**CITADEL REINSURANCE COMPANY LIMITED**

**Consolidated Financial Statements**
(With Independent Auditors' Report Thereon)

Year ended December 31, 2010

KPMG

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## AUDITORS' REPORT

To the Shareholder of
Citadel Reinsurance Company Limited

We have audited the accompanying consolidated balance sheet of Citadel Reinsurance Company Limited as of December 31, 2010, and the consolidated statements of earnings and retained earnings and cash flows for the year then ended. These consolidated financial statements are the responsibility of the company's management. Our responsibility is to express an opinion on these consolidated financial statements based on our audit.

We conducted our audit in accordance with auditing standards generally accepted in Bermuda and Canada. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the consolidated financial statements.

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the consolidated financial position of Citadel Reinsurance Company Limited as of December 31, 2010, and the results of its consolidated operations and its cash flows for the period then ended in conformity with accounting principles generally accepted in Bermuda and Canada.

KPMG

Chartered Accountants
Hamilton, Bermuda
May 25, 2011

**CITADEL REINSURANCE COMPANY LIMITED**

Consolidated Balance Sheet

December 31, 2010
*(Expressed in United States Dollars)*

| | 2010 | 2009 |
|---|---|---|
| **Assets** | | |
| Cash and cash equivalents (Note 3) | $ 12,340,625 | $ 14,692,591 |
| Marketable securities (Notes 4 and 8) | 20,632,872 | 17,948,161 |
| Other investments | 147,756 | – |
| Accounts receivable and accrued interest (Note 12) | 2,339,527 | 1,863,390 |
| Deferred underwriting expenses | 29,901 | 36,800 |
| Deposit assets (Note 6) | 48,971,860 | 50,676,248 |
| Property, plant and equipment (Note 9) | 117,015 | 62,204 |
| | $ 84,579,556 | $ 85,279,394 |
| **Liabilities** | | |
| Accounts payable and accruals (Note 12) | $ 5,268,730 | $ 6,251,049 |
| Deposit liabilities (Note 7) | 48,971,860 | 50,676,248 |
| Unearned premium | 403,729 | 488,605 |
| Provision for claims | 3,182,658 | 3,030,094 |
| Unearned service fee | 3,547,805 | 4,273,531 |
| | 61,374,782 | 64,719,527 |
| **Shareholder's equity** | | |
| Capital stock (Note 11) | 20,000,000 | 20,000,000 |
| Retained earnings | 2,700,688 | 1,670,859 |
| Accumulated other comprehensive income (loss) | 560,381 | (1,110,992) |
| Non-controlling interest | (56,295) | – |
| | $ 84,579,556 | $ 85,279,394 |

*See accompanying notes to consolidated financial statements*

Signed on behalf of the Board

Director

Director

**CITADEL REINSURANCE COMPANY LIMITED**

Consolidated Statement of Earnings, Retained Earnings and Comprehensive Income

Year Ended December 31, 2010
*(Expressed in United States Dollars)*

| | 2010 | 2009 |
|---|---|---|
| **Underwriting income** | | |
| Net premiums earned | $ 1,515,119 | $ 2,040,850 |
| Investment income | 314,370 | 77,830 |
| | 1,829,489 | 2,118,680 |
| **Underwriting expenses** | | |
| Net claims incurred | 784,948 | 1,380,398 |
| Other expenses | 463,378 | 639,306 |
| | 1,248,326 | 2,019,704 |
| **Underwriting profit (loss)** | 581,163 | 98,976 |
| Other income (Note 10) | 4,169,548 | 7,026,017 |
| | 4,750,711 | 7,124,993 |
| Foreign exchange gain | 277,422 | 379,873 |
| General and administrative expenses | (3,908,190) | (3,648,541) |
| Earnings for the year before taxation | 1,119,943 | 3,856,325 |
| Taxation expense (Note 15) | (146,409) | (2,544,313) |
| Net earnings for the year | 973,534 | 1,312,012 |
| Retained earnings, beginning of year | 1,670,859 | 1,358,847 |
| Non-controlling interest | 56,295 | – |
| Dividends declared (Note 14) | – | (1,000,000) |
| Retained earnings, end of year | $ 2,700,688 | $ 1,670,859 |
| **Other comprehensive income** | | |
| Net unrealized gain (loss) on available for sale investments | $ 560,381 | $ (1,110,992) |

