ArielHoldings

Annual Report 2009

# *Managing Volatility*

# Financial Highlights

(Expressed in thousands of US dollars, except per share data)

| For the years ended December 31, | 2009 | 2008 | 2007 | 2006 |
|---|---|---|---|---|
| Gross premiums written | $644,134 | $616,145 | $355,785 | $289,226 |
| Net premiums earned | 521,707 | 557,148 | 322,651 | 200,160 |
| Net investment income | 81,424 | 84,131 | 72,440 | 57,078 |
| Net realized and unrealized gains (losses) on investments | 84,717 | (89,737) | (14,936) | (5,669) |
| Other income (loss), net | 32,098 | 28,149 | (6,148) | 1,854 |
| Total revenues | 719,946 | 579,691 | 374,007 | 253,423 |
| Net income (loss) | 372,346 | (38,531) | 233,118 | 156,280 |
| Comprehensive income (loss) | 348,923 | (56,623) | 241,361 | 158,588 |
| **Diluted net income (loss) per share** | **$34.52** | **$(3.69)** | **$22.49** | **$15.09** |
| Total assets | $2,876,625 | $2,612,231 | $2,423,957 | $1,295,903 |
| Shareholders' equity | 1,767,714 | 1,400,095 | 1,439,636 | 1,178,725 |
| Fully diluted book value per share | $161.94 | $131.40 | $136.43 | $113.80 |
| Return on average equity | 23.5% | (2.7%) | 17.8% | 14.2% |

Note 1: In 2007 and 2006, net realized and unrealized gains (losses) on investments did not include unrealized gains (losses) on investments.

AarielHoldings

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Donald Kramer
Chairman

February 19, 2010

To Our Shareholders,

Every so often things go right, 2009 was a near perfect example. We achieved record profits, and continued the rapid growth in book value per share. Our underwriting results were very strong, and our investment performance was exceptional. We were able to grow both the size and the quality of key existing lines, as well as hiring an industry leading credit and surety reinsurance team. Just as importantly, we continued to improve the way we operate in almost every aspect of our business.

Net income for 2009 totaled $372.3 million, compared with a loss of $38.5 million for the prior year. Fully diluted earnings per share totaled $34.52 versus a loss of $3.69 in 2008. Fully diluted book value per share on December 31, 2009 reached a new high of $161.94, a 23.2% gain over 2008 year end and our return on average equity totaled 23.5%.

On a segment basis, Ariel Reinsurance Company Limited, our Bermuda operation, accounted for 89.6% of total net income before corporate overhead; Atrium, our Lloyd's facility, produced 11.6%; and the Valiant Insurance Group, our US subsidiary, accounted for a loss of 1.2%.

The numbers speak for themselves. Summary financial data and our audited financials are attached. Some of the highlights were: Ariel Re opened a new branch office in Zurich to target the credit and surety business. We recruited a highly skilled staff to take advantage of a void in the market created by a cut back in capacity from several leading participants. Atrium expanded their aviation and satellite underwriting capabilities during the year with the addition of a highly respected aviation reinsurance underwriter. At Ariel Holdings, we took advantage of several investment opportunities that presented themselves in 2009 which allowed us to achieve an impressive 7.8% return on investments.

Our prognosis for 2010, while generally positive, cannot be expected to match the unusually favorable accomplishments of 2009. Prices are down moderately in our principal subsidiary, Ariel Re, due to increasing competition for the best priced risks in the P&C sector. Moreover, we cannot anticipate as benign a hurricane season as we experienced last year. Atrium is also forecasting somewhat lower results for 2010, while Valiant is operating in the softest sector of the insurance market and accordingly has taken a more restrained policy toward new business. Finally, we face the challenge of historically low interest rates and the potential for a rise in rates later this year having a modest impact on the value of our bond portfolio.

Nevertheless, our range of probable outcomes suggests a reasonably healthy double digit return on equity in 2010. To date, we have had a reasonably encouraging renewal season at Ariel, with revenue and income somewhat above our initial forecasts.

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During the year we explored the possibility of finding a pathway to liquidity for our investors given the significant growth we've achieved since inception. Regrettably the public markets offered us little prospect for achieving an attractive return given the significant discount to book value that most of our publicly traded peers currently sell at. We also examined the option of combining with a publicly traded entity to achieve scale, diversification and potential liquidity. At the end of the day, we found none of the foregoing options to be sufficiently rewarding to our investors.

We ended the year in a very strong capital position, but found little opportunity for reinvestment of our capital at attractive risk-adjusted returns. Accordingly we decided to return excess capital to our shareholders in the form of a dividend. In early February 2010, we paid a $40.00 per share dividend to shareholders. This represented a return of 40% of original invested funds or a total of $420.3 million. We believe that this represents prudent capital management, allowing us to reward shareholders a return at full book value while maintaining conservative capital adequacy within the group. We continually focus our efforts on building shareholder value through organic growth.

Shortly after year end we elevated our President, George Rivaz, to the role of Chief Executive Officer. George was a key player in establishing Ariel Re's original franchise and led our acquisition of Atrium in 2007. I believe that he is a truly talented insurance leader who has not only a deep understanding of underwriting strategy and risk management but also a commitment to developing talent throughout the organization. I will remain as Chairman in a non-executive role and will continue to work closely with the Board as we try to maximize shareholder value.

I want to thank our entire management team for producing outstanding profits last year and our shareholders for their patience and support as we attempt to produce superior risk adjusted returns on your investment in the year ahead.

Yours Truly

Donald Kramer
Chairman

## Cautionary Statement on Forward-Looking Statements

This report includes forward looking statements, both with respect to us and our industry. Statements that include the words "expect," "intend," "plan," "believe," "project," "anticipate," "will," "may" and similar statements of a future or forward looking nature identify forward looking statements. All forward looking statements included in this report reflect our current views with respect to future events and our financial results and address matters that involve risks and uncertainties. Accordingly, there are or will be important factors that could cause actual results to differ materially from those indicated in such statements. We believe that the important factors for determining future events and our financial results include, but are not limited to, the following:

- our limited operating history;
- the cyclicality of demand and pricing in the reinsurance and insurance markets;
- general economic and market conditions (including inflation, recessionary pressures, interest rates and foreign currency exchange rates) and their impact on access to capital in the financial markets and conditions specific to the reinsurance and insurance markets in which we expect to operate;
- our ability to successfully implement our business strategy during favorable and unfavorable market conditions;
- the extent and degree of competition on the basis of pricing, capacity, coverage or other terms, at any particular time or from time to time;
- the adequacy of our risk management and loss limitation methods and policies;
- the adequacy of our loss reserves against actual losses;
- the timing of required loss payments being faster or the actual receipt of reinsurance recoverables being slower than anticipated by us;
- the availability to us of retrocessions to manage our gross and net exposures and the cost of such retrocessions;
- the failure of retrocessionaires, producers or others to meet their obligations to us;
- our ability to obtain and, in the case of our principal operating subsidiaries, maintain credit ratings, which may be affected by our ability to raise additional equity and/or debt capital and other factors described herein;
- the acceptance of our business strategy and financial condition by rating agencies and regulators, as well as continued business from our insureds (including reinsurance and insurance companies) and insurance intermediaries;
- the amount of capital and scope of financing alternatives available to us on favorable terms, or at all;
- our ability to identify, hire and retain, on a timely and unimpeded basis and on favorable terms, experienced and capable senior management, as well as risk analysts, underwriters, claims professionals and support staff;
- our ability to implement, successfully, efficiently, and on a timely basis, complex infrastructure, distribution capabilities, systems, procedures and internal controls, and to develop accurate actuarial data to support the business and regulatory and reporting requirements;
- the successful integration of Atrium and Valiant, or other businesses we may acquire;

- accuracy of those estimates and judgments utilized in the preparation of our financial statements, including those related to revenue recognition, insurance and other reserves, reinsurance recoverables, investment valuations, intangible assets, bad debts, income taxes, contingencies, litigation and any determination to use the deposit method of accounting, which, for a relatively new reinsurance and insurance company like our company, are even more difficult to make than those made in a mature company because of limited historical information;
- changes in accounting principles or the application of such principles by regulators;
- changes in domestic or foreign laws or regulations, or their interpretations;
- significant litigation or arbitration proceeding or developments that are unfavorable to reinsurance and/or insurance companies generally or to us specifically;
- statutory or regulatory or rating agency developments, including as to tax policy and matters and reinsurance and other regulatory matters such as the adoption of proposed legislation that would affect Bermuda headquartered companies and/or Bermuda based reinsurers or insurers;
- the unpredictable nature and severity of catastrophic events; and
- acts of terrorism, political unrest and other hostilities or other unforecasted and unpredictable events;

The foregoing list of important factors should not be construed as exhaustive and should be read in conjunction with the other cautionary statements that are included in this report. All of the forward looking statements made in this report are qualified by these cautionary statements, and there can be no assurance that the actual developments or events anticipated by us will be realized or, even if substantially realized, that they will have the expected consequences to, or effects on, us or our business or financial results. We undertake no obligation to update or revise any forward looking statement, whether as a result of new information, future developments or otherwise, except as required by applicable law.

# Financials

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# REPORT OF INDEPENDENT AUDITORS

TO THE SHAREHOLDERS

ARIEL HOLDINGS LTD.

We have audited the accompanying consolidated balance sheets of Ariel Holdings Ltd. (the "Company") as of December 31, 2009 and 2008, and the related consolidated statements of operations and comprehensive income (loss), shareholders' equity, and cash flows for the three year period ended December 31, 2009. These consolidated 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 audit to obtain reasonable assurance about whether the consolidated financial statements are free of material misstatement. We were not engaged to perform an audit of the Company's internal control over financial reporting. Our audits included 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 consolidated financial statements, assessing the accounting principles used and significant estimates made by management, and evaluating the overall consolidated financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the consolidated financial position of Ariel Holdings Ltd. at December 31, 2009 and 2008, and the consolidated results of its operations and comprehensive income (loss) and its cash flows for the three year period ended December 31, 2009, in conformity with U.S. generally accepted accounting principles.

As discussed in Note 2 to the consolidated financial statements, with effect from January 1, 2008, the Company prospectively reclassified as trading, investments previously designated as available-for-sale and changed the manner in which movements in unrealized gains and losses on these investments are recognized.

Ernst & Young Ltd.

February 19, 2010

**CONSOLIDATED FINANCIAL STATEMENTS**

**For the year ended December 31, 2009**

# ARIEL HOLDINGS LTD.

(Exact name as specified in its charter)

| | |
|---|---|
| **Bermuda** | **98-0486783** |
| (State or other jurisdiction of incorporation or organization) | (I.R.S. Employer Identification No.) |


**Victoria Place, 5th Floor, 31 Victoria Street, Hamilton HM10, Bermuda**
(Address of principal executive offices and zip code)

**(441) 295 5485**
(Telephone number, including area code)


As of February 4, 2010 there were 10,506,573 Common Shares, $1.00 par value per share, of the Company outstanding.

**ARIEL HOLDINGS LTD.**

**INDEX TO CONSOLIDATED FINANCIAL STATEMENTS**

**Consolidated Financial Statements**

**ARIEL HOLDINGS LTD.**
**CONSOLIDATED BALANCE SHEETS**
**As at December 31, 2009 and 2008**
(Expressed in thousands of U.S. dollars, except share and per share amounts)

| | December 31, 2009 | December 31, 2008 |
|---|---|---|
| **Assets** | | |
| Investments | | |
| Fixed maturities, at fair value (amortized cost: 2009: $1,555,582, 2008: $1,410,487) | $ 1,568,163 | $ 1,379,023 |
| Other investments, at fair value | 253,105 | 275,482 |
| Short-term investments, at fair value | 400,369 | 174,320 |
| Total investments | 2,221,637 | 1,828,825 |
| Cash and cash equivalents | 118,418 | 158,139 |
| Accrued investment income | 13,755 | 14,517 |
| Deferred acquisition costs | 35,745 | 35,471 |
| Premiums receivable | 212,308 | 187,788 |
| Prepaid reinsurance premiums | 16,927 | 13,440 |
| Paid losses recoverable | 10,391 | 5,294 |
| Loss reserves recoverable | 46,791 | 64,894 |
| Goodwill and intangible assets | 134,101 | 175,810 |
| Other assets | 60,700 | 41,381 |
| Receivable for investments sold | 5,852 | 86,672 |
| **Total assets** | **$ 2,876,625** | **$ 2,612,231** |
| | | |
| **Liabilities** | | |
| Reserve for losses and loss adjustment expenses | 574,293 | 650,189 |
| Unearned premiums | 239,056 | 210,917 |
| Reinsurance premiums payable | 35,829 | 26,235 |
| Losses payable | 34,213 | 22,718 |
| Payable for investments purchased | 57,393 | 131,869 |
| Notes payable | 1,150 | 2,147 |
| Subordinated debentures payable | 91,800 | 91,800 |
| Deferred tax liabilities | 24,264 | 38,547 |
| Other liabilities | 50,913 | 37,714 |
| **Total liabilities** | **1,108,911** | **1,212,136** |
| | | |
| **Shareholders' equity** | | |
| Common shares (par value: $1.00, authorized: 100,000,000 shares, issued and outstanding, 2009: 10,506,573, 2008: 10,458,596) | 10,507 | 10,459 |
| Additional paid-in capital | 1,064,629 | 1,045,981 |
| Accumulated other comprehensive loss | (41,515) | (18,092) |
| Retained earnings | 734,093 | 361,747 |
| **Total shareholders' equity** | **1,767,714** | **1,400,095** |
| | | |
| **Total liabilities and shareholders' equity** | **$ 2,876,625** | **$ 2,612,231** |

See accompanying notes to consolidated financial statements

**ARIEL HOLDINGS LTD.**
**CONSOLIDATED STATEMENTS OF OPERATIONS AND COMPREHENSIVE INCOME (LOSS)**
**For the years ended December 31, 2009, 2008 and 2007**
(Expressed in thousands of U.S. dollars, except share and per share amounts)

| | December 31, 2009 | December 31, 2008 | December 31, 2007 |
|---|---|---|---|
| **Revenues** | | | |
| Gross premiums written | $ 644,134 | $ 616,145 | $ 355,785 |
| Reinsurance premiums ceded | (75,113) | (74,869) | (9,241) |
| Net premiums written | 569,021 | 541,276 | 346,544 |
| Change in net unearned premiums | (47,314) | 15,872 | (23,893) |
| Net premiums earned | 521,707 | 557,148 | 322,651 |
| Other underwriting income | 24,955 | 22,232 | 621 |
| Gain on sale of intangible assets | 6,138 | - | - |
| Gain on repurchase of subordinated debentures | - | 1,520 | - |
| Net investment income | 81,424 | 84,131 | 72,440 |
| Net realized gains (losses) on investments | 12,575 | (9,551) | (14,936) |
| Net unrealized gains (losses) on investments | 72,142 | (80,186) | - |
| Net foreign exchange gains (losses) | 1,005 | 4,397 | (6,769) |
| **Total revenues** | **719,946** | **579,691** | **374,007** |
| **Expenses** | | | |
| Net losses and loss adjustment expenses | 136,804 | 387,591 | 37,463 |
| Acquisition costs | 85,051 | 106,318 | 39,827 |
| General and administrative expenses | 117,032 | 107,296 | 56,975 |
| Interest expense | 3,891 | 6,592 | 4,689 |
| Amortization of intangible assets | 1,341 | 1,647 | 1,993 |
| **Total expenses** | **344,119** | **609,444** | **140,947** |
| **Income (loss) before income taxes** | **375,827** | **(29,753)** | **233,060** |
| Income tax expense (benefit) | 3,481 | 8,778 | (58) |
| **Net income (loss)** | **$ 372,346** | **$ (38,531)** | **$ 233,118** |
| **Comprehensive income (loss)** | | | |
| Net unrealized investment loss arising during the year | $ - | $ - | $ (6,693) |
| Adjustments for losses included in net income | - | - | 14,936 |
| Currency translation adjustments | (23,423) | (18,092) | - |
| **Comprehensive income (loss)** | **$ 348,923** | **$ (56,623)** | **$ 241,361** |
| **Earnings (loss) per share** | | | |
| Weighted average number of common shares outstanding – basic | 10,492,195 | 10,450,327 | 10,349,500 |
| Weighted average number of common shares and common share equivalents outstanding - diluted | 10,785,842 | 10,450,327 | 10,366,796 |
| **Basic earnings (loss) per share** | **$ 35.49** | **$ (3.69)** | **$ 22.52** |
| **Diluted earnings (loss) per share** | **$ 34.52** | **$ (3.69)** | **$ 22.49** |

