010 and 2009

(Expressed in thousands of United States Dollars)

2. Summary of significant accounting policies (continued)

(b) Reserve for losses and loss expenses

The reserve for losses and loss expenses includes estimates for unpaid claims and claim expenses on reported losses as well as an estimate of losses incurred but not reported and development on reported claims. The reserve is based on individual claims, case reserves and other reserve estimates reported by ceding companies and their brokers as well as management estimates of ultimate losses derived from in-house actuarial projections, reports from industry sources for catastrophes and from commercially available catastrophe loss models. For certain catastrophic events, there is considerable uncertainty underlying the assumptions and associated estimated reserve for loss and loss adjustment expenses.

For proportional treaties, an estimated loss and loss adjustment expense ratio is initially used, based upon information provided by the ceding company and/or their brokers and the Company's historical experience of that treaty. Changes are recognized when determined and as actual experience becomes known.

These estimates are reviewed regularly and, as experience develops and new information becomes known, the reserves are adjusted as necessary. It is reasonably possible that ultimate losses may vary materially from the amounts provided in the financial statements. Any resulting adjustments are reflected in income in the period in which they become known.

(c) Investments

The Company's investment portfolio comprises fixed income securities and holdings of certain traded mutual funds. These are classified as trading and are carried at fair value with any unrealized gains/losses included in the income statement.

Fair value of government securities are based on quoted market prices and fair value of fixed income securities are based on bid prices and matrix pricing for less liquid securities as provided by leading pricing services. The cost of fixed income securities is adjusted for premium amortization and discount accretion. Realized gains and losses are recognized in income using the specific identification method.

Investments in mutual funds are carried at net asset value. The mutual funds that the Company invests with carry their trading positions and investments at fair value as determined by their respective investment managers. All changes in net asset values are included within income.

Investments in catastrophe bonds are carried at fair value which is based on indicative bid prices. Income earned on these instruments, including changes in fair value, is recognized as underwriting income – catastrophe bonds.

(d) Derivative financial instruments

Derivative financial instruments are initially recognized at fair value on the date on which a derivative contract is entered into and are subsequently valued at their fair value at each balance sheet date. Fair values are obtained from quoted market values and, if these are not available, valuation techniques including option pricing models as appropriate. None of the Company's derivatives are designated as hedging instruments; as such, fair value changes are recognized immediately in the income statement.

HISCOX INSURANCE COMPANY (BERMUDA) LIMITED

Notes to Financial Statements

December 31, 2010 and 2009

(Expressed in thousands of United States Dollars)

2. Summary of significant accounting policies (continued)

(e) Reinsurance

Amounts recoverable from reinsurers are estimated in a manner consistent with the claim liability associated with the reinsured policies. Reinsurance does not relieve the Company from its obligation to policyholders. Failure of reinsurers to honor their obligation could result in losses to the Company.

As of December 31, 2010 and 2009, the Company did not deem any losses recoverable from reinsurers as uncollectible. Losses recoverable from reinsurers at December 31, 2010 and 2009 represent amounts that are either fully collateralized by a trust fund whereby the Company is the beneficiary with counterparties not having a credit rating or uncollateralized from parties having a minimum rating of A from AM Best.

(f) Interest income

Interest income is accrued to the balance sheet date.

(g) Cash and Cash Equivalents

Cash and cash equivalents include commercial paper deposits with a maturity of ninety days or less when purchased.

(h) Foreign exchange

The Company's functional currency is the United States Dollar. Revenues and expenses denominated in foreign currencies are translated at the prevailing exchange rate at the transaction date. Monetary assets and liabilities denominated in foreign currencies are translated at exchange rates in effect at the balance sheet date. Exchange gains or losses are included in the determination of net income.

(i) Share based compensation

The Company's parent, Hiscox Ltd, operates a number of equity settled share based employee compensation plans in which certain employees of the Company participate.

The Company applies the fair value method of accounting for these awards, as promulgated by ASC 718 *Compensation-Stock Compensation* (formerly "FAS 123R"). Compensation expense is recorded ratably over the vesting period based on the fair value of awards at the date of grant with a corresponding amount recognized as other liabilities in the current year (previously recognized as contributed surplus).