*See accompanying notes to consolidated financial statements*

**CITADEL REINSURANCE COMPANY LIMITED**

Consolidated Statement of Cash Flows

Year Ended December 31, 2010
*(Expressed in United States Dollars)*

| | 2010 | 2009 |
|---|---|---|
| **Operating activities** | | |
| Earnings (loss) from continuing operations | $ 973,534 | $ 1,312,012 |
| Add (deduct) items not affecting cash resources: | | |
| Amortisation | 23,532 | 18,220 |
| Unrealised (gain) on foreign exchange | (190,171) | (84,854) |
| Realised and unrealized loss on marketable securities | (563,430) | (1,472,406) |
| Change in assets and liabilities: | | |
| Unearned premium | (84,876) | 143,484 |
| Accounts receivable and accrued interest | (476,137) | (214,215) |
| Unearned service fee | (725,726) | 4,273,531 |
| Deferred underwriting expense | 6,899 | (36,800) |
| Non-controlling interest | (56,295) | – |
| Other investments | (147,756) | – |
| Deposit assets | 1,704,388 | 320,309 |
| Accounts payable and accruals | (982,319) | 4,936,696 |
| Deposit liabilities | (1,704,388) | (320,309) |
| Provision for claims | 152,564 | 334,751 |
| | (2,070,181) | 9,210,419 |
| **Investing activities** | | |
| Proceeds on disposal of marketable securities | 6,057,457 | 3,415,985 |
| Purchases of marketable securities | (6,260,648) | (6,938,071) |
| Purchases of property, plant and equipment | (78,594) | (39,523) |
| | (281,785) | (3,561,609) |
| **Financing activity** | | |
| Dividends paid | – | (1,000,000) |
| (Decrease) increase in cash and cash equivalents | (2,351,966) | 4,648,810 |
| Cash and cash equivalents, beginning of year | 14,692,591 | 10,043,781 |
| Cash and cash equivalents, end of year | $ 12,340,625 | $ 14,692,591 |

*See accompanying notes to consolidated financial statements*

1. **Nature of business**

Citadel Reinsurance Company Limited (the "Company"), which underwrites insurance and reinsurance, was incorporated under the laws of Bermuda on January 4, 1984 and is registered as a Class 3A insurer under The Insurance Act 1978, amendments thereto and related regulations ("The Act"). The Company is managed and has its principal place of business in Bermuda. The Company's ultimate parent company is Sirius International Limited, a company incorporated in Bermuda.

2. **Significant accounting policies**

These consolidated financial statements are prepared in accordance with accounting principles generally accepted in Bermuda and Canada. The preparation of financial statements in accordance with generally accepted accounting principles, requires management to make estimates and assumptions that affect reported amounts of assets and liabilities and disclosure of contingent assets and liabilities as at the balance sheet date. Estimates also affect the reported amounts of income and expenses for the reporting period. Actual results could differ from those estimates.

The following is a summary of the significant accounting policies adopted by the Company:

*(a)* *Principles of consolidation*

These financial statements include the operations of the Company and its wholly-owned subsidiaries, namely Citadel International Reinsurance Company Limited ("CIRCL"), Citadel Group Representatives Limited, Citadel Group Representatives, Inc, Citadel Risk Management, Inc, ("CRMI") and Green Park (US) Incorporated. CIRCL is a segregated account company, incorporated in Bermuda. There are three segregated cells (2009 - four) within CIRCL, one of which has been consolidated into these financial statements on the basis that the Company owns 65% of the preferred shares of the cell. The remaining 35% of the cells' income is recognised as a minority interest. To the extent the cell has a deficiency in excess of its share capital the full amount of the deficiency is consolidated into these financial statements. To the extent that the cell's retained earnings exceed its share capital the non-controlling 35% interest is accrued on the balance sheet.

On January 1, 2009, CRMI purchased from Arthur J. Gallagher the entire share capital of Gallagher Risk Services, a company incorporated in Delaware, U.S.A., for a nominal amount of $1. Under the terms of the agreement, Gallagher Risk Services was renamed Citadel Risk Services, Inc. (CRS). The operations of CRS have been consolidated in these financial statements.

During 2010, the Company and CRS jointly acquired 64.44% of Great Falls Holding Company ("GFH"), a company incorporated in Delaware, U.S.A. GFH has a wholly owned subsidiary, Great Falls Insurance Company ("GFI"), which is engaged in the business of writing workers compensation insurance in the State of Maine, U.S.A. The operations of GFH and GFI have been consolidated in these financial statements on the basis that the Company owns 64.44% of the issued capital. The remaining 35.56% is recognised as a non-controlling interest.

*(b)* *Premium written*

Premiums are written when received and net premiums are earned on a pro-rata basis over the term of the related policies. Written premiums comprise the premiums on contracts entered into during the accounting period and are disclosed gross of commission payable to intermediaries and exclude taxes and duties levied on premiums.