See accompanying notes to consolidated financial statements

**ARIEL HOLDINGS LTD.**
**CONSOLIDATED STATEMENTS OF SHAREHOLDERS' EQUITY**
**For the years ended December 31, 2009, 2008 and 2007**
(Expressed in thousands of U.S. dollars, except share and per share amounts)

| | December 31, 2009 | December 31, 2008 | December 31, 2007 |
|---|---|---|---|
| **Common shares** | | | |
| Balance, beginning of year | $ 10,459 | $ 10,451 | $ 10,310 |
| Issuance of common shares | 48 | 25 | 141 |
| Repurchase of common shares | - | (17) | - |
| **Balance, end of year** | **$ 10,507** | **$ 10,459** | **$ 10,451** |
| | | | |
| **Additional paid-in capital** | | | |
| Balance, beginning of year | $ 1,045,981 | $ 1,028,907 | $ 1,009,498 |
| Issuance of common shares | 554 | 2,607 | 8,950 |
| Settlement of equity awards | - | (6,409) | - |
| Repurchase of common shares | (3,593) | (2,415) | - |
| Stock-based compensation expense | 21,687 | 23,291 | 10,459 |
| **Balance, end of year** | **$ 1,064,629** | **$ 1,045,981** | **$ 1,028,907** |
| | | | |
| **Accumulated other comprehensive (loss) income** | | | |
| Balance, beginning of year | $ (18,092) | $ 10,551 | $ 2,308 |
| Change in unrealized gains on investments | - | - | 8,243 |
| Currency translation adjustments | (23,423) | (18,092) | - |
| Cumulative effect of adoption of fair value option | - | (10,551) | - |
| **Balance, end of year** | **$ (41,515)** | **$ (18,092)** | **$ 10,551** |
| | | | |
| **Retained earnings** | | | |
| Balance, beginning of year | $ 361,747 | $ 389,727 | $ 156,609 |
| Cumulative effect of adoption of fair value option | - | 10,551 | - |
| Net income (loss) | 372,346 | (38,531) | 233,118 |
| **Balance, end of year** | **$ 734,093** | **$ 361,747** | **$ 389,727** |
| | | | |
| **Total shareholders' equity** | **$ 1,767,714** | **$ 1,400,095** | **$ 1,439,636** |

See accompanying notes to consolidated financial statements

**ARIEL HOLDINGS LTD.**
**CONSOLIDATED STATEMENTS OF CASH FLOWS**
**For the years ended December 31, 2009, 2008 and 2007**
(Expressed in thousands of U.S. dollars, except share and per share amounts)

| | December 31, 2009 | December 31, 2008 | December 31, 2007 |
|---|---|---|---|
| **Cash flows provided by operating activities:** | | | |
| Net income (loss) | $ 372,346 | $ (38,531) | $ 233,118 |
| **Adjustments to reconcile net income (loss) to net cash provided by operating activities** | | | |
| Net realized (gains) losses on investments | (12,575) | 9,551 | 14,936 |
| Net amortization of (discounts) premiums of fixed maturities | (409) | 1,216 | (1,060) |
| Net unrealized (gains) losses on investments | (72,142) | 80,186 | - |
| Gain on sale of intangible asset | (6,138) | - | - |
| Gain on repayment of subordinated debentures | - | (1,520) | - |
| Stock-based compensation expense | 21,687 | 23,291 | 10,459 |
| Amortization and depreciation | 5,726 | 5,186 | 2,899 |
| Change in value of other investments | - | - | (6,692) |
| Other items | 2,564 | 4,235 | 5,618 |
| **Change in:** | | | |
| Accrued investment income | 108 | 2,098 | (1,688) |
| Deferred acquisition costs | (3,916) | (17,266) | (3,565) |
| Premiums receivable | (43,589) | (9,447) | (23,668) |
| Prepaid reinsurance premiums | (5,466) | 8,555 | (629) |
| Paid losses recoverable | (6,352) | 6,061 | - |
| Loss reserves recoverable | 4,253 | 9,824 | (297) |
| Other assets | (24,187) | 19,346 | (8,195) |
| Reserve for losses and loss adjustment expenses | 12,236 | 170,680 | 29,020 |
| Unearned premiums | 46,022 | (13,456) | 24,521 |
| Reinsurance premiums payable | 15,379 | (925) | 695 |
| Losses payable | 16,318 | 2,717 | (11) |
| Deferred tax liabilities | (5,994) | (4,859) | - |
| Other liabilities | 9,467 | (2,573) | 2,505 |
| **Net cash provided by operating activities** | **325,338** | **254,369** | **277,966** |
| **Cash flows used in investing activities:** | | | |
| Purchases of fixed maturities | (3,262,176) | (4,708,349) | (1,416,535) |
| Proceeds from sales and maturities of fixed maturities | 3,194,797 | 4,498,634 | 1,494,209 |
| Net (purchases) sales of short-term investments | (275,221) | (93,810) | 14,048 |
| Net sales (purchases) of other investments | 7,311 | 28,043 | (96,417) |
| Change in payable for investments purchased | 80,819 | 89,502 | 30,802 |
| Change in receivable for investments sold | (62,911) | (77,291) | (8,535) |
| Purchase of subsidiaries, net of cash acquired | - | - | (229,996) |
| Purchases of fixed assets | (3,908) | (8,624) | (3,437) |
| Proceeds from sale of intangible assets | 12,781 | - | - |
| **Net cash used in investing activities** | **(308,508)** | **(271,895)** | **(215,861)** |
| **Cash flows (used in) provided by financing activities:** | | | |
| Repurchase of common shares | (3,593) | (2,432) | - |
| Settlement of equity awards | - | (6,409) | - |
| Issuance of common shares | 601 | 2,632 | 9,091 |
| Repayment of notes payable | (1,228) | (4,200) | - |
| Proceeds from issuance of bridge loan | - | - | 150,000 |
| Repayment of bridge loan | - | - | (150,000) |
| Repayment of subordinated debentures | - | (6,680) | - |
| Proceeds from issuance of subordinated debentures | - | - | 100,000 |
| **Net cash (used in) provided by financing activities** | **(4,220)** | **(17,089)** | **109,091** |
| Effect of exchange rate changes on cash and cash equivalents | (52,331) | 394 | (3,733) |
| Net (decrease) increase in cash and cash equivalents | (39,721) | (34,221) | 167,463 |
| Cash and cash equivalents, beginning of year | 158,139 | 192,360 | 24,897 |
| **Cash and cash equivalents, end of year** | **$ 118,418** | **$ 158,139** | **$ 192,360** |
| Supplemental disclosures of cash information: | | | |
| Income taxes paid | $ 10,780 | $ 15,796 | $ 10 |
| Interest paid | $ 3,953 | $ 6,720 | $ 2,991 |

See accompanying notes to consolidated financial statements

## 1. Organization

Ariel Holdings Ltd. ("Ariel Holdings" or, collectively with its subsidiaries, the "Company") was incorporated on October 21, 2005 under the laws of Bermuda. On December 16, 2005, Ariel Holdings completed a private offering of 10,310,050 common shares for gross proceeds of approximately $1.0 billion. Ariel Holdings is owned by various private equity investors, no one of which owns a controlling interest.

Ariel Holdings conducts its operations through three wholly owned subsidiaries: Ariel Reinsurance Company Ltd. ("Ariel Re"), Atrium Underwriting Group Limited ("Atrium") and Valiant Insurance Group, Inc. ("VIG").

The Company's initial operations were conducted by Ariel Re and focused principally on catastrophe exposed property and marine reinsurance business. Catastrophe reinsurance covers unpredictable events such as hurricanes, windstorms, hailstorms, earthquakes, volcanic eruptions, fires, freezes, industrial explosions and other man-made or natural disasters. Loss experience associated with catastrophe reinsurance is characterized by infrequent events of high severity. Although catastrophe-exposed business constitutes the majority of Ariel Re's business, Ariel Re also underwrites property and professional liability insurance on a direct basis. During 2009, Ariel Re established a Zurich Branch which underwrites credit and surety reinsurance on a global basis.

The Company completed the acquisition of Atrium with an effective date of September 30, 2007. Atrium is a specialist insurer at Lloyd's of London that manages two syndicates (Syndicate 570, non-marine and Syndicate 609, marine) and participates in certain non-managed syndicates.

VIG was incorporated on May 14, 2007 as a wholly-owned subsidiary of Ariel Holdings Ltd. On October 1, 2007, VIG acquired all of the outstanding shares of Valiant Insurance Company ("Valiant") from a wholly owned subsidiary of Zurich Insurance Company for $26.0 million. Valiant is a Delaware-domiciled insurance corporation with admitted licenses in 47 states plus the District of Columbia and writes specialty property and casualty insurance in the U.S. In 2008, Valiant Specialty Insurance Company ("Valiant Specialty") was formed as a wholly owned subsidiary of Valiant which writes surplus lines.

## 2. Significant Accounting Policies

### Basis of presentation and consolidation

The consolidated financial statements include Ariel Holdings and its wholly owned subsidiaries, Ariel Re, Atrium, and VIG (collectively, the "Company"), and have been prepared in accordance with U.S. Generally Accepted Accounting Principles ("U.S. GAAP"). All significant intercompany accounts and transactions have been eliminated in preparing these consolidated financial statements.

For accounting purposes, the acquisition date of Atrium was September 30, 2007. The Company records its pro-rata share of syndicate assets, liabilities, revenues and expenses as a participant in the underwriting activities of Lloyd's syndicates. Due to the delay in receiving information from third parties relating to Atrium's participation in non-managed syndicates, the Company consolidates the results of Atrium on a three month lag, in order for the Company to prepare more timely consolidated financial statements. In the event that material events occur during a given quarter, the impact is included in the current period. For the year ended December 31, 2007, the Company's consolidated statement of operations and comprehensive income (loss) did not include the results of operations from Atrium due to the three month lag in reporting.

Certain comparative financial information has been reclassified to conform to the current year presentation.

### Use of estimates

The preparation of the consolidated financial statements in conformity with U.S. GAAP requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the consolidated financial statements and the reported amounts of revenues and expenses during the reporting period. While the estimates included in the consolidated financial statements reflect the Company's best estimates and assumptions, actual results could differ materially from these estimates. The significant estimates reflected in the Company's consolidated financial statements include the reserve for losses and loss adjustment expenses, premium estimates for business written, the valuation of goodwill and intangible assets, and the fair value measurement of certain fixed maturities and other investments. Estimates and assumptions are periodically reviewed and the effects of revisions are recorded in the consolidated financial statements in the periods in which they are determined.

**Premiums**

Premiums written are recorded in accordance with the terms of the underlying policies and contracts of insurance and reinsurance. Premiums written are recorded at the inception of the policy and are estimated based upon information received from insureds, ceding companies and their brokers. Subsequent differences arising on such estimates are recorded in the period in which they are determined. Premiums written are earned on a pro-rata basis over the period for which coverage is provided. The reserve for unearned premiums represents the portion of premiums written applicable to the unexpired risk period of policies and contracts and insurance and reinsurance in force.

For contracts and policies written on a losses occurring basis, the risk period is generally the same as the contract or policy term. For contracts written on a risks attaching basis, the risk period is based on the terms of the underlying contracts and policies.

Reinstatement premiums that reinstate coverage are estimated based on loss experience and are recorded in accordance with the contract terms based upon the ultimate loss estimate associated with each contract. Reinstatement premiums are generally written and earned at the time the associated loss event occurs.

A portion of the Company's assumed reinsurance agreements contain loss sensitive or loss limiting provisions, such as adjustable or sliding scale commissions or occurrence limitations, that may impact the ultimate amounts paid to or received from ceding companies. In some loss scenarios, these features would result in the ceding company's results not being proportional to the Company's results under the proportional reinsurance agreement, and such differences may be meaningful. The Company has recorded these agreements as deposits and are included in Other liabilities on the consolidated balance sheets. These contracts were deemed as either transferring only significant timing risk or transferring only significant underwriting risk. During the years ended December 31, 2009 and 2008 the Company did not enter into any contracts that were accounted for as deposits.

**Deferred acquisition costs**

Acquisition expenses are costs that vary with, and are directly related to, the production of new and renewal business and consist principally of commissions and brokerage expenses incurred at the time a contract or policy is issued. These costs are deferred and amortized over the period in which the related premiums are earned. Deferred acquisition costs are limited to their estimated realizable value based on the related unearned premiums. Anticipated loss and loss adjustment expenses and anticipated investment income related to those premiums are considered in determining the recoverability of deferred acquisition costs. Acquisition costs are shown net of commissions earned on reinsurance ceded.

**Reinsurance ceded**

In the normal course of business, the Company may seek to mitigate underwriting risk that could cause unfavorable results by reinsuring certain amounts of risk with other reinsurers. Reinsurance premiums ceded are expensed on a pro-rata basis over the period the reinsurance coverage is provided. Prepaid reinsurance premiums represent the portion of premiums ceded on the unexpired term of the policies purchased.

Reinsurance recoverables are presented on the balance sheet net of any reserves for uncollectible reinsurance. The method for determining the reinsurance recoverable on unpaid losses and loss adjustment expenses involves actuarial estimates in a manner consistent with the determination of unpaid losses and loss adjustment expenses. Any reserve for uncollectible reinsurance is based on an estimate of the amount of the reinsurance recoverable balance that will ultimately not be recovered due to reinsurer insolvency, contractual dispute or other reason. The valuation of this reserve for uncollectible reinsurance includes several processes including a review of the credit ratings of the reinsurance recoverables by reinsurer, an analysis of default probabilities as well as coverage issues. These factors require considerable management judgment and the factors are reviewed in detail on a quarterly basis with any resulting adjustments recorded in earnings in the period that collection issues are identified.

**Reserve for losses and loss adjustment expenses**

The reserve for losses and loss adjustment expenses is established by management and includes estimates for unpaid claims and claim expenses on reported losses as well as an estimate of losses incurred but not reported. The reserve is based on individual claims, case reserves and other reserve estimates reported by insureds and ceding companies as well as management's estimate of ultimate losses. The reserve for incurred but not reported losses and loss adjustment expenses is established by management based on actuarially determined estimates of ultimate losses and loss adjustment expenses. Inherent in the estimate of ultimate losses are expected trends in claim severity and frequency and other factors which could vary significantly as claims are settled.