The total amount to be expensed over the vesting period is determined by reference to the fair value of the awards granted, excluding the impact of any non-market vesting conditions (e.g. profitability or net asset growth targets). Non-market vesting conditions are included in assumptions about the number of awards that are expected to become exercisable. At each balance sheet date, the Company revises its estimates of the number of awards that are expected to vest. It recognizes the impact of the revision of original estimates, if any, in the income statement, and a corresponding adjustment to other liabilities (previously equity), over the remaining vesting period.

The charge recorded for the year ended December 31, 2010 was \$688 (2009: \$408).

HISCOX INSURANCE COMPANY (BERMUDA) LIMITED

Notes to Financial Statements

December 31, 2010 and 2009

(Expressed in thousands of United States Dollars)

3. Investments

(a) The fair values of investments in marketable securities are as follows:

	<u>2010</u>	<u>2009</u>
Government and government agencies		
US	\$ 398,230	\$ 334,770
Non US	179,550	162,086
Corporate securities	342,081	280,066
Asset backed securities	47,938	26,732
Mortgage backed securities	<u>27,737</u>	<u>8,341</u>
Total fixed income securities	995,536	811,995
Mutual funds	73,790	69,110
Other investments	6,530	2,403
Investments in derivatives	<u>(154)</u>	<u>763</u>
Total investments in marketable securities	<u>\$ 1,075,702</u>	<u>\$ 884,271</u>

(b) The fair value of the Company's investment in fixed income securities, categorized by credit rating is as follows:

	<u>2010</u>	<u>2009</u>
Government and government agencies		
US	\$ 398,230	\$ 334,770
Government and government agencies		
Non US	179,550	162,085
AAA	98,840	39,765
AA	49,062	57,244
A	140,942	122,336
BBB	101,218	53,583
Non-investment grade	<u>27,694</u>	<u>42,212</u>
	<u>\$ 995,536</u>	<u>\$ 811,995</u>

Approximately 6% of the Company's fixed income investment portfolio as of December 31, 2010 (2009: 5%) was composed of mortgage-backed securities (including Government Agency mortgage backed securities) and these had a weighted average rating of AAA by Standard & Poor's. 66% (2009: 17%) of these mortgage-backed securities are residential mortgage-backed securities and the remaining 34% (2009: 83%) are commercial mortgage-backed securities. The Company's investments in asset-backed securities comprise primarily of instruments backed by auto, credit card, and student loans originating in the United States of America and these had a weighted average rating of AAA as at December 31, 2010.

HISCOX INSURANCE COMPANY (BERMUDA) LIMITED

Notes to Financial Statements

December 31, 2010 and 2009

(Expressed in thousands of United States Dollars)

3. Investments (continued)

(c) For the year ended December 31, 2010, the gross realized gain on investments in securities held for trading by the Company was \$9,393 and the realized foreign exchange loss related to these securities was \$530 (2009: realized loss on investments of \$5,596 and realized foreign exchange gain of \$nil). The change in gross unrealized gain on investments in securities held for trading by the Company was \$6,086 and the change in the unrealized foreign exchange was a loss of \$7,031 (2009: unrealized gain on investments of \$60,444 and unrealized foreign exchange gain of \$1,535). The realized and unrealized gains and losses on investments in securities held for trading by the Company was included within net investment income on the income statement while the realized and unrealized foreign exchange gains and losses are included within foreign exchange loss (gain) in the income statements.

(d) Fair value of financial instruments

Fair values measurements are established in accordance with the framework provided by ASC 820, *Fair Value Measurements and Disclosures*. ASC 820 establishes a fair value hierarchy with the highest priority given to quoted prices in active markets and the lowest priority given to unobservable inputs.

The following are the levels within the fair value hierarchy.

Level 1 – Fair values are measured using quoted prices (unadjusted) in active markets for identical instruments.

Level 2 – Fair values are measured using directly or indirectly observable inputs or other similar valuation techniques for which all significant inputs are based on observable market data.