2. **Significant accounting policies (continued)**

(c) *Net claims incurred*

Net claims incurred represent claims paid after the deduction of claims recovered and the adjustment for the change in the provision for claims.

(d) *Other income*

Other income represents the income on assets not matched to the Company's deposit liabilities, and comprises interest received and accrued on interest bearing deposits with banks, coupons received and accrued on fixed interest securities and the profit or loss on the sale of such securities. Other income also includes unrealised gains and losses on investments in ordinary shares and hedge funds and income from non risk transferring insurance transactions.

Service fee income from CRMI and CRS is included in other income. CRS, a reinsurance intermediary, was acquired on January 1, 2009. CRS was the contractual intermediary for a portfolio of run-off reinsurance business through which paid and reported losses have to flow. CRS was acquired with $7m in corporate cash to cover CRMI for the anticipated cost of administering the run-off book. At acquisition, the $7m corporate cash was recognised as unearned service income. The Company is recognising this income using the percentage of completion method. Percentage of completion is determined by reference to actual costs incurred to date over estimated costs to complete the services. Estimated costs to completion are inherently uncertain and based on management's best estimate including an estimate of time to completion.

Income recognised in the year in relation to CRS services is $725,726 (2009 - $1,327,587) and is included in other income.

(e) *Marketable securities/change in accounting policy*

The Company differentiates between "available for sale" marketable securities, which are recognised at fair value with unrealised gains and losses being reported as net unrealised gain (loss) in the consolidated statement of earnings, retained earnings and comprehensive income, and "held for trading" marketable securities, which are recognised at market value with unrealised gains and losses being reported as other income in the consolidated statement of earnings, retained earnings and comprehensive income. Equities and floating note rate securities are all actively traded on public markets.

The Company changed its accounting policy for marketable securities during the year. Securities previously classified as "held for maturity" were reclassified as "available for sale". Held for maturity securities are recognised at amortised cost, whereas available for sale securities are recognised at fair value, as described above. The comparatives have been restated for the effect of the change in accounting policy. The effect of the change in accounting policy in 2010 was to increase marketable securities by $560,381 (2009 - ($1,110,992)). The unrealised gains (losses) arising from the change in accounting policy are reported as unrealised gain (loss) in the consolidated statement of earnings, retained earnings and comprehensive income.

The Company may sell securities it does not own in anticipation of a decline in market value of that security. Upon entering a short position, the Company records the proceeds in cash and cash equivalents and establishes an offsetting accounts payable for the securities due under the short sale agreement, which is subsequently marked to market. The Company will generally borrow the security sold short in order to make delivery to a buyer and then replace the borrowed security by purchasing it at the market price at the time of replacement. Until the security is replaced, the Company is required to pay the lender any interest or dividend earned, which is recorded as a reduction of other income to the Company. The Company realises a gain if the security declines in price between the date of the short sale and the date on which the Company replaces the borrowed security and the Company incurs a loss as a result of the short sale if the price of the security increases. Realized and unrealized gains and losses arising from short sales of securities are included in other income. There were no short positions open at year end, and all short positions have been covered.

2. **Significant accounting policies** (continued)

*(f) Provision for claims*

The estimated liability for losses and loss expenses is determined from reports received from the company ceding insurance business to the Company. Management reviews this loss information and establishes loss and loss expense reserves, including a reserve for losses incurred but not reported ("IBNR"). Loss estimates were derived from sound actuarial methods based on many items including but not limited to historical account data, industry data and pertinent pricing information.

Management believes that the reserve for losses and loss expenses at December 31, 2010 is adequate to cover the ultimate net cost of losses incurred, however, such liability is necessarily based on estimates and no representation is made that the ultimate liability may not exceed such estimates. Subsequent revisions to estimated ultimate losses will be reflected in operations in the period in which they are determined.

The Company has reduced its loss and loss expense provisions by discounting for the time value of money. The value of the discount at December 31, 2010 was $4,408 (2009 - $24,933) using a discount rate of 3% (2009 - 3%). Assumed maturity dates range between December 31, 2012 and December 31, 2014.

*(g) Deposit assets and deposit liabilities*

For all insurance/reinsurance agreements where no risk is assumed by the Company, the Company records, in the consolidated statement of earnings, the net fee or margin earned as a result of the transactions. These fees are earned in accordance with the terms of the agreements.

The insurance/reinsurance assets and liabilities related to the agreements are recorded at their gross amounts in the balance sheet within Deposit assets and Deposit liabilities. The provision for claims reflected as part of the Deposit liabilities is discounted based upon the liability after taking account of the known duration of such liability, the rate of return on the matching assets and the future reductions in deferred underwriting expenses and the provision for unearned premiums.