Ultimate losses and loss adjustment expenses may vary materially from the amounts provided in the consolidated financial statements. These estimates are reviewed regularly and, as experience develops and new information becomes known, the reserves are adjusted as necessary. Such adjustments, if any, are recorded in earnings in the period in which they become known and are accounted for as changes in estimates.

**Investments**

The Company's fixed maturity investments are reported as trading securities and are carried at estimated fair value with changes in fair value included in earnings in the consolidated statement of operations and comprehensive income (loss). The Company determines fair value of its fixed maturity investments in accordance with current accounting guidance, which defines fair value and establishes a fair value hierarchy based on inputs to the various valuation techniques used for each fair value measurement. The use of valuation techniques for any given investment requires a significant amount of judgment and consideration of factors specific to the underlying investment.

Effective January 1, 2008, the Company elected the fair value option for all of the Company's fixed maturity investments, short-term investments, and other investments. The Company believes that accounting for its fixed maturity investments as trading, with all changes in estimated fair value included in earnings, reduces an element of management judgment as the Company is no longer required to perform an analysis of its investments for other-than-temporary impairment.

Prior to January 1, 2008, the Company's investments in fixed maturities were classified as available-for-sale and carried at estimated fair value, with related net unrealized gains or losses excluded from earnings and included in shareholders' equity as a component of accumulated other comprehensive income (loss). This resulted in a cumulative increase in retained earnings of $10.6 million offset by a decrease in accumulated other comprehensive income (loss), as described in the consolidated statement of shareholders' equity.

Investment transactions are recorded on the trade date with balances pending settlement reflected separately in the balance sheet. Interest on fixed maturity investments is recorded in net investment income when earned and is adjusted for any amortization of premium or discount. Net investment income includes interest, dividend income and amortization of premiums or discounts and is recorded net of investment management fees. The amortization of premiums and accretion of discounts for fixed maturity investments is computed using the effective yield method. Premiums and discounts arising from the purchase of mortgage-backed securities are amortized using the effective yield method over the estimated remaining term of the securities, adjusted for anticipated prepayments.

Realized gains or losses on the sale of investments are determined on the basis of the first-in-first-out method and included in earnings when realized.

Effective January 1, 2008, net realized gains or losses and net unrealized gains or losses relating to fixed maturity and short-term investments and other investments are included within net realized gains or losses and net unrealized gains or losses in the consolidated statements of operations and comprehensive income (loss). Prior to this date, net unrealized gains or losses relating to fixed maturity and short-term investments had been included in shareholders' equity as a component of accumulated other comprehensive income (loss) and net realized and unrealized gains or losses relating to other investments had been included in net investment income.

Short-term investments, which are managed as part of the Company's investment portfolio and have a maturity of one year or less when purchased, are carried at fair value, which approximates amortized cost.

The Company participates in a securities lending program whereby blocks of securities, which are included in fixed maturity investments, are loaned to third parties, primarily major brokerage firms. The Company retains all economic interest in the securities it lends, retains the earnings and cash flows associated with the loaned securities and receives a fee from the borrower for the temporary use of the securities. Collateral is required at a rate of 102% - 105% of the market value of the loaned securities and is monitored daily and maintained by the lending agent. The collateral has not been recorded on the balance sheet as the Company does not have the right to sell or repledge the collateral.

Other investments are carried at estimated fair value with interest, dividend income and income distributions included in net investment income. The fair value of the hedge funds is generally established on the basis of the net valuation criteria established by the managers of the investments. These net valuations are determined based upon the valuation criteria established by the governing documents of such investments. The Company records the fair value of the hedge funds on a month lag as valuation information provided by the managers of the investments is not available on a timely basis. This lag in reporting is applied consistently until timely information becomes available. The fair value of catastrophe bonds is based on quoted market prices, or when such prices are not available, by reference to broker or underwriter bid indications. Such valuations may differ significantly from the values that would have been used had ready markets existed for the shares, partnership interests or notes of the other investments. Other investments also include the Company's pro-rata share of investments held by the non-managed Lloyd's syndicates in which the Company participates and that the Company does not manage nor control. These investments principally include fixed maturities, equities and short term investments.

The Company currently enters into derivative instruments such as swaps, futures, options and forward foreign exchange contracts in order to manage its foreign currency exposure, obtain exposure to a particular financial market, or to manage the duration of the fixed maturity investment portfolio and yield curve. The Company records its derivatives at fair value on the Company's balance sheet as either assets or liabilities, depending on their rights or obligations, with changes in fair value included in unrealized gains (losses) on investments in the consolidated statement of operations and comprehensive income (loss). The fair value of the Company's derivatives is estimated by reference to quoted prices or broker quotes, where available, or in the absence of quoted prices or broker quotes, by the use of industry or internal valuation models.

**Cash and cash equivalents**
Cash and cash equivalents include highly liquid short-term deposits and securities with maturities of ninety days or less at the time of purchase.

**Goodwill and intangible assets**
The Company accounts for intangible assets that arose from business combinations in accordance with the accounting guidance for business combinations. A purchase price that is in excess of net assets ("goodwill") arising from a business combination is recorded as an asset, and is not amortized. Intangible assets with a finite life are amortized on a straight-line basis over the estimated useful life of the asset. Intangible assets with an indefinite useful life are not amortized. Goodwill and intangible assets are tested for impairment on an annual basis or more frequently if events or changes in circumstances indicate that the carrying amount may not be recoverable. If the goodwill or intangible asset is impaired, it is written down to its realizable value with a corresponding expense charged to earnings in the consolidated statements of operations.

**Foreign exchange**
The Company's functional currency is the United States dollar ("U.S. dollar"). Effective January 1, 2009, the functional currency of Atrium changed from the British pound to the U.S. dollar. As the Company consolidates the results of Atrium on a three month lag, the change in Atrium's functional currency was effective April 1, 2009 for purposes of preparing these consolidated financial statements.

Assets and liabilities of foreign operations whose functional currency was not the U.S. dollar were translated at prevailing exchange rates in effect at the balance sheet dates. Revenues and expenses of such foreign operations were translated at average exchange rates for the year. The net effect of translation differences between functional and reporting currencies in foreign operations, net of applicable deferred income taxes, was included in accumulated other comprehensive income (loss).

Monetary assets and liabilities denominated in foreign currencies are re-measured into the functional currency at the exchange rates in effect at the balance sheet dates and revenues and expenses denominated in foreign currencies are translated at the prevailing exchange rate on the transaction date, with the resulting foreign exchange gains and losses included in earnings.

**Earnings per share**
Basic earnings per common share are calculated by dividing net income by the weighted average common shares outstanding during the period. Diluted earnings per common share are computed by dividing net income by the weighted average number of common shares and common share equivalents outstanding during the period. Stock options and unvested stock grants are considered common share equivalents for the purposes of calculating diluted earnings per common share, and are included in the weighted average number of shares outstanding using the treasury stock method. In a period where there is a net loss, the dilutive effect of common share equivalents is not included in the weighted average number of shares, as this would be anti-dilutive.

**Stock based compensation plans**
The Company accounts for its share plans in accordance with the fair value recognition provisions of the accounting guidance for stock compensation. Accordingly, the Company recognizes the compensation expense for stock options, restricted share units and restricted shares based on the fair value of the award on the date of grant over the requisite service period.

**Taxation**
The Company provides for income taxes for those subsidiaries operating in taxable jurisdictions. The Company records deferred income taxes which reflect the tax effect of the temporary differences between the carrying amounts of assets and liabilities for financial reporting purposes and their respective tax bases. A valuation allowance against a deferred tax asset is provided for if and when the Company believes that a portion or all of the deferred tax asset may not be realized in the near term.

In addition, the Company is required to recognize the tax benefits of uncertain tax positions only where the position is "more likely than not" to be sustained, assuming examination by tax authorities. The Company has not recognized any liabilities for unrecognized tax benefits as a result of this guidance. The Company does not anticipate any significant changes to its total unrecognized tax benefits within the next twelve months and classifies all income tax associated with interest and penalties as income tax expense.

**Recent accounting pronouncements**
Effective January 1, 2009, the Company adopted new accounting guidance issued by the Financial Accounting Standards Board ("FASB") related to the disclosure of derivative instruments and hedging activities. This standard expanded the disclosure requirements about an entity's derivative financial instruments and hedging activities. The adoption of this standard did not have an impact on the Company's financial position or results of operations.

Effective January 1, 2009, the Company adopted new accounting guidance which amends the factors considered in developing assumptions used to determine the useful life of an intangible asset. The new guidance was issued to improve the consistency between the useful life of a recognized intangible asset and the period of expected cash flows used to measure its fair value. The adoption of this standard did not have a material impact on the Company's financial position or results of operations.

Effective June 30, 2009, the Company adopted new accounting guidance related to estimating the fair value of an asset or liability when the volume and level of activity have significantly decreased in relation to normal market activity for that asset or liability. The standard required interim disclosures to be made related to the inputs and valuation techniques used to measure fair value and any changes in valuation techniques and related inputs. The adoption of this standard did not have a material impact of the Company's financial position and results of operations.

In June 2009, an amendment to the accounting guidance related to the consolidation of variable interest entities was issued. The standard provides a new approach for determining which entity should consolidate a variable interest entity. This standard is effective for the Company as of January 1, 2010. The Company does not expect the impact of its adoption to be material to its financial position and results of operations.

On July 1, 2009, the FASB issued the FASB Accounting Standards Codification ("ASC" or "the Codification"). The ASC supersedes all existing accounting standards documentation to become the single source of authoritative accounting and reporting standards in the United States for all non-government entities. Since the Codification only amends the manner in which the Company refers to U.S. GAAP in its financial statements, its adoption had no impact on the Company's financial position or results of operations.

In September 2009, new accounting guidance was issued which provides additional guidance on measuring the fair value of certain alternative investments. Under this guidance, entities are permitted to estimate the fair value of investments within its scope using net asset value per share of the investment. The standard is effective for interim periods and annual periods ending after December 15, 2009 and its adoption did not have a material impact on the Company's financial position or results of operations.

Effective October 1, 2009, the Company adopted an amendment to the accounting guidance related to the measurement of liabilities that are recognized or disclosed at fair value on a recurring basis. This standard clarifies how a company should measure the fair value of liabilities and that restrictions preventing the transfer of a liability should not be considered as a factor in the measurement of liabilities within the scope of this standard. The adoption of this standard did not have a material impact on the Company's financial position and results of operations.

## 3. Investments

The Company determines the fair value of its fixed maturity investments in accordance with current accounting guidance, which defines fair value and establishes a fair value hierarchy based on inputs to the various valuation techniques used for each fair value measurement. The use of valuation techniques for any given investment requires a significant amount of judgment and consideration of factors specific to the underlying investment. Current accounting guidance establishes three levels in the hierarchy as follows:

Level 1: Inputs are unadjusted quoted prices in active markets for identical assets or liabilities that the reporting entity has the ability to access at the measurement date.

Level 2: Inputs are other than quoted prices within Level 1 that are observable for the asset or liability, either directly or indirectly. A significant adjustment to a Level 2 input could result in the Level 2 measurement becoming a Level 3 measurement.

Level 3: Inputs are unobservable inputs for the asset or liability.

The Company determines the estimated fair value of each individual security utilizing the highest level inputs available. The Company uses quoted values and other data provided by an independent pricing service and its third-party investment managers in determining fair values for its fixed maturity investments. Each source has its own proprietary method for determining fair value of any security that is not actively traded. In general, the methods involve the use of "matrix pricings" in which the independent pricing sources use observable market inputs including, but not limited to, yield curves, trade execution data, market spreads, cash flows, credit risks and benchmarking like securities to determine a reasonable fair value.

The Company reviews its investments measured at fair value and discusses the proper classification of such investments with its investment advisors. The Company's review process includes, but is not limited to, initial and ongoing evaluation of methodologies used by outside parties to calculate fair value and back testing, where information is available, which includes selecting securities sold and comparing the executed prices to the fair values estimates from the pricing services. At December 31, 2009, the Company has not adjusted any pricing provided by independent pricing services or its third-party investment managers.

The Company determined that the securities classified as Level 1 would include highly liquid U.S. Treasuries, European and Canadian Sovereign debt, exchange traded preferred securities and certain highly liquid short-term investments where it believes that quoted prices are available in an active market. Where the Company believes that quoted market prices are not available or that the market is not active, fair values are estimated by using quoted prices of securities with similar characteristics, pricing models or matrix pricings that consider various assumptions, including time value, yield curves, interest rates, as well as other relevant economic measures. Substantially all of these assumptions are observable in the marketplace, can be derived from observable data or are supported by observable levels at which transactions are executed in the marketplace. The Company determined that Level 2 securities include short-term and fixed maturity investments such as non-U.S. governments, corporate bonds, U.S. government agencies and non-U.S. government agencies, U.S. states and municipalities, mortgage-backed, commercial mortgage-backed and asset-backed securities.

Other investments include catastrophe bonds, hedge funds, derivatives, preferred securities and investments held by non-managed syndicates. All of these investments are classified as Level 2, except for the hedge funds, which are classified as Level 3. The Company's estimate of the fair value of catastrophe bonds is based on quoted market prices or when such prices are not available, by reference to broker or underwriter bid indications. The fair values of the Company's over-the-counter derivatives such as interest rate swaps, credit default swaps and forward foreign exchange contracts are estimated by reference to quoted prices or broker quotes, where available, or in the absence of quoted prices or broker quotes, the use of industry or internal valuation models used by an independent pricing service. Investments held by non-managed syndicates include the Company's pro-rata share of investments that the Company does not manage nor control. These investments principally include fixed maturities, equities and short-term investments. The fair value of these investments is provided by the non-managed syndicates' independent pricing service or investment managers utilizing observable data.

The Company's hedge funds have been classified as Level 3 due to the restrictions on redemptions and sale of these investments. The fair value of the hedge funds is generally determined on the basis of the net valuation criteria established by the managers of the investments. The Company believes the published net asset value represents the fair value that market participants would apply to an interest in the fund. Some of the hedge funds are subject to restrictions on redemptions and sale which are determined by the governing documents and limit the Company's ability to liquidate these investments in the short-term. The Company obtains the audited financial statements for every hedge fund annually and regularly reviews and discusses fund performance with fund managers to corroborate the reasonableness of the published net asset value.