Level 3 – Fair values are measured using valuation techniques for which significant inputs are based on unobservable data.

As required by ASC 820, when the inputs used to measure fair value fall within different levels of the hierarchy, the level within which the fair value measurement is categorized is based on the lowest level input that is significant to the fair value measurement in its entirety. Thus, a Level 3 fair value measurement may include inputs that are observable (Level 1 and 2) and unobservable (Level 3).

The Company used the following valuation technique and assumptions in estimating the value of our financial instruments as well as the general classification of such financial instruments pursuant to the above fair value hierarchy.

Fixed interest securities

At each valuation date, the fair values of the Company's fixed interest securities are based on prices provided by investment managers who obtain market data from numerous independent pricing services. The pricing services used by the investment manager obtain actual transaction prices for securities that have quoted prices in active markets. For those securities which are not actively traded, the pricing services use common market valuation pricing models.

HISCOX INSURANCE COMPANY (BERMUDA) LIMITED

Notes to Financial Statements

December 31, 2010 and 2009

(Expressed in thousands of United States Dollars)

3. Investments (continued)

(d) Fair value of financial instruments (continued)

The following describes the significant inputs generally used to determine the fair value of our fixed interest securities by asset class.

U.S. treasuries

When pricing these securities, the pricing services may utilize daily data from many real time market sources, including active broker dealers; as such, the Company considers its U.S. Treasury fixed interest securities as Level 1.

Non-U.S. government (Sovereign debt)

The issuers for securities in this sector are supranational organizations. When evaluating these securities, the pricing services may gather information from market sources and integrate other observations from markets and sector news. Evaluations are updated by obtaining broker dealer quotes and other market information including actual trade volumes, when available. For securities in which trade volume is low, the pricing services may also utilize data from more frequently traded securities with similar attributes. These are considered quoted prices from active markets therefore, the fair value of the securities are classified as Level 1.

Corporate

Corporate debt securities consist primarily of investment-grade debt of a wide variety of well known corporate issuers. When evaluating these securities, the pricing services may gather information from market sources regarding the issuer of the security, obtain credit data, as well as other observations from markets and sector news. Evaluations are updated by obtaining broker dealer quotes and other market information including actual trade volumes, when available. The pricing services may also consider the specific terms and conditions of the securities, including any specific features which may influence risk. These are considered observable inputs therefore, the fair value of the securities are classified as Level 2.

Asset-backed

When pricing asset-backed securities, the pricing services may apply dealer quotes and other available trade information such as bid and offers, prepayment spreads which may be adjusted for the underlying collateral or current price data, the U.S. treasury curve, swap curve and TBA values as well as cash settlement. These are considered observable inputs therefore, the fair value of the securities are classified as Level 2.

Mortgage-backed

When pricing the residential mortgage-back securities and commercial mortgage-backed securities, pricing services utilize daily inputs from the active TBA market which is extremely liquid, as well as the U.S. treasury market. The pricing services may also utilize additional information, such as the weighted average maturity, weighted average coupon and other pool level data which is provided by the sponsoring agency. Valuations may also be corroborated by daily active market quotes. These are considered observable inputs therefore, the fair value of the securities are classified as Level 2.

Mutual funds

Investments in mutual funds comprise a portfolio of stock investments in trading entities which are invested in various quoted investments. The fair value of shares in unit trusts are based on the net asset value of the fund as reported by independent pricing sources or the fund manager. These funds are classified as Level 2.

HISCOX INSURANCE COMPANY (BERMUDA) LIMITED

Notes to Financial Statements

December 31, 2010 and 2009

(Expressed in thousands of United States Dollars)

3. Investments (continued)

(d) Fair value of financial instruments (continued)

Investments in catastrophe bonds

The Company's investments in catastrophe bonds are recorded at fair value based on quoted market prices, or when such prices are not available, by reference to published broker or underwriter bid and offer indications. As such, the Company considers its investments in catastrophe bonds as Level 2.

Other investments

Other investments consist of an investment in a Limited Partnership invested in emerging markets in three asset classes: private equity, infrastructure and real estate. As this investment has limited observable inputs on which to measure fair value, it has been classified as Level 3.