*(h) Provision for unearned premiums*

The provision for unearned premiums represents that portion of the premiums written in respect of the current and prior years, which is attributable to the unexpired term of the corresponding policy in force.

*(i) Property, plant and equipment and amortization*

Property, plant and equipment are carried at cost less amortization which is calculated in equal annual installments to write off the assets over the following estimated useful lives:

Office furnishings and equipment - three to five years

*(j) Foreign currency balances*

Monetary assets and liabilities are translated into U.S. dollars at year-end exchange rates and non-monetary assets and liabilities at the exchange rates prevailing when the assets were acquired or liabilities incurred. Income and expenses are translated at the rate of exchange prevailing at the transaction date. Translation gains and losses are included in foreign exchange gains or losses unless the gain or loss is a result of trading foreign currency as part of the Company's overall investment strategy, in which case the income is recognized as other income.

2. **Significant accounting policies** (continued)

*(k) Cash and cash equivalents*

Cash and cash equivalents are short-term, highly liquid investments that are readily convertible to known amounts of cash and which are subject to an insignificant risk of changes in value.

*(l) Fair values of financial instruments*

Fair values of financial instruments are disclosed in the notes to the financial statements when they differ from the carrying values. Where amounts receivable and payable are subject to normal credit terms, their carrying values are used as an approximation of their fair values.

In compliance with CICA Handbook Section 3862, *Financial Instruments – Disclosures (Improvements to fair value and liquidity risk disclosures)*, the Company has categorised its financial instruments that are carried at fair value based on the priority of the inputs to the valuation techniques used to measure fair value, into a three level fair value hierarchy as follows:

Level 1 – Fair value is based on unadjusted quoted prices for identical assets or liabilities in an active market. The investments classified as Level 1 include exchange–traded equities, preferred shares, notes and bonds.

Level 2 – Fair value is based on quoted prices for similar assets or liabilities in active markets. The valuation is based on significant observable inputs or inputs that are derived principally from or corroborated with observable market data through correlation or other means. The investments classified as Level 2 are investments in hedge funds.

Level 3 – Fair value is based on valuation techniques that require one or more significant inputs that are not based on observable market inputs. These unobservable inputs reflect the Group's assumptions about the market participants in pricing the investments.

For each class of financial instrument, disclosures are required of the level of inputs used to measure fair value, and the significant effect on the fair value measurements if one or more of the inputs used in the fair value measurements are changed to a reasonably possible alternative assumption.

Disclosures are required of any significant transfers between the fair value hierarchy levels from one period to another, as well as changes in valuation techniques, and the reasons thereof.

3. **Letters of credit**

The Company has pledged cash and cash equivalents of $2,890,031 (2009 - $2,582,360) and deposits of $39,024,569 (2009 - $40,450,983) to banks as security for letters of credit totalling $40,620,863 (2009 - $43,618,317) in respect of the Company's obligations under reinsurance programs and the Company's guarantee for a letter of credit of $604,500 (2009 - $604,500) for the benefit of members of the PMA Insurance Group. The Company is also the account party under a letter of credit of $Nil (2009 - $543,280) for the benefit of members of the PMA Insurance Group ("PMA LC") which is collateralised by a letter of credit in the same amount and in favour of the bank that has issued the PMA LC.

*(Expressed in United States Dollars)*

4. **Marketable securities**

The total carrying value of held for trading securities and available for sale securities as at December 31, 2010 was $20,632,872 (2009 - $17,948,161).

| | 2010 Fair value | 2009 Fair value |
|---|---|---|
| **Held for trading** | | |
| Hedge fund | $ 4,269,041 | $ 4,186,305 |
| Convertible notes | 1,051,685 | – |
| Ordinary shares | 2,089,251 | 1,723,830 |
| Treasury funds | 2,476 | 2,564 |
| | $ 7,412,453 | $ 5,912,699 |

Net realised and unrealised gains were $563,430 and $1,472,406 for the years ended December 31, 2010 and 2009 respectively.

| | 2010 | | | 2009 | | |
|---|---|---|---|---|---|---|
| | Amortised cost $ | Fair value $ | Unrealized gain $ | Amortised cost $ | Fair value $ | Unrealized gain (loss) $ |
| **Available for sale** | | | | | | |
| Preferred shares | 9,576,352 | 9,836,012 | 259,660 | 10,261,618 | 9,547,600 | (714,018) |
| Floating notes | 2,736,321 | 3,005,439 | 269,118 | 2,457,675 | 2,036,365 | (421,310) |
| Corporate bonds | 347,365 | 378,968 | 31,603 | 427,161 | 451,497 | 24,336 |
| | 12,660,038 | 13,220,419 | 560,381 | 13,146,454 | 12,035,462 | (1,110,992) |

Fair values of convertible notes, ordinary shares, preferred shares, floating notes, corporate bonds and treasury funds have been determined using established third party pricing services. The fair value is derived based on inputs that are observable for the asset including actual transaction prices for securities that have quoted prices in active markets.