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

**a)** At December 31, 2009, the Company's investments were allocated between Levels 1, 2, and 3 as follows:

| | Level 1 | Level 2 | Level 3 | Total |
|---|---|---|---|---|
| U.S. government and government agencies | $ 159,001 | $ 130,448 | $ - | $ 289,449 |
| Non-U.S. governments | 34,551 | 45,313 | - | 79,864 |
| U.S. states and municipalities | - | 8,909 | - | 8,909 |
| Corporate | - | 636,152 | - | 636,152 |
| Residential mortgage-backed securities | - | 362,229 | - | 362,229 |
| Asset-backed securities | - | 100,341 | - | 100,341 |
| Commercial mortgage-backed securities | - | 91,219 | - | 91,219 |
| Total fixed maturity investments | $ 193,552 | $ 1,374,611 | $ - | $ 1,568,163 |
| Other investments | - | 193,171 | 59,934 | 253,105 |
| Short-term investments | 37,688 | 362,681 | - | 400,369 |
| Total | $ 231,240 | $ 1,930,463 | $ 59,934 | $ 2,221,637 |

**b)** At December 31, 2008, the Company's investments were allocated between Levels 1, 2, and 3 as follows:

| | Level 1 | Level 2 | Level 3 | Total |
|---|---|---|---|---|
| U.S. government and government agencies | $ 189,609 | $ 128,600 | $ - | $ 318,209 |
| Non-U.S. governments | 16,149 | 19,756 | - | 35,905 |
| U.S. states and municipalities | - | 4,753 | - | 4,753 |
| Corporate | - | 399,375 | - | 399,375 |
| Residential mortgage-backed securities | - | 416,240 | - | 416,240 |
| Asset-backed securities | - | 99,134 | - | 99,134 |
| Commercial mortgage-backed securities | - | 105,407 | - | 105,407 |
| Total fixed maturity investments | $ 205,758 | $ 1,173,265 | $ - | $ 1,379,023 |
| Other investments | - | 227,239 | 48,243 | 275,482 |
| Short-term investments | 56,119 | 118,201 | - | 174,320 |
| Total | $ 261,877 | $ 1,518,705 | $ 48,243 | $ 1,828,825 |

The following table presents a reconciliation of the beginning and ending balances for hedge funds, included in other investments that are measured at fair value using Level 3 inputs as at December 31, 2009 and 2008:

| **Other investments** | **2009** | **2008** |
|---|---|---|
| Beginning balance at January 1 | $ 48,243 | $ - |
| Transfers in Level 3 assets, at fair value | - | 62,226 |
| Purchases, sales and issuances | (2,577) | - |
| Total net realized and unrealized gains (losses) included in earnings: | | |
| Net unrealized gains (losses) | 19,163 | (13,983) |
| Net realized losses | (4,895) | - |
| Ending balance at December 31 | $ 59,934 | $ 48,243 |

Total net unrealized gains of $19.2 million from the hedge funds held at December 31, 2009 were included in earnings for the year ended December 31, 2009 (2008 – net unrealized losses of $18.4 million).

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

**c)** The amortized cost, gross unrealized gains and losses and fair value of fixed maturities by category at December 31, 2009 and 2008 are as follows:

| | December 31, 2009 | | | |
|---|---|---|---|---|
| | Amortized Cost | Gross Unrealized Gains | Gross Unrealized Losses | Fair Value |
| **Fixed maturity investments, trading:** | | | | |
| U.S. government and government agencies | $ 286,684 | $ 3,094 | $ (329) | $ 289,449 |
| Non-U.S. governments | 79,766 | 158 | (60) | 79,864 |
| U.S. states and municipalities | 8,610 | 299 | - | 8,909 |
| Corporate | 622,957 | 17,170 | (3,975) | 636,152 |
| Residential mortgage-backed securities | 363,481 | 8,862 | (10,114) | 362,229 |
| Asset-backed securities | 103,564 | 1,852 | (5,075) | 100,341 |
| Commercial mortgage-backed securities | 90,520 | 4,658 | (3,959) | 91,219 |
| Total | $ 1,555,582 | $ 36,093 | $ (23,512) | $ 1,568,163 |

| | December 31, 2008 | | | |
|---|---|---|---|---|
| | Amortized Cost | Gross Unrealized Gains | Gross Unrealized Losses | Fair Value |
| **Fixed maturity investments, trading:** | | | | |
| U.S. government and government agencies | $ 307,084 | $ 14,571 | $ (3,446) | $ 318,209 |
| Non-U.S. governments | 35,767 | 163 | (25) | 35,905 |
| U.S. states and municipalities | 4,576 | 177 | - | 4,753 |
| Corporate | 406,228 | 3,773 | (10,626) | 399,375 |
| Residential mortgage-backed securities | 422,978 | 10,816 | (17,554) | 416,240 |
| Asset-backed securities | 117,319 | 129 | (18,314) | 99,134 |
| Commercial mortgage-backed securities | 116,535 | 60 | (11,188) | 105,407 |
| Total | $ 1,410,487 | $ 29,689 | $ (61,153) | $ 1,379,023 |

**d)** The contractual maturity dates of fixed maturities, trading at December 31, 2009 and 2008 are as follows:

| | December 31, 2009 | | December 31, 2008 | |
|---|---|---|---|---|
| | Amortized Cost | Fair Value | Amortized Cost | Fair Value |
| Due within one year or less | $ 149,157 | $ 150,164 | $ 127,320 | $ 127,570 |
| Due after one year through five years | 794,961 | 812,522 | 590,355 | 595,431 |
| Due after five years through ten years | 42,760 | 43,866 | 21,536 | 23,088 |
| Due after ten years | 11,139 | 7,822 | 14,444 | 12,153 |
| Residential mortgage-backed securities | 363,481 | 362,229 | 422,978 | 416,240 |
| Asset-backed securities | 103,564 | 100,341 | 117,319 | 99,134 |
| Commercial mortgage-backed securities | 90,520 | 91,219 | 116,535 | 105,407 |
| Total | $ 1,555,582 | $ 1,568,163 | $ 1,410,487 | $ 1,379,023 |

Actual maturities may differ from contractual maturities because borrowers may have the right to prepay obligations with or without prepayment penalties.

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

**e)** The following table summarizes the composition of the fixed maturity portfolio by investment ratings assigned by rating agencies at December 31, 2009 and 2008:

| | December 31, 2009 | | December 31, 2008 | |
|---|---|---|---|---|
| | Fair Value | % of Total | Fair Value | % of Total |
| AAA/Aaa | $ 1,003,161 | 64.0 | $ 1,051,956 | 76.3 |
| AA/Aa | 137,487 | 8.8 | 70,851 | 5.1 |
| A/A | 182,807 | 11.7 | 188,041 | 13.6 |
| BBB/Baa | 163,182 | 10.4 | 67,750 | 4.9 |
| Below BBB | 79,689 | 5.0 | 425 | 0.1 |
| NR | 1,837 | 0.1 | - | - |
| Total | $ 1,568,163 | 100.0 | $ 1,379,023 | 100.0 |

The primary rating source is Standard & Poor's Corporation ("S&P").

**f)** Certain of the Company's cash and fixed maturity investments are held in pledged accounts (see Note 12c).

**g)** The following table reflects the Company's other investments, at fair value at December 31, 2009 and 2008:

| | December 31, 2009 | |
|---|---|---|
| | Cost | Fair Value |
| **Other investments:** | | |
| Catastrophe bonds | $ 88,992 | $ 86,551 |
| Hedge funds | 58,528 | 59,934 |
| Derivative instruments | 2,056 | 2,654 |
| Investments held by non-managed syndicates | 103,966 | 103,966 |
| Total | $ 253,542 | $ 253,105 |

| | December 31, 2008 | |
|---|---|---|
| | Cost | Fair Value |
| **Other investments:** | | |
| Catastrophe bonds | $ 93,663 | $ 86,065 |
| Hedge funds | 66,000 | 48,243 |
| Derivative instruments | (12,489) | (14,013) |
| Preferred securities | 3,146 | 3,035 |
| Investments held by non-managed syndicates | 152,153 | 152,152 |
| Total | $ 302,473 | $ 275,482 |

The catastrophe bonds are variable rate notes where the return is contingent upon certain climatic or geological events. The hedge funds include the Company's investment in credit, long and short equity, distressed capital, event-driven and other multi-strategy funds. These investments utilize a variety of different investment approaches, designed to maximize diversity. The fair values for the hedge funds are determined by management using the net asset values provided by the third party administrators of these funds. The hedge funds are subject to restrictions on redemptions which are determined by the governing documents and may limit the Company's ability to liquidate its investment in these funds. The investments held by non-managed syndicates is the portion of the Atrium portfolio that is administrated by third parties and principally includes fixed maturities, equities and short-term investments.

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

The components of net investment income for the years ended December 31, 2009, 2008 and 2007 are as follows:

| **Year ended December 31,** | | **2009** | | **2008** | | **2007** |
|---|---|---|---|---|---|---|
| Fixed maturities and short-term investments | $ | 70,575 | $ | 79,714 | $ | 58,332 |
| Cash and cash equivalents | | 3,106 | | 5,132 | | 3,509 |
| Other investments | | 11,785 | | 1,817 | | 12,165 |
| | | 85,466 | | 86,663 | | 74,006 |
| Investment expenses | | (4,042) | | (2,532) | | (1,566) |
| Net investment income | $ | 81,424 | $ | 84,131 | $ | 72,440 |

Effective January 1, 2008, net realized and net unrealized gains or losses relating to fixed maturities, short-term investments and other investments are included in net realized gains (losses) and net unrealized gains (losses) in the consolidated statements of operations and comprehensive income (loss). Prior to this date, net unrealized gains (losses) relating to fixed maturity and short-term investments had been included in shareholders' equity as a component of accumulated other comprehensive income (loss) and net realized and unrealized gains (losses) relating to other investments had been included in net investment income.

**h)** The analysis of realized gains and losses on investments for the years ended December 31, 2009, 2008 and 2007 is as follows:

| **Year ended December 31,** | | **2009** | | **2008** | | **2007** |
|---|---|---|---|---|---|---|
| Gross realized gains | $ | 42,652 | $ | 51,569 | $ | 3,577 |
| Gross realized losses | | (30,077) | | (61,120) | | (6,592) |
| Other-than-temporary impairments | | - | | - | | (11,921) |
| Net realized gains (losses) on investments included in net income (loss) | $ | 12,575 | $ | (9,551) | $ | (14,936) |

## 4. Derivative Instruments

The Company reports its derivatives at estimated fair value as either assets or liabilities on the consolidated balance sheet, depending on their rights or obligations, with changes in fair value included in unrealized gains (losses) on investments in the consolidated statement of operations and comprehensive income (loss). The fair value of the Company's derivatives is estimated by reference to quoted prices or broker quotes, where available, or in the absence of quoted prices or broker quotes, by the use of industry or internal valuation models. The Company does not hold any derivatives designated as hedging instruments.

The Company's investment guidelines permit investments in derivative instruments such as forward foreign exchange contracts, interest rate swaps, credit default swaps, options, repurchase agreements and swaptions. The Company principally has exposure to derivatives related to the following types of risks: foreign currency risk, interest rate risk and credit risk.

**Forward foreign exchange contracts**
Under the Company's investment guidelines, the Company may invest in non-U.S. dollar denominated investments but is required to hedge any significant foreign currency exposure. The forward foreign exchange contracts in the Company's investment portfolio are related to those hedges.

**Interest rate swaps**
The Company uses interest rate swaps to manage its exposure to interest rate risk, to manage the duration of its fixed maturities investment portfolio and yield curve without transacting in the underlying securities.

**Futures**
The Company uses futures to manage its exposure to interest rate risk, to manage the duration of its fixed maturities investment portfolio and yield curve.

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

**Credit default swaps**
The Company uses credit default swaps to manage its exposure to credit risk included in its fixed maturities investment portfolio and short-term investments and to obtain certain credit exposure more efficiently than purchasing the fixed maturities with the same credit risk.

**Swaptions**
The Company uses swaptions or options on interest rate swaps to manage its exposure to interest rate risk, and to hedge the duration of the Company's investment portfolio and yield curve.

**Options**
The Company uses options on U.S. Treasury futures to manage its exposure to interest rate risk, and to hedge the duration of the Company's investment portfolio and yield curve.

**Repurchase agreements**
The Company uses repurchase agreements to earn an enhanced return over cash.

The following table shows the location on the consolidated balance sheet and fair value of the Company's derivative instruments at December 31, 2009:

| | Derivative Assets | | Derivative Liabilities | |
|---|---|---|---|---|
| | Balance Sheet Location | Fair Value | Balance Sheet Location | Fair Value |
| Forward foreign exchange contracts | Other investments | $ 235 | Other investments | $ 7 |
| Futures | Other investments | 281 | Other investments | 281 |
| Interest rate swaps | Other investments | 3 | Other investments | 255 |
| Repurchase agreements | Other investments | 3,800 | Other investments | - |
| Swaptions | Other investments | 8 | Other investments | 1,160 |
| Options | Other investments | 70 | Other investments | 40 |
| Total | | $ 4,397 | | $ 1,743 |

The location and amount of the gains (losses) recognized in the Company's consolidated statement of operations and comprehensive income (loss) related to its derivative instruments for the year ended December 31, 2009 are shown in the following table:

| | Location of gains (losses) recognized on derivatives | Amount of gains (losses) recognized on derivatives |
|---|---|---|
| Forward foreign exchange contracts | Net foreign exchange gains | $ 198 |
| Swaps | Net investment income | 635 |
| Swaps | Net unrealized gains on investments | 1,171 |
| Swaps | Net realized gains on investments | 162 |
| Swaps | Net foreign exchange losses | (13) |
| Futures | Net realized gains on investments | 1,384 |
| Futures | Net foreign exchange gains | 23 |
| Swaptions | Net unrealized gains on investments | 106 |
| Swaptions | Net realized losses on investments | (8,431) |
| Swaptions | Net foreign exchange losses | (6) |
| Options | Net unrealized gains on investments | 471 |
| Options | Net realized gains on investments | 339 |
| Repurchase agreements | Net investment income | 13 |
| Total | | $ (3,948) |

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

## 5. Reserve for losses and loss adjustment expenses

The reserve for losses and loss adjustment expenses is an estimate which is subject to material variability. The variability arises because all events affecting the ultimate settlement of claims have not taken place and may not take place for some time. Variability can be caused by the receipt of additional claim information, changes in judicial interpretation of contracts or significant differences in the severity or frequency of claims from historical trends. In addition, Ariel Re and VIG do not have the benefit of their own historical loss experience due to their short operating histories. Accordingly, the Company's reserves for losses and loss adjustments may be subject to greater variability than a more mature company.

Loss and loss adjustment expense reserve estimates are based on all relevant information available to the Company. The Company believes that the reserve for losses and loss adjustment expenses is sufficient to cover losses that fall within coverages assumed by the Company; however, there can be no assurance that actual losses will not exceed the Company's total reserves for losses and loss adjustment expenses.

Activity in the reserve for losses and loss adjustment expenses is summarized as follows for the years ended December 31, 2009 and 2008:

| | December 31, 2009 | December 31, 2008 |
|---|---|---|
| Gross reserves for losses and loss expenses, beginning of year | $ 650,189 | $ 478,240 |
| Loss reserves recoverable, beginning of year | 64,894 | 73,964 |
| Total net reserves for losses and loss expenses | 585,295 | 404,276 |
| Net losses incurred related to: | | |
| Current year | 176,368 | 415,613 |
| Prior years | (22,018) | (16,440) |
| Reinsurance to close | (17,546) | (11,582) |
| Total net incurred losses | 136,804 | 387,591 |
| Net paid losses related to: | | |
| Current year | (36,756) | (120,939) |
| Prior years | (135,318) | (84,910) |
| Total net paid losses | (172,074) | (205,849) |
| Loss portfolio transfer | (17,546) | (11,582) |
| Effect of foreign exchange movements | (4,977) | 10,859 |
| Total net reserves for losses and loss expenses, end of year | 527,502 | 585,295 |
| Loss reserves recoverable, end of year | 46,791 | 64,894 |
| Total gross reserves for losses and loss expenses, end of year | $ 574,293 | $ 650,189 |

During 2009, the Company experienced net favorable development on prior years of $22.0 million, consisting of net favorable development of $18.6 million from the Bermuda segment, $1.6 million from the Lloyd's segment and $1.8 million from the U.S. segment. Favorable development from the Bermuda segment was mainly due to a decrease in property reinsurance reserves of $10.3 million relating to 2006 and 2007 accident years, and a decrease in catastrophe loss reserves of $8.3 million, including favorable development of $4.2 million relating to Hurricane Ike.