The following tables present the Company's fair value hierarchy as of December 31, 2010 and 2009.

<u>December 31, 2010</u>	<u>Level 1</u>	<u>Level 2</u>	<u>Level 3</u>	<u>Total</u>
Government and government agencies				
US	\$ 68,369	\$ 329,861	\$ —	\$ 398,230
Non US	90,472	89,078	—	179,550
Corporate securities	—	342,081	—	342,081
Asset backed securities	—	47,938	—	47,938
Mortgage backed securities	—	27,737	—	27,737
Mutual funds	—	73,790	—	73,790
Derivative instruments	—	(154)	—	(154)
Other investments	—	—	6,530	6,530
Catastrophe bonds	—	24,261	—	24,261
	<u>\$ 158,841</u>	<u>\$ 934,592</u>	<u>\$ 6,530</u>	<u>\$ 1,099,963</u>
<u>December 31, 2009</u>	<u>Level 1</u>	<u>Level 2</u>	<u>Level 3</u>	<u>Total</u>
Government and government agencies				
US	\$ 71,742	\$ 263,028	\$ —	\$ 334,770
Non US	159,263	2,823	—	162,086
Corporate Securities	—	280,066	—	280,066
Asset Backed Securities	—	26,732	—	26,732
Mortgage Backed Securities	—	8,341	—	8,341
Mutual Funds	—	69,110	—	69,110
Derivative instruments	—	763	—	763
Other investments	—	—	2,403	2,403
Catastrophe bonds	—	18,209	—	18,209
	<u>\$ 231,005</u>	<u>\$ 669,072</u>	<u>\$ 2,403</u>	<u>\$ 902,480</u>

There were no transfers made between Level 1 and Level 2 of the fair value hierarchy in either 2010 or 2009.

HISCOX INSURANCE COMPANY (BERMUDA) LIMITED

Notes to Financial Statements

December 31, 2010 and 2009

(Expressed in thousands of United States Dollars)

3. Investments (continued)

(d) Fair value of financial instruments (continued)

The following tables provide a summary of changes in fair value of the Company's Level 3 financial instruments for the years ended December 31, 2010 and 2009:

	<u>Mutual funds</u>	<u>Other investments</u>	<u>Total</u>
Balance at January 1, 2010	\$ -	\$ 2,403	\$ 2,403
Purchases	-	2,821	2,821
Settlements	-	-	-
Total gains	<u>-</u>	<u>1,306</u>	<u>1,306</u>
Balance December 31, 2010	<u>\$ -</u>	<u>\$ 6,530</u>	<u>\$ 6,530</u>
	<u>Mutual Funds</u>	<u>Other Investments</u>	<u>Total</u>
Balance at January 1, 2009	\$ 8,464	\$ 776	\$ 9,240
Purchases	-	1,242	1,242
Settlements	(8,464)	-	(8,464)
Total Gains	<u>-</u>	<u>385</u>	<u>385</u>
Balance December 31, 2009	<u>\$ -</u>	<u>\$ 2,403</u>	<u>\$ 2,403</u>

(e) Investments in catastrophe bonds

- (i) The Company's investments in catastrophe bonds comprise fifteen (2009: twelve) catastrophe bonds with Standard and Poor's credit ratings ranging from B to BB (2009: B to BB) and Moody's credit ratings ranging from B to Ba (2009: B to Ba). Maturities on these bonds range from 2011 to 2015. The issuers of these securities have used the proceeds raised to collateralize certain catastrophe reinsurance obligations, mainly U.S. and European wind and earthquake risks. The investment in these securities is therefore at risk of loss, in whole or in part, if a covered catastrophe occurs.