Fair values of hedge funds are based on the Net Asset Value of the underlying investment funds as reported by the investment managers, or their independent administrators, on the 1st day of each calendar month.

*(Expressed in United States Dollars)*

4. **Marketable securities** (continued)

The following table represents the fair value hierarchy for the Company's investments measured at fair value as at December 31, 2010:

| | Level 1 | Level 2 | Level 3 | Total |
|---|---|---|---|---|
| Hedge fund | $ – | $ 4,269,041 | $ – | $ 4,269,041 |
| Convertible notes | 1,051,685 | – | – | 1,051,685 |
| Ordinary shares | 2,089,251 | – | – | 2,089,251 |
| Preferred shares | 9,836,012 | – | – | 9,836,012 |
| Floating notes | 3,005,439 | – | – | 3,005,439 |
| Corporate bonds | 378,968 | – | – | 378,968 |
| Treasury funds | 2,476 | – | – | 2,476 |
| | $ 16,363,831 | $ 4,269,041 | $ – | 20,632,872 |

The following table represents the fair value hierarchy for the Company's investments measured at fair value as at December 31, 2009:

| | Level 1 | Level 2 | Level 3 | Total |
|---|---|---|---|---|
| Hedge fund | $ – | $ 4,186,305 | $ – | 4,186,305 |
| Convertible notes | – | – | – | – |
| Ordinary shares | 1,723,830 | – | – | 1,723,830 |
| Preferred shares | 9,547,600 | – | – | 9,547,600 |
| Floating notes | 2,036,365 | – | – | 2,036,365 |
| Corporate bonds | 451,497 | – | – | 451,497 |
| Treasury funds | 2,564 | – | – | 2,564 |
| | $ 13,761,856 | $ 4,186,305 | $ – | 17,948,161 |

The Company does not have any Level 3 investments in 2010 or 2009. There were no significant transfers between the fair value hierarchy levels during 2010.

The Company did not impair its investment in the available for sale portfolio in 2010 or 2009. The Company considers impairment as other than temporary if evidence indicating that an investment's cost is recoverable within a reasonable period of time is outweighed by evidence to the contrary. The Company also considers its ability and intent to hold an investment until such recovery of the security's fair value. Recognition of impairment losses for declines in the value of securities attributable to issuer-specific events are based upon all relevant facts and circumstances for each investment. Factors considered by management include, but are not limited to, the impact of issuer-specific events, dividend flow, industry-specific events, current and expected future market and economic conditions, the nature of the investment, the severity and duration of the impairment and the volatility of the security's market price.

*(Expressed in United States Dollars)*

4. **Marketable securities** (continued)

The amortized cost and estimated fair value amounts for Preferred Shares and Corporate Bonds held at December 31, 2010 are shown by contractual maturity. Actual maturity may differ from contractual maturity because certain borrowers have the right to call or prepay certain obligations with or without call or prepayment penalties.

| | Amortized cost | Estimated fair value | Estimated yield % |
|---|---|---|---|
| Due within one year | $ 384,970 | $ 429,178 | 7.05 |
| Due after one year through five years | 266,576 | 297,626 | 6.73 |
| Due after five years | 9,272,171 | 9,488,176 | 7.85 |
| | $ 9,923,717 | $ 10,214,980 | |

Excluded from the above table are floating rate notes aggregating $2,736,321. The interest rates are reset quarterly, based on a margin over the Australian 90 day bank bill benchmark rate. Most of these securities have passed early redemption dates and can be redeemed at any time by the issuer of the securities. In such cases, this would be taken as the maturity date.

5. **Risk management**

The primary goals of the Company's risk management are to ensure that the outcomes of activities involving elements of risk are consistent with the Company's objectives and risk tolerance, while maintaining an appropriate risk/reward balance and protecting the Company's balance sheet from events that have the potential to materially impair its financial strength. Balancing risk and reward is achieved through identifying risk appropriately, aligning risk tolerances with business strategy, diversifying risk, pricing appropriately for risk, mitigating risk through preventive controls and transferring risk to third parties.

The Company is exposed to risk of potential loss arising from its insurance and reinsurance operations and also its investment activities. These risks primarily relate to underwriting risk, credit risk, liquidity risk and various market risks, including interest rate risk, equity market fluctuation risk and foreign currency risk.