During 2008, the Company experienced net favorable development on prior years of $16.4 million, consisting of net favorable development of $20.0 million from the Lloyd's segment resulting from better than expected loss experience in prior underwriting years, which was partially offset by net adverse development of $3.6 million from the Bermuda segment, mainly due to the marine and aviation lines.

Under the accounting conventions used by Lloyd's, each syndicate underwriting account is normally closed at the end of the third year by means of reinsurance into the following year, which reinsures all future liabilities for the closed year and all previous years in return for a premium. The payment of a reinsurance to close does not eliminate the liability of the closed year for outstanding claims. If the reinsuring syndicate was unable to meet its obligations and other elements of the Lloyd's security were to fail, then the members of the closed underwriting year would have to settle the claims.

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

In 2009, Atrium participated in six syndicates, which closed their 2006 underwriting year of account in 2008 by way of a Lloyd's reinsurance to close. In closing the 2006 year of accounting, all outstanding losses were transferred into the 2007 year of account, effective January 1, 2009. Atrium continued its participation in four of these syndicates for the 2007 underwriting year of account, but with changes in participation. Atrium participated in one new syndicate for the 2007 year of account. Additionally, two syndicates which were in run-off closed at December 31, 2008, into syndicates that Atrium does not participate in. This resulted in a decrease in loss reserves of $17.5 million and has been treated as a ceded loss portfolio transfer. To the extent that the future run-off of the 2006 year of account differs from what has been estimated, that development will be recorded in earnings in the period that it is incurred.

In 2008, Atrium participated in seven syndicates, which closed their 2005 underwriting year of account in 2007 by way of a Lloyd's reinsurance to close. In closing the 2005 year of accounting, all outstanding losses were transferred into the 2006 year of account, effective January 1, 2008. Atrium continued its participation in six of these syndicates for the 2006 underwriting year of account, but with changes in participation. Additionally, two syndicates which were in run-off closed into the 2006 year of account. This resulted in a decrease in loss reserves of $11.6 million and has been treated as a ceded loss portfolio transfer. To the extent that the future run-off of the 2005 year of account differs from what has been estimated, that development will be recorded in earnings in the period that it is incurred.

## 6. Reinsurance ceded

a) **Reinsurance premiums written and earned and losses and loss adjustment expenses**. The effects of reinsurance ceded on premiums written, earned and on losses and loss adjustment expenses, during the years ended December 31, 2009, 2008 and 2007, are as follows:

| | 2009 | 2008 | 2007 |
|---|---|---|---|
| **Premiums written** | | | |
| Direct | $ 306,043 | $ 283,945 | $ 39,012 |
| Assumed | 338,091 | 332,200 | 316,773 |
| Ceded | (75,113) | (74,869) | (9,241) |
| Net | $ 569,021 | $ 541,276 | $ 346,544 |
| **Premiums earned** | | | |
| Direct | $ 280,294 | $ 303,651 | $ 43,729 |
| Assumed | 310,304 | 335,310 | 288,403 |
| Ceded | (68,891) | (81,813) | (9,481) |
| Net | $ 521,707 | $ 557,148 | $ 322,651 |
| **Losses and loss adjustment expenses** | | | |
| Gross losses and loss adjustment expenses | $ 189,435 | $ 444,360 | $ 37,760 |
| Losses and loss adjustment expenses recoverable | (52,631) | (56,769) | (297) |
| Net losses and loss adjustment expenses | $ 136,804 | $ 387,591 | $ 37,463 |

The Company uses reinsurance ceded contracts to reduce its exposure to risk of loss on certain reinsurance contracts. Reinsurance ceded contracts do not relieve the Company from its obligations to policyholders. The Company remains primarily liable to its policyholders for the portion reinsured to the extent that any reinsurer does not meet the obligations assumed under the reinsurance agreements.

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

b) **Credit Risk**. The Company evaluates the financial condition of its reinsurers and monitors concentration of credit risk arising from its exposure to individual reinsurers. The reinsurance program is generally placed with reinsurers whose rating, at the time of placement, was A- ("Excellent") or better by A.M. Best or the equivalent with other rating agencies. Exposure to a single reinsurer is also controlled with restrictions dependent on rating. At December 31, 2009, the total reinsurance recoverable balance (which includes loss reserves recoverable and recoverables on paid losses) excluding non-managed syndicates was $45.2 million (2008 - $41.7 million). Reinsurance recoverables is analyzed as follows:

| | December 31, 2009 | | | December 31, 2008 | |
|---|---|---|---|---|---|
| | Reinsurance Recoverable | % of Total | | Reinsurance Recoverable | % of Total |
| Top 10 reinsurers | $ 34,186 | 59.8% | | $ 29,603 | 42.2% |
| Other reinsurers balances | 10,986 | 19.2% | | 12,133 | 17.3% |
| Non-managed syndicates | 12,010 | 21.0% | | 28,452 | 40.5% |
| Total | $ 57,182 | 100.0% | | $ 70,188 | 100.0% |

The Company estimates the provision for uncollectible reinsurance by applying specific percentages against each recovery based on the counterparty's credit rating. The percentages applied are based on historical industry default statistics developed by major rating agencies and are then adjusted based on industry knowledge and the Company's judgment and estimates. The Company then evaluates the overall adequacy of the provision for uncollectible reinsurance. At December 31, 2009 and 2008, the provision for uncollectible reinsurance relating to losses recoverable was $1.7 million and $1.0 million, respectively.

## 7. Goodwill and intangible assets

The following table shows an analysis of goodwill and other intangible assets for the years ended December 31, 2009 and 2008:

| | Goodwill | Intangible Assets - Indefinite Life | Intangible Assets - Finite Life | Total |
|---|---|---|---|---|
| Balance at December 31, 2007 | $ 79,136 | $ 91,119 | $ 27,723 | $ 197,978 |
| Amortization | - | - | (1,647) | (1,647) |
| Foreign exchange revaluation | (8,631) | (8,867) | (3,023) | (20,521) |
| Balance at December 31, 2008 | 70,505 | 82,252 | 23,053 | 175,810 |
| Amortization | - | - | (1,341) | (1,341) |
| Foreign exchange revaluation | (14,338) | (14,728) | (4,659) | (33,725) |
| Sale of intangible assets | - | (6,643) | - | (6,643) |
| Balance at December 31, 2009 | $ 56,167 | $ 60,881 | $ 17,053 | $ 134,101 |

In 2007, the Company acquired Atrium and recorded a total of $188.2 million of goodwill and intangible assets at the acquisition date. The intangible assets acquired consisted of syndicate capacity, management contract, distribution network and trade name. Syndicate capacity represents Atrium's authorized premium income limit to write insurance and reinsurance business in the Lloyd's of London market. The capacity is renewed annually at no cost to Atrium, but may be freely purchased or sold, subject to Lloyd's approval, during an annual auction process. During 2009, the Company sold syndicate capacity related to one of its non-managed syndicates and recognized a gain of $6.1 million.

The management contract governs the profit commission and management fee earned by Atrium for managing Syndicates 570 and 609. The fair value of the distribution network was estimated using the excess earning methodology, which present values all cash flows associated with the existing broker relationships, net of a fair return on the assets that contribute to these cash flows. These cash flows were discounted using a risk adjusted rate. The fair value of the trade name was estimated using the relief-from-royalty methodology. A trade name has a value for reasons such as its ability to generate sales or differentiate on price.

In 2007, the Company also acquired Valiant, an admitted insurer in 47 states plus the District of Columbia. The fair value of the U.S. state licenses acquired was $9.8 million. The U.S. state insurance licenses have value as they allow an insurance company to offer its products in markets that otherwise would not be immediately accessible.

Trade name and distribution network intangible assets are estimated to have finite useful lives of 15 years and are amortized on a straight line basis. Syndicate capacity, the management contract, U.S. state licenses and goodwill are estimated to have indefinite useful lives and as such are subject to annual impairment testing.

No impairment of the Company's goodwill or intangible assets was noted following the annual impairment review for the years ended December 31, 2009 and 2008. The Company expects the amortization of the intangible assets with finite lives to approximate $1.3 million in each of the years 2010 to 2013 and to be $11.8 million in aggregate for all years thereafter.

## 8. Segment Information

The Company is currently organized into three segments: Bermuda, United States and Lloyd's operations. These segments form the basis of how the Company monitors the performance of its operations and the manner in which management makes strategic decisions. The Company evaluates the performance of its segments based on their individual operating results prior to intercompany reinsurance arrangements. General and administrative expenses relating to the holding company are included in "corporate and other reconciling items". The Company does not manage its assets by segment and therefore total assets are not allocated to the segments.

**Bermuda**
The Company's Bermuda segment provides both insurance and reinsurance coverage. The insurance sub-segment generally provides coverage to large multi-national companies on a worldwide basis. The principal lines are currently property and professional liability insurance. The reinsurance sub-segment provides treaty property, marine and aviation reinsurance to insurance companies on a worldwide basis.

**Lloyd's**
The Company's Lloyd's segment focuses on a diversified underwriting portfolio including non-marine physical damage, excess of loss reinsurance, energy, non-marine liability, aviation physical damage, marine, personal accident, motor and other.

**United States**
The Company's U.S. segment focuses on new specialty property and casualty insurance. The segment focuses on management and professional lines, and excess of loss, umbrella and non-standard general liability insurance.

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

The following tables summarize the underwriting income (loss), income (loss) before income taxes, net income (loss), ratios and the reserves for losses and loss adjustment expenses for the years ended December 31, 2009, 2008 and 2007.

**Year ended December 31, 2009**

| | Bermuda | Lloyd's | United States | Corporate & Other Reconciling Items (c) | Total |
|---|---|---|---|---|---|
| **Revenues:** | | | | | |
| Gross premiums written | $ 363,415 | $ 217,303 | $ 63,416 | $ - | $ 644,134 |
| Net premiums written | 356,385 | 156,498 | 56,138 | - | 569,021 |
| Net premiums earned | 336,385 | 142,199 | 43,123 | - | 521,707 |
| Other underwriting (loss) income | (368) | 25,323 | - | - | 24,955 |
| Gain on sale of intangible assets | - | 6,138 | - | - | 6,138 |
| **Expenses:** | | | | | |
| Net losses and loss adjustment expenses | (47,712) | (63,064) | (26,028) | - | (136,804) |
| Acquisition costs | (38,705) | (39,103) | (7,243) | - | (85,051) |
| General and administrative expenses | (45,837) | (37,348) | (17,550) | - | (100,735) |
| Amortization of intangible assets | - | (1,341) | - | - | (1,341) |
| **Underwriting income (loss) (a)** | **$ 203,763** | **$ 32,804** | **$ (7,698)** | **$ -** | **$ 228,869** |
| Corporate expenses | - | - | - | (16,297) | (16,297) |
| Interest expense | - | - | - | (3,891) | (3,891) |
| Net investment income | 63,448 | 14,248 | 2,130 | 1,598 | 81,424 |
| Net realized investment gains (losses) | 13,679 | (1,682) | 246 | 332 | 12,575 |
| Net unrealized investment gains (losses) | 70,333 | 1,868 | 996 | (1,055) | 72,142 |
| Net foreign exchange (losses) gains | (485) | 1,515 | - | (25) | 1,005 |
| **Income (loss) before taxes** | **350,738** | **48,753** | **(4,326)** | **(19,338)** | **375,827** |
| Income tax benefit (expense) | 344 | (3,256) | (569) | - | (3,481) |
| **Net income (loss)** | **$ 351,082** | **$ 45,497** | **$ (4,895)** | **$ (19,338)** | **$ 372,346** |
| Net losses and loss expenses ratio | 14.2% | 44.3% | 60.4% | n/a | 26.2% |
| Acquisition cost ratio | 11.5% | 27.5% | 16.8% | n/a | 16.3% |
| General and administrative expense ratio (b) | 13.6% | 26.3% | 40.7% | n/a | 22.4% |
| Combined ratio (b) | 39.3% | 98.1% | 117.9% | n/a | 64.9% |
| Net reserve for losses and loss adjustment expenses | $ 204,345 | $ 288,845 | $ 34,312 | $ n/a | $ 527,502 |

*(a) The Company utilizes underwriting income (loss) as a measure of underwriting profitability as it evaluates profitability solely on underwriting related revenues and expenses. Items not considered to be part of underwriting include: corporate expenses, interest expense, net investment income, net realized gains (losses) on the sale of investments, net unrealized investment gains (losses), net foreign exchange gains (losses), and income tax expense (benefit). These items are evaluated separately from underwriting income (loss). Underwriting income (loss) takes into account net premiums earned, other insurance related income and gain on sale of intangible assets as revenues and net losses and loss adjustment expenses, acquisition costs, underwriting related general and administrative expenses and amortization of intangible assets as expenses. Underwriting income (loss) is the difference between the revenue and expense items.*
*(b) The general and administrative expense ratio is calculated by dividing the sum of the general and administrative expenses and the corporate expenses by net premiums earned. It does not include the amortization of intangible assets, interest expense or net foreign exchange gains (losses). The combined ratio is the sum of the net losses and loss expenses ratio, the acquisition cost ratio and the general and administrative expense ratio.*
*(c) Includes the general and administrative expenses of the holding Company and any other amounts required to reconcile the Company's underwriting results by segment to the Company's financial statement presentation.*

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

**Year ended December 31, 2008**

| | Bermuda | Lloyd's | United States | Corporate & Other Reconciling Items (c) | Total |
|---|---|---|---|---|---|
| **Revenues:** | | | | | |
| Gross premiums written | $ 357,507 | $ 233,733 | $ 24,905 | $ - | $ 616,145 |
| Net premiums written | 347,435 | 169,205 | 24,636 | - | 541,276 |
| Net premiums earned | 356,609 | 191,591 | 8,948 | - | 557,148 |
| Other underwriting (loss) income | (217) | 22,449 | - | - | 22,232 |
| **Expenses:** | | | | | |
| Net losses and loss adjustment expenses | (283,679) | (93,553) | (10,359) | - | (387,591) |
| Acquisition costs | (38,648) | (66,118) | (1,552) | - | (106,318) |
| General and administrative expenses | (32,084) | (42,294) | (13,143) | - | (87,521) |
| Amortization of intangible assets | - | (1,647) | - | - | (1,647) |
| **Underwriting income (loss) (a)** | **$ 1,981** | **$ 10,428** | **$ (16,106)** | **$ -** | **$ (3,697)** |
| Gain on repurchase of subordinated debentures | - | - | - | 1,520 | 1,520 |
| Corporate expenses | - | - | - | (19,775) | (19,775) |
| Interest expense | - | - | - | (6,592) | (6,592) |
| Net investment income | 61,886 | 17,053 | 2,160 | 3,032 | 84,131 |
| Net realized investment (losses) gains | (11,527) | 2,311 | 314 | (649) | (9,551) |
| Net unrealized investment (losses) gains | (80,734) | (811) | (281) | 1,640 | (80,186) |
| Net foreign exchange (losses) gains | (4,561) | 8,789 | - | 169 | 4,397 |
| **(Loss) income before taxes** | **(32,955)** | **37,770** | **(13,913)** | **(20,655)** | **(29,753)** |
| Income tax expense | - | (8,733) | (45) | - | (8,778) |
| **Net (loss) income** | **$ (32,955)** | **$ 29,037** | **$ (13,958)** | **$ (20,655)** | **$ (38,531)** |
| Net losses and loss expenses ratio | 79.6% | 48.8% | 115.8% | n/a | 69.6% |
| Acquisition cost ratio | 10.8% | 34.5% | 17.3% | n/a | 19.5% |
| General and administrative expense ratio (b) | 9.0% | 22.1% | 146.9% | n/a | 18.8% |
| Combined ratio (b) | 99.4% | 105.4% | 280.0% | n/a | 107.9% |
| Net reserve for losses and loss adjustment expenses | $ 232,734 | $ 342,124 | $ 10,437 | $ n/a | $ 585,295 |