The cost, fair value and unrealised gains and losses of catastrophe bonds are as follows:

	<u>Cost</u>	<u>Unrealised gains</u>	<u>Unrealised losses</u>	<u>Fair value</u>
At December 31, 2010	\$ 23,851	\$ 441	\$ (31)	\$ 24,261
At December 31, 2009	<u>\$ 18,032</u>	<u>\$ 177</u>	<u>\$ -</u>	<u>\$ 18,209</u>

HISCOX INSURANCE COMPANY (BERMUDA) LIMITED

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3. Investments (continued)

(e) Investments in catastrophe bonds (continued)

- (ii) The Company earns income on these securities based upon LIBOR, Euribor and Money Market Yield plus a fixed rate of interest.
- (iii) Unrealised gains and losses on catastrophe bonds held as of December 31, 2010 and 2009 comprise an accumulation of relatively small unrealized gains and losses on a security by security basis caused by general interest rate movements rather than credit events.

4. Concentration of credit risk

Financial instruments which potentially subject the Company to concentration of credit risk consist principally of cash and cash equivalents and investments. The commercial paper portfolio along with the investment portfolio is managed following standards of diversification with restrictions on the allowable holdings of a single issue or issuer. 37% (2009: 27%) of cash and cash equivalents are held at a US financial institution rated A+ by Fitch Ratings, 24% (2009: 51%) at a Bermuda bank rated AA- by Standard & Poor's, 15% (2009: 22%) at an Irish Corporate Money Fund rated AAA by Standard & Poor's, and 24% (2009: -) at a UK financial institution rated A by Standard & Poor's. The Company's management evaluates the financial strength and stability of these institutions on a periodic basis.

The Company's investment portfolio is managed by an external investment manager in accordance with the Company's investment guidelines. These guidelines follow prudent standards of diversification and a prudent investment philosophy.

The Company underwrites the majority of its reinsurance business through brokers and a credit risk exists should any of these brokers be unable to fulfill their contractual obligations with respect to the payments of reinsurance and insurance balances to the Company. In 2010, approximately 98% (2009: 98%) of reinsurance balances receivable due from rated cedants are due from cedants with ratings of A- or above. Rated cedants account for 88% (2009: 91%) of reinsurance balances receivable.

Concentration of credit risk related to losses recoverable is addressed in Note 2(e).

5. Commitments and security arrangements

As Hiscox is not an admitted insurer or reinsurer in the U.S., the terms of certain U.S. insurance and reinsurance contracts require Hiscox to provide letters of credit or other terms of collateral to clients.

In February 2009, Hiscox renegotiated its Letter of Credit Reimbursement and Pledge Agreement with Citibank for the provision of a letter of credit facility in favor of U.S. ceding companies. The agreement is a three year secured facility of \$450,000. Letters of credit issued under these facilities are collateralized by U.S. government securities. At December 31, 2010 approximately \$89,110 (2009: \$109,000) in letters of credit were in issue under this facility, collateralized by U.S. government securities with a fair value of \$105,699 (2009: \$122,648).

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5. Commitments and security arrangements (continued)

During 2010, the Company maintained assets in trust accounts to collateralize obligations under various reinsurance agreements. At December 31, 2010 total assets with a carrying value of approximately \$54,680 (2009: \$607) were held in trust.

During 2006, the Company entered into a quota share reinsurance contract with Hiscox Insurance Company (Guernsey) Limited ("HIG"). In conjunction with the quota share contract, Hiscox Bermuda has also entered into an unconditional guarantee to pay on demand to HIG all monies required by HIG for the payment, performance and discharge of HIG's obligations. At December 31, 2010 and 2009 there was \$nil amounts due under this guarantee.

6. Outstanding losses and loss expenses

The movement in the reserve for outstanding losses and loss expenses is summarized below:

	2010	2009
Balance at January 1	\$ 240,889	\$ 362,305
Less reinsurance recoverable	<u>(53,365)</u>	<u>(116,029)</u>
Net balance at January 1	<u>187,524</u>	<u>246,276</u>
Net losses incurred related to:		
Current year	245,213	235,518
Prior years	<u>(32,653)</u>	<u>(11,575)</u>
Total incurred	<u>212,560</u>	<u>223,943</u>
Net paid losses related to:		
Current year	(44,145)	(49,740)
Prior years	<u>(50,852)</u>	<u>(60,500)</u>
Total paid	<u>(94,997)</u>	<u>(110,240)</u>
Reinsurance To Close	-	69,594
Settled novation	-	(242,866)
Effect of foreign exchange movements	<u>(1,535)</u>	<u>817</u>
Total net reserves at December 31	303,552	187,524
Loss reserves recoverable at December 31	<u>28,267</u>	<u>53,365</u>
Gross loss reserves at December 31	<u>\$ 331,819</u>	<u>\$ 240,889</u>