***Underwriting risk***

Underwriting risk is the risk that the total cost of claims, claims adjustment expenses and premium acquisition expenses will exceed premiums received and can arise as a result of numerous factors including pricing risk, reserving risk and catastrophe risk.

Pricing risk arises because actual claims experience may differ adversely from the assumptions included in pricing calculations. The market cycle is affected by the frequency and severity of losses, levels of capacity and demand, general economic conditions and competition on rates and terms of coverage. The Company focuses on profitable underwriting using statistical and historic analysis as well as actuarial expertise.

*(Expressed in United States Dollars)*

5. **Risk management** (continued)

Reserving risk arises because actual claims experience may differ adversely from the assumptions included in setting reserves, in large part due to the length of time between the occurrences of a loss, the reporting of the loss to the insurer and the ultimate resolution of the claim. Claims provisions are expectations of the ultimate cost of resolution and administration of claims based on an assessment of facts and circumstances then known, a review of historical settlement patterns, estimates of trends in claims severity and frequency, legal theories of liability and other factors. Variables in the reserve estimation process can be affected by both internal and external events, such as changes in claims handling procedures, economic inflation, legal trends, legislative changes, inclusion of exposures not contemplated at the time of policy inception and significant changes in severity or frequency of claims relative to historical trends. Due to the amount of time between the occurrence of a loss, the actual reporting of the loss and the ultimate payment, provisions may ultimately develop differently from the actuarial assumptions made when initially estimating the provision for claims. The Company's provision for claims is reviewed by an externally appointed actuary.

The directors of Citadel believe that the nature and amount of current risk transferring business being underwritten, using a combination of low per occurrence and aggregate limits results in no significant exposure to catastrophic risk.

***Credit risk***

Credit risk is the risk that one party to a financial instrument fails to discharge an obligation and thereby causes financial loss to another party. The Company's exposure to credit risk is currently confined primarily to the credit risk on investments and reinsurance recoverable. The aggregate gross credit risk exposure at December 31, 2010 (without taking into account amounts pledged to and held by the Company as collateral) was $20,632,872 for investments and $385,572 for reinsurance recoverable.

*Investments in debt instruments*

The Company's risk management strategy is to invest primarily in debt instruments of high credit quality issuers and to limit the amount of credit exposure with respect to any one issuer. While the Company reviews third party ratings, it carries out its own analysis and does not delegate the credit decision to rating agencies.

The composition of the Company's available for sale portfolio as at December 31, 2010, classified according to the higher of each security's respective S & P and Moody's issuer credit ratings, is presented below:

| | Fair Value | % |
|---|---|---|
| A or above | $ 4,541,452 | 34.35 |
| BBB | 6,704,948 | 50.72 |
| Unrated | 1,974,019 | 14.93 |
| | $ 13,220,419 | 100.00 |

5. **Risk management** (continued)

***Credit risk*** (continued)

At December 31, 2010, 85.07% of the fixed and floating income portfolio at carrying value was rated investment grade.

*Reinsurance recoverable and receivables*

Credit exposure on the Company's reinsurance recoverable and receivable balances exists to the extent that any reinsurer may not be able or willing to reimburse the Company under the terms of the relevant reinsurance arrangements.

The Company makes specific provisions against reinsurance recoverable from companies considered to be in financial difficulty. There were no provisions for uncollectible reinsurance as at December 31, 2010.

***Liquidity risk***

Liquidity risk is the risk that an entity will encounter difficulty in raising funds to meet cash flow commitments associated with financial instruments. The purpose of liquidity management is to ensure that there will be sufficient cash to meet all financial commitments and obligations as they become due. To manage cash flow requirements, the Company maintains a portion of invested assets in liquid securities.

The company believes that its cash position provides adequate liquidity to meet all of the Company's obligations at December 31, 2010. Besides these, the Company expects to continue to receive investment income on its holdings of cash.

***Market risk***

Market risk is the risk of loss arising from adverse changes in market rates and prices, such as interest rates, the trading price of equity and other securities, and foreign currency exchange rates. Market risk is directly influenced by the volatility and liquidity in the markets in which the related underlying assets and liabilities are traded. The following is a discussion of the Company's primary market risk exposures and how those exposures are currently managed.

*Interest rate risk*

Fluctuations in interest rates have a direct impact on the market valuation of the Company's fixed income securities portfolio. As interest rates rise, the market value of fixed income securities portfolios should in theory decline and, conversely, as interest rates decline, the market value of fixed income securities portfolios rises. Credit risk aside, the Company positions its fixed income securities portfolio based on its view of future interest rates and the yield curve, balanced with liquidity requirements, and may reposition the portfolio in response to changes in the interest rate environment.