*(a) The Company utilizes underwriting income (loss) as a measure of underwriting profitability as it evaluates profitability solely on underwriting related revenues and expenses. Items not considered to be part of underwriting include: corporate expenses, interest expense, net investment income, net realized gains (losses) on the sale of investments, net unrealized investment gains (losses), net foreign exchange gains (losses), gain on repurchase of subordinated debentures, and income tax expense (benefit). These items are evaluated separately from underwriting income (loss). Underwriting income (loss) takes into account net premiums earned and other insurance related income as revenues and net losses and loss adjustment expenses, acquisition costs, underwriting related general and administrative expenses and amortization of intangible assets as expenses. Underwriting income (loss) is the difference between the revenue and expense items.*
*(b) The general and administrative expense ratio is calculated by dividing the sum of the general and administrative expenses and the corporate expenses by net premiums earned. It does not include the amortization of intangible assets, interest expense or net foreign exchange gains (losses). The combined ratio is the sum of the net losses and loss expenses ratio, the acquisition cost ratio and the general and administrative expense ratio.*
*(c) Includes the general and administrative expenses of the holding Company and any other amounts required to reconcile the Company's underwriting results by segment to the Company's financial statement presentation.*

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

**Year ended December 31, 2007**

| | Bermuda | Lloyd's | United States | Corporate & Other Reconciling Items (c) | Total |
|---|---|---|---|---|---|
| **Revenues:** | | | | | |
| Gross premiums written | $ 354,632 | $ - | $ 1,153 | $ - | $ 355,785 |
| Net premiums written | 345,391 | - | 1,153 | - | 346,544 |
| Net premiums earned | 322,307 | - | 344 | - | 322,651 |
| Other underwriting income | 621 | - | - | - | 621 |
| **Expenses**: | | | | | |
| Net losses and loss adjustment expenses | (37,239) | - | (224) | - | (37,463) |
| Acquisition costs | (39,736) | - | (91) | - | (39,827) |
| General and administrative expenses | (48,095) | - | (2,281) | - | (50,376) |
| Amortization of intangible assets | (1,993) | - | - | - | (1,993) |
| **Underwriting income (loss) (a)** | **$ 195,865** | **$ -** | **$ (2,252)** | **$ -** | **$ 193,613** |
| Corporate expenses | - | - | - | (6,599) | (6,599) |
| Interest expense | - | - | - | (4,689) | (4,689) |
| Net investment income | 70,311 | - | 343 | 1,786 | 72,440 |
| Net realized investment losses | (14,911) | - | (25) | - | (14,936) |
| Net foreign exchange loss | (590) | - | - | (6,179) | (6,769) |
| **Income (loss) before taxes** | **250,675** | **-** | **(1,934)** | **(15,681)** | **233,060** |
| Income tax benefit (expense) | - | - | 115 | (57) | 58 |
| **Net income (loss)** | **$ 250,675** | **$ -** | **$ (1,819)** | **$ (15,738)** | **$ 233,118** |
| Net losses and loss expenses ratio | 11.6% | n/a | 65.1% | n/a | 11.6% |
| Acquisition cost ratio | 12.3% | n/a | 26.5% | n/a | 12.3% |
| General and administrative expense ratio (b) | 14.9% | n/a | 663.1% | n/a | 17.7% |
| Combined ratio (b) | 38.8% | n/a | 754.7% | n/a | 41.6% |
| Net reserve for losses and loss adjustment expenses | $ 48,711 | $ 355,341 | $ 224 | $ n/a | $ 404,276 |

*(a) The Company utilizes underwriting income (loss) as a measure of underwriting profitability as it evaluates profitability solely on underwriting related revenues and expenses. Items not considered to be part of underwriting include: corporate expenses, interest expense, net investment income, net realized gains (losses) on the sale of investments, net unrealized investment gains(losses), net foreign exchange gains (losses), and income tax expense (benefit). These items are evaluated separately from underwriting income (loss). Underwriting income (loss) takes into account net premiums earned and other insurance related income as revenues and net losses and loss adjustment expenses, acquisition costs, underwriting related general and administrative expenses and amortization of intangible assets as expenses. Underwriting income (loss) is the difference between the revenue and expense items.*
*(b) The general and administrative expense ratio is calculated by dividing the sum of the general and administrative expenses and the corporate expenses by net premiums earned. It does not include the amortization of intangible assets, interest expense or net foreign exchange gains (losses). The combined ratio is the sum of the net losses and loss expenses ratio, the acquisition cost ratio and the general and administrative expense ratio.*
*(c) Includes the general and administrative expenses of the holding Company and any other amounts required to reconcile the Company's underwriting results by segment to the Company's financial statement presentation.*

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

The following tables summarize gross premiums written allocated by territory of coverage exposure for the years ended December 31, 2009, 2008 and 2007:

| | December 31, 2009 | | | December 31, 2008 | | | December 31, 2007 (a) | | |
|---|---|---|---|---|---|---|---|---|---|
| U.S. | $ 349,917 | 54.3 | % | $ 342,242 | 55.6 | % | $ 229,695 | 64.5 | % |
| Worldwide, including U.S. (b) | 22,840 | 3.5 | | 11,428 | 1.9 | | 3,912 | 1.1 | |
| Europe | 43,918 | 6.8 | | 47,848 | 7.7 | | 30,238 | 8.5 | |
| Worldwide, excluding U.S. (b) | 478 | 0.1 | | 3,240 | 0.5 | | 1,290 | 0.4 | |
| Others | 58,956 | 9.2 | | 61,522 | 10.0 | | 17,944 | 5.0 | |
| Marine (c) | 113,374 | 17.6 | | 124,544 | 20.2 | | 65,406 | 18.4 | |
| Aviation (c) | 54,651 | 8.5 | | 25,321 | 4.1 | | 8,088 | 2.3 | |
| Deposit accounting (d) | - | - | | - | - | | (788) | (0.2) | |
| Total | $ 644,134 | 100.0 | % | $ 616,145 | 100.0 | % | $ 355,785 | 100.0 | % |

a) *For the year ended December 31, 2007, no data was included from Atrium due to the three month lag in the reporting of this segment.*
b) *"Worldwide" comprises insurance and reinsurance contracts that insure or reinsure risks in more than one geographic area.*
c) *Not classified as a territory as Marine and Aviation risks can span multiple territories and are not fixed locations in some instances.*
d) *Reconciles the Company's underwriting results by segment to the Company's financial statement presentation.*

## 9. Earnings per share

The following table sets forth the calculation of basic and diluted earnings (loss) per share for the years ended December 31, 2009, 2008 and 2007:

| | December 31, 2009 | December 31, 2008 | December 31, 2007 |
|---|---|---|---|
| Basic earnings (loss) per share | | | |
| Net income (loss) available to common shareholders | $ 372,346 | $ (38,531) | $ 233,118 |
| Weighted average common shares outstanding | 10,492,195 | 10,450,327 | 10,349,500 |
| Basic earnings (loss) per share | $ 35.49 | $ (3.69) | $ 22.52 |
| Diluted earnings (loss) per share | | | |
| Net income (loss) | $ 372,346 | $ (38,531) | $ 233,118 |
| Weighted average common shares outstanding | 10,492,195 | 10,450,327 | 10,349,500 |
| Share equivalents: | | | |
| Options | 167,398 | - | - |
| Restricted shares and restricted share units | 126,249 | - | 17,296 |
| Weighted average common shares and common share equivalents outstanding - diluted | 10,785,842 | 10,450,327 | 10,366,796 |
| Net income (loss) per share - diluted | $ 34.52 | $ (3.69) | $ 22.49 |

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

## 10. Stock compensation

The Company's Private Placement Memorandum provided for grants of restricted shares, restricted share units and options to certain employees at the time of the Company's initial financing, as well as providing for future awards of stock-based compensation. All such awards are subject to, or operate under terms broadly similar to, the Company's Long Term Incentive Plan ("LTIP"). The LTIP provides the Compensation Committee of the Board of Directors with the sole discretion to grant awards to employees and to determine the exercise price, vesting period and other applicable terms of such awards. Under the terms of the LTIP, a total of 1,570,200 common shares has been reserved for issuance of awards of all types. On exercise or vesting the awards will be fulfilled by the issuance of additional shares.

### a) Stock options

The Company issued stock options to employees with exercise prices equal to the fair value of the Company's shares on the grant dates. The options vest over three or four years from the date of grant and have a maximum contractual term of 10 years.

A summary of option awards granted for the years ended December 31, 2009, 2008 and 2007 is as follows:

| | Number of options | | Aggregate Fair Value |
|---|---|---|---|
| Options outstanding, December 31, 2006 | 837,500 | $ | 33,011 |
| Granted | 55,214 | | 2,748 |
| Forfeited | (1,375) | | (61) |
| Exercised | (125) | | (5) |
| Options outstanding, December 31, 2007 | 891,214 | $ | 35,693 |
| Granted | 48,000 | | 2,116 |
| Forfeited | (215,000) | | (8,418) |
| Exercised | - | | - |
| Options outstanding, December 31, 2008 | 724,214 | $ | 29,391 |
| Granted | 20,587 | | 991 |
| Forfeited | - | | - |
| Exercised | - | | - |
| Options outstanding, December 31, 2009 | 744,801 | | 30,382 |
| Options exercisable, December 31, 2009 | 615,498 | $ | 24,612 |

The weighted average exercise price of options for the years ended December 31, 2009, 2008 and 2007 is a follows:

| | | 2009 | | 2008 | | 2007 |
|---|---|---|---|---|---|---|
| Weighted average exercise price of: | | | | | | |
| Options outstanding, beginning of year | $ | 105.12 | $ | 102.03 | $ | 100.63 |
| Granted | | 137.79 | | 139.49 | | 125.38 |
| Forfeited | | - | | 100.00 | | 109.49 |
| Exercised | | - | | - | | 105.07 |
| Options outstanding, end of year | | 106.02 | | 105.12 | | 102.03 |
| Options exercisable, end of year | $ | 102.41 | $ | 101.29 | $ | 100.28 |

The weighted average remaining contractual term of options outstanding and exercisable at December 31, 2009 was 6.16 years (2008 - 7.33 years and 2007- 8.13 years).

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

The weighted average fair value of options granted during the year ended December 31, 2009 was $1.0 million (2008 - $2.2 million, 2007 - $2.7 million), with 20,587 options being granted (2008 – 48,000, 2007 - 55,214). The fair value of each option granted was estimated using the Black-Scholes-Merton option pricing model, using the following assumptions:

| | 2009 | | 2008 | | 2007 | |
|---|---|---|---|---|---|---|
| Risk free rate | 1.8 – 5.1 | % | 2.9 – 5.1 | % | 4.0 - 5.1 | % |
| Expected term | 7 years | | 7 years | | 7 years | |
| Expected volatility | 18.1 – 28.5 | % | 18.1 – 27.0 | % | 27.0 | % |
| Dividend yield | 0 | % | 0 | % | 0 | % |

The expected volatility is based on the historical volatility of the Dow Jones U.S. Property & Casualty Index. The expense recorded during the years ended December 31, 2009, 2008 and 2007 related to the options awarded amounted to $7.1 million, $9.1 million and $7.8 million respectively. The total unamortized expense relating to non-vested option awards at December 31, 2009, 2008 and 2007 was $3.7 million $9.8 million and $19.2 million, respectively. The weighted average period over which the unamortized cost is expected to be recognized is 1.62 years (2008 – 1.66 years, 2007 - 2.19 years), assuming the employees complete their service period for the vesting of the options.

**b) Restricted share units**

The Company issues restricted share unit awards to employees. Certain restricted share units granted contain two components: one third of the grant will cliff vest three years from the date of grant and two thirds of the grant, being performance-based, will cliff vest three years from the date of grant provided that certain corporate performance conditions are met. In addition, certain restricted share units granted in 2009 and 2008 are performance-based and will cliff vest over three years from the date of grant provided that certain corporate performance conditions are met.

**c) Restricted shares**

The Company also issues restricted shares to employees and certain non-employee directors. Restricted shares issued to employees vest pro-rata from 18 months to four years from the date of grant. Restricted shares granted to non-employee directors vest twelve months following the date of grant. In addition, the Company maintains a restricted share matching plan for eligible employees. Under this plan, employees may purchase the Company's common shares up to a maximum amount which the Company matches by awarding each employee with an equivalent amount of restricted shares. The restricted shares issued under the restricted matching plan cliff vest three years following the date of grant.

A summary of unvested restricted shares and restricted share units granted for the years ended December 31, 2009, 2008 and 2007 is as follows:

| | Unvested restricted shares | | | Restricted share units | | |
|---|---|---|---|---|---|---|
| | Number of shares | | Aggregate Fair Value | Number of shares | | Aggregate Fair Value |
| Outstanding, December 31, 2006 | 68,884 | $ | 6,920 | - | $ | - |
| Granted | 2,805 | | 344 | 22,718 | | 2,600 |
| Forfeited | - | | - | (455) | | - |
| Vested | (66,950) | | (6,695) | - | | - |
| Outstanding, December 31, 2007 | 4,739 | $ | 569 | 22,263 | $ | 2,600 |
| Granted | 14,167 | | 1,998 | 239,585 | | 32,260 |
| Forfeited | - | | - | (2,630) | | (335) |
| Vested | (3,719) | | (445) | - | | - |
| Outstanding, December 31, 2008 | 15,187 | $ | 2,122 | 259,218 | $ | 34,525 |
| Granted | 5,792 | | 842 | 97,542 | | 12,817 |
| Forfeited | - | | - | (751) | | (96) |
| Vested | (4,815) | | (648) | (64,588) | | (8,439) |
| Outstanding, December 31, 2009 | 16,164 | $ | 2,316 | 291,421 | $ | 38,807 |

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

The weighted average fair values of the unvested restricted shares and restricted share units for the years ended December 31, 2009 and 2008 are as follows:

| | December 31, 2009 | | | December 31, 2008 | | |
|---|---|---|---|---|---|---|
| | | Unvested restricted shares | Restricted share units | | Unvested restricted shares | Restricted share units |
| Outstanding, beginning of year | $ | 139.75 | 133.19 | $ | 119.50 | 116.63 |
| Granted | | 145.32 | 131.40 | | 141.08 | 134.65 |
| Forfeited | | - | 128.23 | | - | 126.26 |
| Issued | | 134.64 | 130.65 | | 119.58 | - |
| Outstanding, end of year | $ | 143.28 | 133.17 | $ | 139.75 | 133.19 |

The expense recorded during the years ended December 31, 2009, 2008 and 2007 related to the awards of restricted shares and restricted share units amounted to $14.5 million, $14.2 million and $3.2 million respectively. The total unamortized expense relating to unvested restricted shares and restricted share units was $13.2 million at December 31, 2009 (2008 - $10.6 million, 2007 - $2.1 million). The weighted average period over which the unamortized cost is expected to be recognized for the years ended December 31, 2009, 2008 and 2007 was 1.62, 1.30 and 2.18 years respectively, assuming the employees complete their service period for the vesting of the restricted shares and restricted share units. Certain restricted share units issued have performance criteria which could limit the number of shares issued. At December 31, 2009, of the 291,421 units outstanding, the Company currently estimates that 240,203 units will vest at the end of the respective performance periods. (2008 – 259,218 units, 2007 - 177,168 units)

## 11. Pension plan

The Company provides pension benefits to eligible employees through defined contribution plans sponsored by the Company. Under the Company's defined contribution plans, the Company makes contributions to its employees' accounts in amounts ranging from between 3.0% to 20.0% of its employees' eligible earnings. The contributions in the defined contribution plans are to be invested at the election of each employee in one or more of several investment funds offered by third party investment advisors. For the year ended December 31, 2009, contributions resulted in an expense of $3.9 million, being recorded in earnings (2008 - $3.5 million, 2007 -$1.5 million).