The Company experienced favorable development on prior years during the year ended December 31, 2010, primarily due to reduced provisions for more developed underwriting years and better than expected loss experience. On a gross basis, there was favorable development on the prior years due to a further reduction in the loss estimate for Hurricane Ike and other smaller events, following settlements and revised notifications in respect of these events; the movement in the net estimate for Hurricane Ike during the year was nil.

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6. Outstanding losses and loss expenses (continued)

Estimates of property claims and claim expenses are based in part upon the estimation of claims resulting from catastrophic events. Estimation by the Company of claims resulting from catastrophic events is inherently difficult because of the potential severity of property catastrophe claims. In particular, complexity arising from problems such as coverage issues, multiple events affecting one geographic area, demand surge and communication from clients and brokers can cause reporting delays. The Company uses both proprietary and commercially available models, as well as historical reinsurance industry property catastrophe claims experience, for purposes of evaluating future trends and providing an estimate of ultimate claims costs.

For specialty business, the Company uses statistical and actuarial methods to estimate ultimate expected claims and claim expenses. The period of time from the reporting of a loss and the settlement of the liability may be several years. During this period, additional facts and trends may be revealed. As these factors become apparent, case reserves will be adjusted, sometimes requiring an increase or decrease in the overall reserves of the Company, and at other times requiring a reallocation of incurred but not reported ("IBNR") reserves to specific case reserves or additional case reserves. These estimates are reviewed regularly, and such adjustments, if any, are reflected in the results of operations in the period in which they become known. Such adjustments may be significant.

In 2009 Hiscox Dedicated Corporate Member Limited ("HDCM"), a related party, provided 72.5% of the capacity of Lloyd's Syndicate 33 and had a quota share agreement with the Company whereby the Company reinsured part of HDCM's obligations with respect to Lloyd's Syndicate 33. On January 1, 2009, the 2006 Year of Account ("YOA") of Lloyd's Syndicate 33 (and all older YOA already closed into 2006 YOA) reinsured its remaining liabilities into the 2007 YOA of Lloyd's Syndicate 33. This transfer of assets received by the 2007 YOA was covered by the HDCM quota share reinsurance. The Reinsurance To Close ("RITC") reflected in the table above represents the Company's share of HDCM's 2006 YOA RITC into the 2007 YOA. The transfer is a no profit/no loss transfer and assets of an equal amount were received by the Company.

On November 18, 2009, the Company entered into a novation agreement with Hiscox Capital Ltd ("HCL"), a related party, and HDCM whereby the Company was discharged from all of its obligations under the quota share agreements entered into with HDCM. As a result, net loss reserves of \$242,866 were settled at no gain or loss and no remaining outstanding loss obligations related to HDCM were held by the Company at December 31, 2009 and 2010.

7. Financial instruments

The following methods and assumptions are used to estimate the fair value of financial instruments not disclosed elsewhere in these financial instruments:

Cash and cash equivalents: The carrying amount of cash and cash equivalents approximates fair value because of the short term maturity of those instruments.

Other assets: The fair value of accrued interest receivable and reinsurance balances receivable, approximate their carrying value due to their relative short term nature.

Liabilities: The fair value of reinsurance balances payable, trades pending settlement and other liabilities approximates their carrying value due to their relative short term nature.

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7. Financial instruments (continued)

The estimates of fair values presented herein are subjective in nature and are not necessarily indicative of the amounts that the Company would actually realize in a current market exchange. However, any differences would not be expected to be material. Certain instruments such as deferred acquisition costs, prepayments, outstanding loss reserves and unearned premiums are excluded from fair value disclosure. Thus the total fair value amounts cannot be aggregated to determine the underlying economic value of the Company.