Investment contracts with fixed and guaranteed terms and debt securities available for sale are accounted for at fair value and their carrying amounts are not sensitive to changes in the level of interest rates.

*(Expressed in United States Dollars)*

5. **Risk management** (continued)

***Market risk*** (continued)

*Market price fluctuation*

The Company's investment portfolios are managed with a long term philosophy. Aggregate exposure to single issuers and total equity positions are monitored by the Company.

The table that follows summarizes the potential impact of 10% change in the Company's equity and equity-related holdings on the Company's net income for the year ended December 31, 2010. Certain shortcomings are inherent in the method of analysis presented, as the analysis is based on the assumptions that the equity and equity-related holdings had increased/decreased by 10% with all other variables held constant and that all the Company's equity and equity-related instruments moved according to a one-to-one correlation with the market.

| | Impact on net income |
|---|---|
| Change in global equity markets: | |
| 10% increase | $ 740,998 |
| 10% decline | (740,998) |

Generally, a 10% decline in global equity markets would decrease the value of the Company's equity investment holdings resulting in decreases in the Company's net income. Conversely, a 10% increase in global equity markets would generally increase the value of the Company's equity investment holdings resulting in increases in the Company's net income. As stated elsewhere, the Company uses short selling techniques periodically to reduce exposure as does the hedge fund that manages some of Citadel's investments.

*Foreign currency risk*

Foreign currency risk is the possibility that changes in exchange rates produce an adverse effect on earnings and equity when measured in a company's functional currency.

The Company's functional currency is the US dollar. The Company operates internationally and is exposed to foreign currency risk arising from various currency exposures, primarily with respect to the Australian dollar, New Zealand dollar, British pound, and the Euro.

A portion of the Company's premiums are written in currencies other than the US dollar. Moreover, a portion of the Company's cash and investments are held in currencies other than the US dollar. The Company monitors the exposure of invested assets to foreign currency risk and limits these amounts as deemed necessary. The Company may and does experience gains or losses resulting form fluctuations in the values of these foreign currencies, which may favourably or adversely affect operating results.

| | Impact on statement of earnings | | | | Impact on net income |
|---|---|---|---|---|---|
| | AUD | NZD | EUR | GBP | US$ |
| | $ | $ | $ | $ | $ |
| Change in currency rates | | | | | |
| 10% appreciation | 69,142 | 78,158 | 14,119 | 113,102 | 274,521 |
| 10% depreciation | (62,856) | (71,052) | (12,835) | (102,823) | (249,566) |

*(Expressed in United States Dollars)*

5. **Risk management** (continued)

***Capital management***

The Company's objectives in managing capital are firstly to protect its policyholders and then to maximize return to shareholders. Effective capital management includes measures designed to maintain capital above levels set by the Bermuda Monetary Authority (Note 16), and above internally determined and calculated risk management levels.

6. **Deposit assets**

Deposit assets represent cash, fixed deposits, accrued interest and marketable securities held to meet the Company's future obligations on non risk transfer business.

| | 2010 | | 2009 | |
|---|---|---|---|---|
| | Carrying value | Fair value | Carrying value | Fair value |
| Cash | $ 1,484,862 | $ 1,484,862 | $ 1,178,851 | $ 1,178,851 |
| Accrued interest | 306,999 | 306,999 | 366,397 | 366,397 |
| Marketable securities | 8,851,839 | 8,851,839 | 9,372,613 | 9,372,613 |
| Fixed deposits | 38,328,160 | 40,660,516 | 39,758,387 | 40,142,480 |
| | $ 48,971,860 | $ 51,304,216 | $ 50,676,248 | $ 51,060,341 |

The total deposit asset balance of $48,971,860 (2009 - $50,676,248) comprises amounts due within one year (current) and amounts due after one year through 5 years (deferred) as follows:

| | 2010 | 2009 |
|---|---|---|
| Current balances | $ 38,725,164 | $ 31,345,694 |
| Deferred balances | 10,246,696 | 19,330,554 |
| | $ 48,971,860 | $ 50,676,248 |

The estimated fair value at December 31, 2010 of $51,304,216 (2009 - $51,060,341) represents management's best estimate using all available information to the report date.