## 12. Commitments and contingencies

a) **Concentrations of credit risk.** As of December 31, 2009 and 2008 substantially all of the Company's cash and investments, other than those held in trust for the benefit of syndicate policyholders, were held by two custodians. Financial instruments that potentially subject the Company to concentrations of credit risk consist principally of investments. The investment portfolio is managed by external advisors in accordance with prudent standards of diversification. Specific provisions limit the allowable holdings of a single issue and issuers. The Company did not have an aggregate exposure in a single entity, other than in U.S. Government, U.S. Government agency securities and U.S. Government-sponsored enterprises, of more than 1.8% of shareholders' equity at December 31, 2009 (2008 - 1.8%).

b) **Major production sources.** During the year ended December 31, 2009, the Company obtained 62% of its gross premiums written, excluding non-managed syndicate gross premiums written, through three brokers:

| | |
|---|---|
| AON Corporation | 33% |
| Marsh & McLennan Companies, Inc. | 20% |
| Willis Companies | 9% |

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

c) **Investment commitments.** As of December 31, 2009, the Company had pledged $138.2 million (2008 - $152.5 million) of its fixed maturity investments and cash as collateral to secure $86.5 million (2008 - $121.7 million) of letters of credit outstanding under its credit facility.

As of December 31, 2009, Ariel Holdings had $75.5 million (2008 - $61.7 million) of its cash and fixed maturity investments as collateral to secure the $100.0 million standby letter of credit and Ariel Re had $78.3 million of cash and fixed maturity investments as collateral for the 2010 Quota Share Agreement (described in Note 13b).

Invested assets with a carrying value of $23.9 million (2008 - $5.9 million) were held in trust for the benefit of the Company's United States surplus line policyholders. In addition, invested assets in the amount of $8.0 million were held on deposit with various state insurance departments in order for Valiant to comply with insurance laws at December 31, 2009 (2008 - $5.6 million).

The Company had invested assets with a carrying value of $167.3 million as at December 31, 2009 (2008 – $116.7 million) held in trust for the benefit of syndicate policyholders.

As of December 31, 2009, the Company had pledged $1.3 million (2008 - $2.2 million) of cash and cash equivalents as collateral to secure the notes payable issued in connection with the acquisition of Atrium.

d) **Employment agreements.** The Company has entered into employment agreements with certain officers that provide for option awards, executive benefits and severance payments under certain circumstances.

e) **Operating leases.** The Company leases office space and office equipment under operating leases. Future minimum lease commitments at December 31, 2009 are as follows:

| **Year ending December 31** | | **Amount** |
|---|---|---|
| 2010 | $ | 3,645 |
| 2011 | | 3,469 |
| 2012 | | 2,552 |
| 2013 | | 2,405 |
| 2014 and thereafter | | 10,006 |

Total rent under operating leases for the year ended December 31, 2009 was $2.5 million (2008 - $1.6 million, 2007 - $0.9 million).

f) **Securities lending.** As part of the Company's securities lending program, the Company had $61.6 million (2008 - $97.9 million) of securities on loan at December 31, 2009 for which $63.5 million (2008 - $100.6 million) of collateral had been posted by the borrowers.

## 13. Debt and Financing Arrangements

### a) Junior Subordinated Deferrable Debentures

During September 2007, the Company issued $100.0 million of junior subordinated deferrable interest debentures due 2037 (the "Junior Subordinated Deferrable Debentures") in a private placement. The Junior Subordinated Deferrable Debentures are redeemable by the Company at par beginning December 15, 2012 and require quarterly interest payments by the Company to the holders of the Junior Subordinated Deferrable Debentures. Interest was payable at 8.844% per annum from the date of issuance through December 15, 2007. Thereafter, interest is payable at a floating rate of three-month LIBOR plus 315 basis points, reset quarterly. The proceeds of $100.0 million from the sale of the Junior Subordinated Deferrable Debentures, after the deduction of commissions paid to the placement agents in the transaction and other expenses, were used by the Company to repay the short term financing for the acquisition of Atrium and for general corporate purposes. During 2008, the Company repurchased $8.2 million of the Junior Subordinated Deferrable Debentures and recognized a gain of $1.5 million

Debt issuance costs relating to the Junior Subordinated Deferrable Debentures were capitalized and are amortized over the term to the earlier of maturity or redemption. At December 31, 2009, debt issuance costs in the amount of $1.9 million were included in Other assets (2008- $2.0 million).

At December 31, 2009, the carrying value of the Junior Subordinated Deferrable Debentures was $91.8 million (2008 – $91.8 million) and the fair value was estimated to be $70.7 million by reference to market valuations of similar securities (2008 - $62.4 million).

**b) Credit facilities**

On December 2, 2009, the Company renewed its standby letter of credit facility (“FALLOC”). The new $100 million FALLOC was entered among Atrium Underwriting Group Limited (“the Borrower”), the Company, Ariel Re and ING Bank N.V., London Branch and Lloyds TSB plc (the “Lenders”).

Proceeds of the FALLOC may be used by the Borrower for the provision of Funds at Lloyd’s to support the general business of the corporate members owned by the Borrower, for the 2010, 2011 and prior years of account. The FALLOC may be utilized on a secured basis such that the secured portion is not less than 100% of the aggregate letters of credit issued. The collateral security will be provided from the invested assets of the Company and the quota share agreement with Ariel Re, subject to certain collateral advance rates. The Company guarantees the obligations under the FALLOC. Ariel Re guaranteed the obligations under the FALLOC from December 2, 2009 until December 17, 2009, the date that it entered into the 2010 Quota Share Agreement with Atrium. Commencing December 17, 2009, Ariel Re was not a guarantor and the FALLOC was secured in part by the 2010 Quota Share Agreement, which is collateralized by Ariel Re in its capacity as reinsurer. The collateral cover is provided in the form of investment collateral by: (i) the Company (in its capacity as Guarantor) in an amount equal in value to 35% of the aggregate of the face amounts of all issued Letters of Credit; and by (ii) Ariel Re (in its capacity as reinsurer under the 2010 Quota Share Agreement and the 2009 Quota Share Agreement), equal in value to 65% of the aggregate of the face amounts of all issued Letters of Credit.

The Borrower is required to pay a commission of 0.625% on the daily stated amount of such letters of credit from the date of issuance.

The FALLOC requires the Company to comply with certain customary restrictive covenants. These include certain financial covenants, such as maintaining a maximum debt to capital ratio (no greater than 0.35:1.00 at any time), a consolidated net worth of the Company ($1.0 billion, plus 70% of new equity raised by Ariel Re) and tangible net worth of Ariel Re ($1.0 billion). In addition, Ariel Re must maintain a financial strength rating from A.M. Best of at least B++ at all times.

The FALLOC also contains restrictions on Atrium’s ability to incur additional indebtedness, the Company’s ability to merge with or be acquired by another entity, and the Company and its subsidiaries’ ability to dispose of certain assets, incur liens other than permitted liens, or cease its business.

Upon the occurrence of an event of default under the FALLOC, the Lenders can give notice of termination of any outstanding letters of credit in accordance with their terms, require the delivery of cash collateral for outstanding letters of credit and foreclose on any security held by the Company and Ariel Re under the FALLOC. Any unreimbursed letters of credit bear interest at the rate of LIBOR plus 5% until reimbursed.

On May 14, 2007, the Company replaced its $350 million Credit Facility (the “Facility”) among the Company and a syndicate of lending institutions (the “Lenders”). The transaction was led by HSBC and JP Morgan Securities Inc. (“JP Morgan”).

Proceeds of the Facility may be used by the Company for general corporate and working capital purposes. The Facility comprises two tranches. The first tranche of $100 million is available for three years on unsecured revolving loans or secured letters of credit. The second tranche of $250 million is available for five years for the issuance of secured letters of credit. Collateral security will be provided from the invested assets of Ariel Re, subject to certain collateral advance rates. The Company guarantees the obligations of the Facility.

Depending on the type of revolving loans issued, the interest rate for revolving loans under the Facility is either (i) the higher of (a) the Federal Funds Effective Rate plus 0.5% and (b) the prime commercial lending rate of HSBC or (ii) the Eurodollar rate plus 0.625%. For secured letters of credit, the Company is required to pay a fee of 0.25% on the daily stated amount of such letters of credit from the date of issuance.

The Facility requires the Borrowers to pay the Lenders a facility fee of 0.08% of total commitments under the Facility. The Company must also pay the lenders a utilization fee of 0.125% of the total amount of revolving loans outstanding when the aggregate amount of revolving loans is greater than 50% of the $100 million aggregate principal available under the unsecured tranche.

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

The Facility requires the Company to comply with certain customary restrictive covenants. These include certain financial covenants, such as maintaining a maximum debt to capital ratio (no greater than 0.35:1.00 at any time), a consolidated tangible net worth (70% of actual net worth at the date of closing, plus 50% of positive quarterly net income plus 70% of new equity raised) and a maximum amount of net premiums written to net equity of Ariel Re (no greater than 1.5 to 1.0). In addition, Ariel Re must maintain a financial strength rating from A.M. Best of at least B++ at all times.

The Facility also includes covenants and default provisions consistent with the FALLOC covenant and default provisions. Upon the occurrence of an event of default under the Facility, the Lenders can terminate their commitments under the revolving loans, require repayment of any outstanding revolving loans, give notice of termination of any outstanding letters of credit in accordance with their terms, require the delivery of cash collateral for outstanding letters of credit and foreclose on any security held by the Lenders under the Facility.

**c) Atrium Loan Notes**

At the time that the Company acquired Atrium, certain existing shareholders of Atrium elected to receive variable rate guaranteed unsecured loan notes ("loan notes") in lieu of cash, totaling $8.3 million. At December 31, 2009, the outstanding principal on these notes was $1.2 million (2008 - $2.1 million). Unless previously redeemed by the holders, the Company shall redeem all of the loan notes on December 31, 2010. The loan notes require biannual interest payments at a floating rate of six-month sterling LIBOR less 75 basis points.

The financing structure at December 31, 2009 was:

| | | Commitment | | Outstanding(1) | | Drawn |
|---|---|---|---|---|---|---|
| Junior Subordinated Deferrable Debentures | $ | 100,000 | $ | 91,800 | $ | 91,800 |
| $350 million Credit Facility | | 350,000 | | 86,538 | | - |
| $100 million FALLOC | | 100,000 | | 93,000 | | - |
| Atrium Loan Notes Payable | | 8,264 | | 1,150 | | 1,150 |
| Total | $ | 558,264 | $ | 272,488 | $ | 92,950 |

(1) Indicates utilization of commitment amount, not drawn borrowings.

Finance expenses for the years ended December 31, 2009 and 2008 were $4.7 million and $7.1 million, respectively. Finance expenses consist of interest on the Junior Subordinated Deferrable Debentures and the Atrium Loan Notes, and the amortization of deferred costs relating to the debt issuance and our credit facilities.

## 14. Statutory requirements and dividend restrictions

As a holding company, Ariel Holdings relies on dividends from its subsidiaries to provide cash flows required to pay expenses and dividends to shareholders.

**Bermuda**

Ariel Re's ability to pay dividends and make capital distributions is subject to certain regulatory restrictions. Under the Insurance Act 1978, amendments thereto and Related Regulations of Bermuda (the "Act"), Ariel Re is required to prepare statutory financial statements and to file in Bermuda a statutory financial return. The Act also requires Ariel Re to maintain certain measures of solvency and liquidity. At December 31, 2009, the statutory capital and surplus of Ariel Re was $1,495.1 million (2008 - $1,120.8 million) which exceeds the statutory capital and surplus required to be maintained under the Act.

Under the Act, Ariel Re is classified as Class 4 insurer, and is therefore restricted as to the payment of dividends in the amount of 25% of the prior year's statutory capital and surplus, unless at least two members of the Board of Directors attest that a dividend in excess of this amount would not cause Ariel Re to fail to meet its relevant margins. During 2009, Ariel Re did not declare any dividends. (2008 – $nil). Subsequent to year end, Ariel Re paid dividends in the amount of $400.0 million.

In 2008, new statutory legislation was enacted in Bermuda, which included, among other things, the Bermuda Solvency Capital Requirement ("BSCR") which is a standard mathematical model designed to give the Bermuda Monetary Authority ("BMA") more advanced methods for determining an insurer's capital adequacy. Underlying the BSCR is the philosophy that all insurers should operate on an ongoing basis with a view to maintaining their capital at a prudent level in excess of the minimum solvency margin otherwise prescribed under the Insurance Act. The BMA requires all Class 4 insurers to maintain their capital at a target level which is set at 120% of the minimum amount calculated in accordance with the BSCR or an approved in-house model. Ariel Re is currently completing the 2009 BSCR and at this time believes that Ariel Re will exceed the target level of capital.

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

**Lloyds**

Atrium's ability to pay dividends is subject to certain regulatory restrictions on the payment of dividends by its subsidiaries. Certain of the U.K. subsidiaries are required under the statutory regulations of the jurisdictions in which they operate to maintain assets on deposit with various regulatory authorities to support their insurance and reinsurance operations and to hold trust funds for the benefit of ceding companies and insureds. In particular, Atrium is required to maintain Funds at Lloyd's amounting to $93.0 million (2008 - $74.3 million) and this is achieved through the provision of Letters of Credit that are guaranteed by Ariel Holdings. During 2009, Atrium paid dividends of $16.4 million.

**United States**

Valiant and Valiant Specialty are subject to certain Risk-Based Capital ("RBC") requirements as specified by the National Association of Insurance Commissioners ("NAIC"). Under those requirements, the amount of capital and surplus maintained by a property casualty company is determined based on the various risk factors related to the company.

In addition, dividends may only be declared or distributed out of earned surplus. The maximum amount of dividends which can be paid by Valiant or Valiant Specialty without the prior approval of the NAIC is limited to the greater of 10% of their respective statutory surplus or respective statutory income, subject to the limitation of its earned surplus. At December 31, 2009, Valiant and Valiant Specialty had no earned surplus, and as such, no dividends can be paid without prior approval of the NAIC. Neither Valiant nor Valiant Specialty paid any dividends during 2009 or 2008.