8. Related party transactions

During the year, the Company entered into reinsurance agreements with companies affiliated through common control. The financial statements include the following amounts which are attributable to reinsurance related party transactions:

	<u>2010</u>	<u>2009</u>
Premiums assumed	\$ 160,279	\$ 295,200
Premiums earned	\$ 149,460	\$ 273,769
Premiums ceded	\$ 2,356	\$ 34,618
Earned premiums ceded	\$ 2,356	\$ 34,560
Investment income	\$ —	\$ 15,552
Net losses and loss expenses incurred	\$ 100,570	\$ 169,863
Acquisition expenses	\$ 338	\$ 7,292
General and administrative expenses	\$ —	\$ 10,130
Foreign exchange loss	\$ —	\$ (4,848)
Reinsurance balances receivable	\$ 59,704	\$ 55,934
Deferred acquisition expenses	\$ 7	\$ 19
Outstanding losses and loss expenses	\$ 140,723	\$ 100,546
Unearned premiums	\$ 81,694	\$ 70,883

The Company has also entered into various service agreements with Hiscox Underwriting Group Services Limited ("HUGS"). The agreements cover investment management services, claims and group legal services, human resources, IT, actuarial, accounting and other general corporate services, modeling services and outwards reinsurance administration services. The Company and HUGS are wholly-owned subsidiaries of Hiscox Ltd.

In accordance with the service agreements, HUGS recharged the Company for services undertaken during the year, on a cost-plus basis. These services resulted in related party transactions and balances with HUGS which have been recorded in the financial statements as follows:

	<u>2010</u>	<u>2009</u>
Other assets	\$ 1,182	\$ 932
Other liabilities	\$ 2,260	\$ 1,013
General and administrative expenses	\$ 4,323	\$ 2,506

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8. Related party transactions (continued)

In addition, the Company has the following related party balances with other Hiscox affiliates which have been recorded in the financial statements as follows:

	<u>2010</u>	<u>2009</u>
Other assets	\$ 1,562	\$ 1,123
Other liabilities	\$ 13	\$ 73

The Company has entered into a loan agreement with the parent company, Hiscox Ltd. The loan resulted in interest income of \$5 (2009: \$19). The loan is interest bearing at LIBOR plus 1% and is repayable on demand. At December 31, 2010 the balance of the loan was \$(44) (2009: \$1,123).

Other liabilities include the fair value of equity awards made to employees of the Company in the form of share options in the parent company, Hiscox Ltd, in the amount of \$nil (2009: \$36). The related expense incurred in 2010 amounted to \$688 (2009: \$408).

On November 18, 2009, the Company entered into a novation agreement with HCL and HDCM, whereby the Company was discharged from all of its obligations under the quota share agreements entered into with HDCM. HCL acquired all assets and assumed all liabilities of the Company related to the quota share agreements. The transaction resulted in a net cash settlement to HCL from the Company of \$5,586, which represents \$726 of cash received by the Company from HDCM as early settlement of the 2007 YOA, and a net cumulative loss result on the portfolio of \$4,860. The Company, HCL and HDCM are wholly-owned subsidiaries of Hiscox Ltd.

As outlined in Note 5, during 2010 the Company maintained assets in trust accounts to collateralize its obligations under various reinsurance agreements. At December 31, 2010, total assets with a carrying value of approximately \$54,240 (2009: \$nil) were held in trust in favor of Hiscox affiliates.

9. Contributed surplus

Contributed surplus represents cash contributed by the parent company in addition to the subscription to the issued share capital.

10. Dividend

In November 2009, the Company declared and paid a dividend of \$250,000 to its parent Hiscox Ltd. The dividend was settled by transferring a part of its US Dollar investment portfolio to Hiscox Ltd with a total fair value of \$250,000 at the date of the dividend. No dividend was declared in 2010.

11. Statutory requirements

As a Class 4 insurer, the Company must at all times maintain a solvency margin and an enhanced capital requirement in accordance with the provisions of the Insurance Act. Each year the Company is required to file with the Bermuda Monetary Authority (the "Authority") a capital and solvency return within four months of its relevant financial year end (unless specifically extended).