7. **Deposit liabilities**

Deposit liabilities represent loss reserves due to insureds and LOC fees due to banks on the Company's non risk transfer business. The total balance of $48,971,860 (2009 - $50,676,248) comprises amounts due in less than one year (current) and amounts due after one year through 5 years (deferred) as follows:

| | 2010 | 2009 |
|---|---|---|
| Current balances | $ 38,700,151 | $ 31,348,863 |
| Deferred balances | 10,271,709 | 19,327,385 |
| | $ 48,971,860 | $ 50,676,248 |

*(Expressed in United States Dollars)*

7. **Deposit liabilities** (continued)

Included in the deposit liability above are amounts aggregating $39,794,585 (2009 - $41,070,080) which are effectively recorded at their estimated net present value using discount rates ranging between 0.70% and 5.68% (2009 - 1.00% and 5.68%) which reflect the anticipated payout patterns of the losses at their ultimate expected value.

The Company's exposure under these contracts is limited to the value of the Deposit assets at any point in time.

8. **Risks relating to securities sold short**

In short selling, the Company sells borrowed securities which must, at some date, be repurchased and returned to the lender. The risk associated with this practice is that, if the market value of the securities sold short increases, the Company may realize losses upon repurchase at prices which may exceed that liability presented in the consolidated balance sheet. Further, in unusual circumstances, the Company may be unable to repurchase securities to close the short position, except at prices above those previously quoted in the market. There were no short positions open at year end, and all short positions have been covered.

9. **Property, plant and equipment**

| | Cost | Accumulated amortization | Net book value 2010 | Net book value 2009 |
|---|---|---|---|---|
| Office furnishings and equipment | $ 240,032 | $ 123,017 | $ 117,015 | $ 62,204 |

10. **Other Income**

Other income comprises:

| | 2010 | 2009 |
|---|---|---|
| Service fee income | $ 2,154,947 | $ 4,083,023 |
| Brokerage | 152,766 | 242,163 |
| Income from deposit programs | 320,210 | 275,451 |
| Interest income | 141,170 | 136,206 |
| Securities income | 188,101 | 86,612 |
| Dividend income | 632,456 | 701,194 |
| Unrealised gains | 518,957 | 1,294,311 |
| Realised gains | 44,473 | 178,095 |
| Other | 16,468 | 28,962 |
| | $ 4,169,548 | $ 7,026,017 |

11. **Capital stock**

Capital stock is comprised of the following authorized, issued and fully paid shares of the par value $1 each:

| | 2010 | 2009 |
|---|---|---|
| Common shares (20,000,000 shares in 2010 and 2009) | $ 20,000,000 | $ 20,000,000 |

12. **Related party transactions**

Included in accounts payable are advances made by affiliated companies totalling $142,831 (2009 - $155,789). Included in accounts receivable and accrued interest are advances made to the parent company and affiliates totaling $870,744 (2009 - $236,028). The advances are non-interest bearing and repayable on demand.

13. **Contingencies and commitments**

The Company is liable on reinsurance ceded to the extent that the companies to which the business is ceded do not meet their contractual obligations. In the opinion of management, no loss to the Company is expected to arise in the future as a result of reinsurance ceded. Recoveries are only due on discontinued business.

14. **Dividends**

No dividends were declared or paid in 2010 (2009 - $1,000,000).

15. **Taxation**

The Company is incorporated in Bermuda, and under current Bermuda law, is not required to pay any taxes in Bermuda on either income or capital gains. The Company has received an undertaking from the Minister of Finance in Bermuda that in the event of such taxes being imposed the Company will be exempted from taxation until the year 2016. The Company is subject to withholding tax on investment income from foreign securities.

The Company's subsidiaries that are based in the United States and the United Kingdom are subject to the tax laws of those jurisdictions and the jurisdictions in which they operate.

At December 31, 2010, the Company had recorded a tax expense of $146,409 (2009 - $2,544,313). The 2009 tax expense is a onetime tax charge for a long-term contract whereby it has been necessary to recognise the majority of anticipated taxable income in the first year of the contract for financial statement reporting purposes.

16. **Statutory requirements**

Under the Bermuda Insurance Act 1978 ("The Act"), the Company is required to prepare Statutory Financial Statements and to file a Statutory Financial Return. The Act also requires the Company to meet certain minimum capital and surplus requirements. To satisfy these requirements, the Company was required to maintain a minimum level of statutory capital and surplus of $1,000,000 at December 31, 2010 (2009 - $1,000,000). The Company's statutory capital and surplus was $21,947,021 at December 31, 2010 (2009 - $20,101,192), of which $20,000,000 is fully paid-up share capital.

Statutory capital and surplus as reported under The Act are different from shareholder's equity as determined in conformity with accounting principles generally accepted in Bermuda and Canada ("GAAP") due to certain items that are capitalized under GAAP but expensed under The Act.

The Company and its subsidiary, Citadel International Reinsurance Company Limited, are required to maintain a minimum liquidity ratio and a minimum statutory capital and surplus. This was achieved for both years.