A summary of Valiant's and Valiant Specialty's statutory positions for the years ended December 31, 2009 and 2008 is as follows:

| | Valiant | | Valiant Specialty | |
|---|---|---|---|---|
| | **2009** | **2008** | **2009** | **2008** |
| Statutory surplus | $ 51,350 | $ 51,070 | $ 20,950 | $ 16,000 |
| Statutory net (loss) income | $ (10,110) | $ (9,380) | $ (100) | $ 10 |
| Authorized control RBC | $ 7,200 | $ 5,080 | $ 350 | $ 50 |

## 15. Taxation

The Company provides for income taxes based upon amounts reported in the financial statements and the provisions of currently enacted tax laws. The Company is registered in Bermuda and is subject to Bermuda law with respect to taxation. Under current Bermuda law, the Company is not taxed on any Bermuda income or capital gains taxes and has received an undertaking from the Bermuda Minister of Finance that, in the event of any Bermuda income or capital gains taxes being imposed, the Company will be exempt from those taxes until March 2016.

The Company has subsidiaries and branches that operate in various jurisdictions that are subject to tax in the jurisdictions in which they operate. The significant jurisdictions in which the Company's subsidiaries and branches are subject to tax are the United Kingdom ("U.K.") and the United States.

The Company subsidiaries based in the U.S. are subject to U.S. tax laws and both U.S. state and federal income taxes.

The Company subsidiaries based in U.K. are subject to U.K. corporation taxes. Income from the Group's operations at Lloyd's is also subject to U.S. income taxes. Under a Closing Agreement between Lloyd's and the Internal Revenue Service ('IRS'), Lloyd's Members pay U.S. income tax on U.S.-connected income written by Lloyd's Syndicates. U.S. income tax due on this U.S. connected income is calculated by Lloyd's and remitted directly to the Internal Revenue Service and is charged by Lloyd's to Members in proportion to their participation on the relevant Syndicates. The Group's Corporate Members are all subject to this arrangement but, as U.K. tax residents, will receive U.K. corporation tax credits for any U.S. income tax incurred up to the value of the equivalent U.K. corporation income tax charge on the U.S. income.

The Company is not subject to income taxation other than as stated above. There can be no assurance that there will not be changes in applicable laws, regulations or treaties, which might require the Company to change the way it operates or become subject to taxation.

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

The Company is required to recognize the tax benefits of uncertain tax positions only where the position is "more likely than not" to be sustained, assuming examination by tax authorities. The Company has no unrecognized tax benefits as of December 31, 2009 (2008 - $nil). The Company does not anticipate any significant changes to its total unrecognized tax benefits within the next twelve months and classifies all income tax associated with interest and penalties as income tax expense. During the year ended December 31, 2009, the Company paid no interest or penalties relating to income taxes (2008 - $161, 2007 - $nil). Income tax returns are open for examination for the tax years 2007 to 2009 in the U.S. and 2008 to 2009 in the U.K.

Income tax expense (benefit) is comprised of current and deferred tax for the years ended December 31, 2009, 2008 and 2007 are as follows:

| | December 31, 2009 | December 31, 2008 | December 31, 2007 |
|---|---|---|---|
| Current | $ 15,110 | $ 13,834 | $ 61 |
| Deferred | (11,629) | (5,056) | (119) |
| Income tax expense (benefit) | $ 3,481 | $ 8,778 | $ (58) |

Income (loss) before income taxes and income tax expense (benefit) attributable to that income (loss) consists of:

| | Year ended December 31, 2009 | | | |
|---|---|---|---|---|
| | Income before tax | Current income taxes | Deferred income taxes | Total income taxes |
| U.S. | $ (8,142) | $ 569 | $ - | $ 569 |
| Non U.S. | 383,969 | 14,541 | (11,629) | 2,912 |
| Total | $ 375,827 | $ 15,110 | $ (11,629) | $ 3,481 |

| | Year ended December 31, 2008 | | | |
|---|---|---|---|---|
| | Income before tax | Current income taxes | Deferred income taxes | Total income taxes |
| U.S. | $ (10,064) | $ 45 | $ - | $ 45 |
| Non U.S. | (19,689) | 13,789 | (5,056) | 8,733 |
| Total | $ (29,753) | $ 13,834 | $ (5,056) | $ 8,778 |

| | Year ended December 31, 2007 | | | |
|---|---|---|---|---|
| | Income before tax | Current income taxes | Deferred income taxes | Total income taxes |
| U.S. | $ (1,599) | $ 61 | $ (119) | $ (58) |
| Non U.S. | 234,659 | - | - | - |
| Total | $ 233,060 | $ 61 | $ (119) | $ (58) |

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

A reconciliation of the expected tax rate of zero under Bermuda law and the actual tax charge per the financial statements is as follows:

| | | Year ended December 31, 2009 | | Year ended December 31, 2008 | | Year ended December 31, 2007 |
|---|---|---|---|---|---|---|
| Computed expected tax expense (benefit) | $ | - | $ | - | $ | - |
| Foreign taxes at local expected rates | | 2,345 | | 6,019 | | (536) |
| Adjustments to prior period tax | | (1,803) | | - | | - |
| Effect of valuation allowance | | 2,910 | | 3,514 | | 471 |
| Other | | 29 | | (755) | | 7 |
| Actual income tax expense (benefit) | $ | 3,481 | $ | 8,778 | $ | (58) |

The deferred tax asset and liability consists of the following:

| | | December 31, 2009 | | December 31, 2008 |
|---|---|---|---|---|
| **Deferred tax asset** | | | | |
| Share based compensation and benefits | $ | 4,516 | $ | 497 |
| Present value of reinsurance recoverable balance | | 158 | | 398 |
| Cost of capital adjustment | | 1,098 | | 2,598 |
| Net operating loss carryforward | | 4,061 | | 2,523 |
| Other | | 3,341 | | 4,098 |
| Deferred tax asset | $ | 13,174 | $ | 10,114 |
| | | | | |
| **Deferred tax liability** | | | | |
| Underwriting profits taxable in future periods | | (8,655) | | (13,445) |
| Present value of losses and loss adjustment expenses | | (1,659) | | (3,918) |
| Intangible assets | | (18,207) | | (26,734) |
| Other timing differences | | (2,013) | | (362) |
| Deferred tax liability | $ | (30,534) | $ | (44,459) |
| Valuation allowance | | (6,904) | | (4,202) |
| **Net deferred tax liability** | $ | (24,264) | $ | (38,547) |

Net deferred liabilities represent the tax effect of temporary differences between the value of assets and liabilities for financial statement purposes and such values as measured by U.S. and U.K. tax laws and regulations.

In assessing whether deferred tax assets can be realized, management considers whether it is more likely than not that part, or all, of the deferred tax asset will not be realized. The realization of deferred tax assets is dependent upon the generation of future taxable income in the period during which those temporary differences and operating losses become deductible. Management considers the reversal of the deferred tax liabilities, projected future taxable income and tax planning strategies in making this assessment. The amount of the deferred tax asset considered realizable could be reduced in the future if estimates of future taxable income are reduced.

Management believes it is more likely than not that VIG will not generate sufficient taxable income to realize the deferred tax asset that currently exists due to the start up nature of VIG's operations. Accordingly, a valuation allowance of $7.0 million has been established against U.S. deferred tax assets as at December 31, 2009 (2008 - $4.2 million).

At December 31, 2009, the Company had U.S. net operating loss carry forwards of approximately $11.5 million (2008 - $7.2 million) which will expire between 2027 and 2029.

## 16. Subsequent Events

On February 2, 2010, the Company declared a dividend in the amount of $420.3 million. The Company has evaluated subsequent events through February 11, 2010, the date the financial statements were issued, and concluded that, other than the declaration of the dividend, there are no subsequent events requiring recognition or disclosure.

## 17. Condensed unaudited quarterly financial data

Quarterly results necessarily rely heavily on estimates. This and certain other factors, such as catastrophic losses, call for caution in drawing specific conclusions from quarterly results. The following is a summary of the unaudited quarterly data for the years ended December 31, 2009 and 2008:

## ARIEL HOLDINGS LTD.
## NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS
## For the years ended December 31, 2009, 2008 and 2007
(Expressed in thousands of U.S. dollars, except share and per share amounts)

| | Quarter Ended | | | |
|---|---|---|---|---|
| | March 31, 2009 | June 30, 2009 | September 30, 2009 | December 31, 2009 |
| Gross premiums written | $ 205,436 | $ 219,299 | $ 129,078 | $ 90,321 |
| Net premiums written | 198,076 | 174,789 | 117,177 | 78,979 |
| Net premiums earned | 118,364 | 122,879 | 134,118 | 146,346 |
| Other underwriting income | 10,388 | 3,502 | 2,613 | 8,452 |
| Gain on sale of intangible assets | - | - | 6,138 | - |
| Net investment income | 22,462 | 20,058 | 19,680 | 19,224 |
| Net realized investment (losses) gains | (3,607) | 1,214 | 4,014 | 10,954 |
| Net unrealized investment (losses) gains | (2,696) | 24,882 | 48,379 | 1,577 |
| Net foreign exchange (losses) gains | (1,694) | 1,523 | 413 | 763 |
| Total revenues | 143,217 | 174,058 | 215,355 | 187,316 |
| Net losses and loss adjustment expenses | 37,906 | 26,662 | 43,103 | 29,133 |
| Acquisition costs | 17,051 | 23,447 | 18,844 | 25,709 |
| General and administrative expenses | 28,218 | 26,840 | 27,813 | 34,161 |
| Interest expense | 1,177 | 1,028 | 876 | 810 |
| Amortization of intangible assets | 357 | 328 | 328 | 328 |
| Income tax (benefit) expense | (4,977) | 3,032 | 345 | 5,081 |
| Net income | $ 63,485 | $ 92,721 | $ 124,046 | $ 92,094 |
| Basic earnings per share | $ 6.07 | $ 8.83 | $ 11.81 | $ 8.77 |
| Diluted earnings per share | $ 5.93 | $ 8.64 | $ 11.45 | $ 8.46 |

| | Quarter Ended | | | |
|---|---|---|---|---|
| | March 31, 2008 | June 30, 2008 | September 30, 2008 | December 31, 2008 |
| Gross premiums written | $ 180,867 | $ 209,703 | $ 139,374 | $ 86,201 |
| Net premiums written | 165,995 | 170,751 | 129,175 | 75,355 |
| Net premiums earned | 149,294 | 130,757 | 143,752 | 133,345 |
| Other underwriting income | 7,378 | 4,554 | 2,324 | 7,976 |
| Gain on repurchase of debentures | - | 1,520 | - | - |
| Net investment income | 24,276 | 22,108 | 20,460 | 17,287 |
| Net realized investment gains (losses) | 9,901 | (3,148) | (4,597) | (11,707) |
| Net unrealized investment losses | (13,641) | (8,044) | (35,286) | (23,215) |
| Net foreign exchange gains (losses) | 3,575 | 1 | (1,288) | 2,109 |
| Total revenues | 180,783 | 147,748 | 125,365 | 125,795 |
| Net losses and loss adjustment expenses | 32,680 | 51,948 | 237,448 | 65,515 |
| Acquisition costs | 32,884 | 25,616 | 23,789 | 24,029 |
| General and administrative expenses | 33,822 | 30,938 | 24,462 | 18,074 |
| Interest expense | 2,007 | 1,559 | 1,518 | 1,508 |
| Amortization of intangible assets | 462 | 462 | 462 | 261 |
| Income tax expense (benefit) | 8,428 | 82 | (588) | 856 |
| Net income (loss) | $ 70,500 | $ 37,143 | $ (161,726) | $ 15,552 |
| Basic earnings (loss) per share | $ 6.74 | $ 3.56 | $ (15.47) | $ 1.49 |
| Diluted earnings (loss) per share | $ 6.65 | $ 3.50 | $ (15.47) | $ 1.46 |

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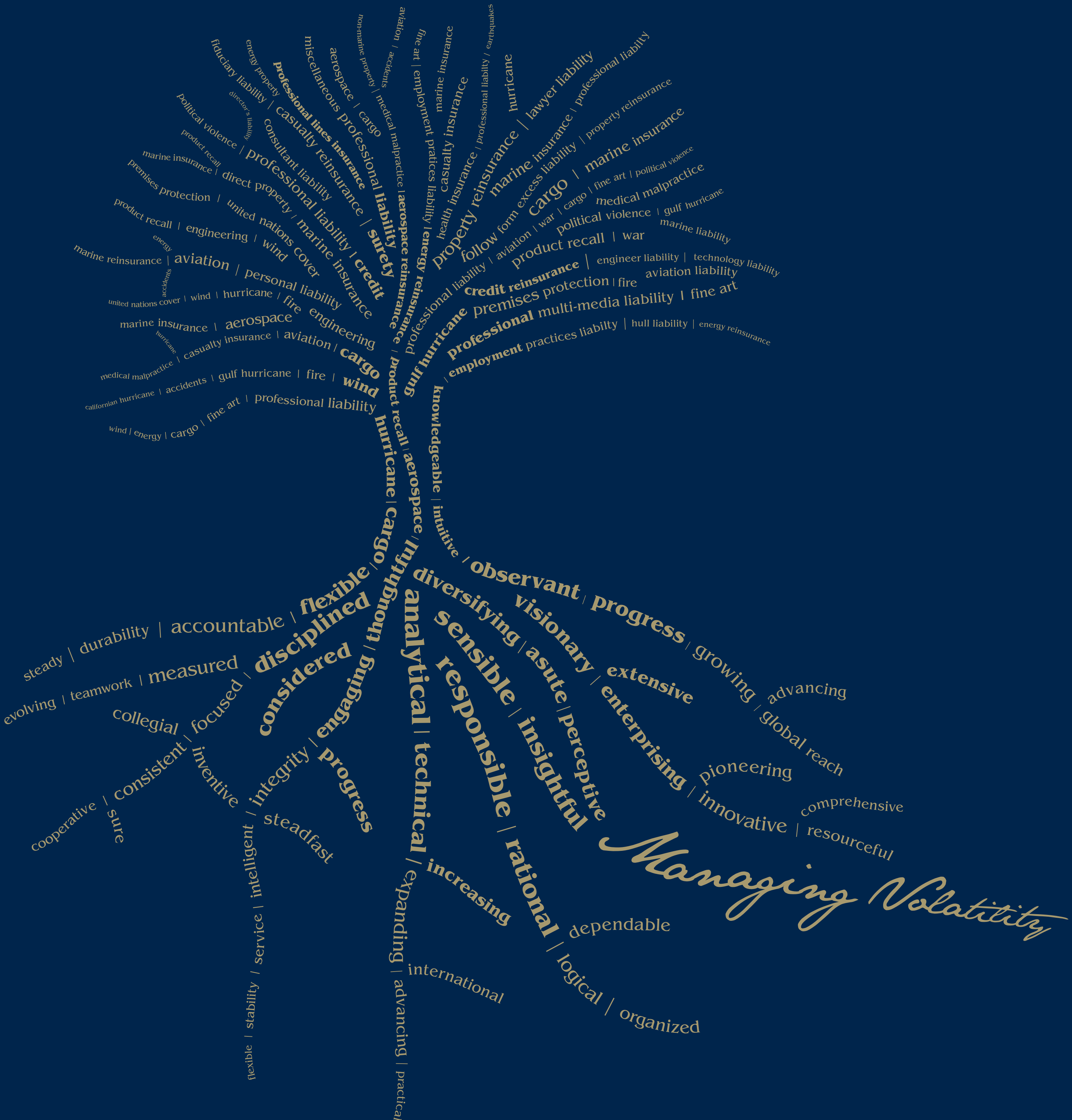


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