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11. Statutory requirements (continued)

The prescribed form of capital and solvency return, which was revised under new legislation enacted in 2008, comprises the insurer's Bermuda Solvency Capital Requirement ("BSCR") model, a schedule of fixed income investments by rating category, a schedule of net loss and loss expense provision by line of business, a schedule of premiums written by line of business, a schedule of risk management and a schedule of fixed income securities. The BSCR includes a standardized model used to measure the risk associated with an insurer's assets, liabilities and premiums, and a formula to take account of catastrophe risk exposure. The Authority has provided for the use of pre-approved internally developed company models in lieu of the standardized BSCR. The Authority requires all Class 4 insurers to maintain their capital at a target level which is 120% of the minimum amount calculated in accordance with the BSCR or the company's approved internal model (the Enhanced Capital Requirement or "ECR").

Statutory capital and surplus at December 31, 2010, as determined using statutory accounting principles, was \$926,698 (2009: \$791,202). The principal difference between statutory capital and surplus and shareholder's equity presented in accordance with U.S. GAAP is deferred acquisition costs, which are non-admitted assets for statutory purposes.

The Insurance Act also requires an insurer engaged in general business to maintain the value of its relevant assets at not less than 75% of the amount of its relevant liabilities. Relevant assets include cash and time deposits, quoted investments, unquoted bonds and debentures, first liens on real estate, investment income due and accrued, accounts and premiums receivable, reinsurance balances receivable and funds held by ceding reinsurers. There are certain categories of assets which, unless specifically permitted by the Authority, do not automatically qualify as relevant assets, such as unquoted equity securities, investments in and advances to affiliates and real estate and collateral loans. The relevant liabilities are total general business insurance reserves and total other liabilities less deferred income tax, sundry liabilities (by interpretation, those not specifically defined) and, letters of credit, guarantees and other instruments.

At December 31, 2010 the Company was required to maintain relevant assets of approximately \$362,468. At that date relevant assets were approximately \$1,412,261 and the minimum liquidity ratio was therefore met.

The Company is prohibited from declaring or paying a dividend if its Class 4 statutory capital and surplus is less than its ECR, or if it is in breach of its solvency margin or minimum liquidity ratio, or if the declaration or payment of such dividend would cause such breach. Further, The Company, as a Class 4 insurer, is prohibited from declaring or paying in any year dividends of more than 25% of its total statutory capital and surplus (as shown on its previous year's statutory balance sheet) unless it files (at least seven days before payment of such dividends) with the Authority an affidavit stating that it will continue to meet its solvency margin and minimum liquidity ratio. The Company must obtain the Authority's prior approval for a reduction by 15% or more of the total statutory capital as set forth in its previous year's financial statements. These restrictions on declaring or paying dividends and distributions under the Insurance Act are in addition to those under the Companies Act 1981, which apply to all Bermuda companies.

Unaudited

The maximum amount available for payment of dividends or other distributions in 2010 without prior regulatory approval is approximately \$231,675. At December 31, 2010 the Company's ECR was \$189,117 (2009: \$236,749).

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12. Taxation

Under current Bermuda law, the Company is not required to pay any taxes in Bermuda on either income or capital gains. The Company has received an undertaking from the Minister of Finance in Bermuda that in the event of any such taxes being imposed the Company will be exempted from taxation until the year 2016. The Bermuda Government plans to extend the exemption to 2035.

13. Subsequent events

Subsequent events have been evaluated up to and including March 9, 2011, the date these financial statements were available to be issued.

Significant flooding in Queensland, Australia dominated the beginning of 2011. The start of 2011 also saw a severe tropical cyclone, Yasi, make landfall in northern Queensland. On February 22, 2011, an earthquake measuring 6.3 on the Richter scale struck approximately 10 kilometres south-east of Christchurch, New Zealand's second most populous town. The earthquake caused extensive damage in the Christchurch area and although it is too early to assess, the Company expects to report losses of a similar or greater magnitude to those recorded for the September 2010 New Zealand earthquake. Losses relating to these events in 2011 are not included within the results for 2010.
