# American Overseas Group Limited

## Consolidated Financial Statements
## For the Year Ended
## December 31, 2012

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## INDEPENDENT AUDITORS' REPORT

To the Board of Directors and Shareholders of
American Overseas Group Limited

We have audited the accompanying consolidated financial statements of American Overseas Group Limited (the "Company"), which comprise the consolidated balance sheets as of December 31, 2012 and 2011, and the related consolidated statements of operations, comprehensive income, equity and cash flows for the years then ended, and the related notes to the financial statements.

### Management's Responsibility for the Financial Statements

Management is responsible for the preparation and fair presentation of these financial statements in accordance with accounting principles generally accepted in the United States of America; this includes the design, implementation, and maintenance of internal control relevant to the preparation and fair presentation of financial statements that are free from material misstatement, whether due to fraud or error.

### Auditors' Responsibility

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 financial statements are free from material misstatement.

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the financial statements. The procedures selected depend on the auditor's judgment, including the assessment of the risks of material misstatement of the financial statements, whether due to fraud or error. In making those risk assessments, the auditor considers internal control relevant to the Company's preparation and fair presentation of the financial statements in order to design 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. Accordingly, we express no such opinion. An audit also includes evaluating the appropriateness of accounting policies used and the reasonableness of significant accounting estimates made by management, as well as evaluating the overall presentation of the financial statements.

We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our audit opinion.

### Opinion

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of American Overseas Group Limited as of December 31, 2012 and 2011, and the results of their operations and their cash flows for the years then ended in accordance with accounting principles generally accepted in the United States of America.

Deloitte & Touche Ltd.

May 1, 2013

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**American Overseas Group Limited**
**Consolidated Balance Sheets**
**December 31, 2012 and 2011**

| | 2012 | 2011 |
|---|---|---|
| **ASSETS** | | |
| Investments: Fixed-maturity securities held as available for sale, at fair value (amortized cost 2012: $154,334,126; 2011: $246,914,146) | $ 165,758,285 | $ 259,809,019 |
| Short term investments, at fair value | - | 14,999,875 |
| Cash and cash equivalents | 36,317,205 | 13,253,185 |
| Restricted cash | 45,138,700 | 49,428,723 |
| Accrued investment income | 1,189,414 | 1,593,075 |
| Reinsurance balances receivable, net | 11,561,369 | 13,505,088 |
| Funds withheld | 1,533,086 | — |
| Recoverables on paid losses | 6,686,859 | 6,157,961 |
| Deferred policy acquisition costs | 28,775,647 | 41,889,959 |
| Deferred expenses | 345,740 | 433,310 |
| Other assets | 90,240 | 153,197 |
| **Total assets** | **$ 297,396,545** | **$ 401,223,392** |
| **LIABILITIES AND EQUITY** | | |
| Liabilities: | | |
| Losses and loss expense reserve | $ 22,246,663 | $ 80,997,653 |
| Unearned premiums | 72,538,525 | 110,187,189 |
| Accounts payable and accrued liabilities | 698,507 | 1,121,133 |
| Derivative liabilities | 65,213,710 | 48,303,395 |
| Redeemable Series A preference shares | 59,700,000 | 59,700,000 |
| **Total liabilities** | **220,397,405** | **300,309,370** |
| Commitments and contingencies (See Note 13) | | |
| Shareholders' equity: | | |
| Common shares | 2,676,608 | 2,643,116 |
| Additional paid-in capital | 231,891,122 | 231,467,675 |
| Accumulated other comprehensive income | 11,424,159 | 12,894,873 |
| Retained deficit | (176,003,604) | (153,102,497) |
| **Total shareholders' equity** | **69,988,285** | **93,903,167** |
| Noncontrolling interest | 7,010,855 | 7,010,855 |
| **Total equity** | **76,999,140** | **100,914,022** |
| **Total liabilities and equity** | **$ 297,396,545** | **$ 401,223,392** |



See Accompanying Notes to Consolidated Financial Statements.

**American Overseas Group Limited**
**Consolidated Statements of Operations**

| | Years Ended December 31, | |
|---|---|---|
| | **2012** | **2011** |
| **Revenues:** | | |
| Net premiums earned | $ 21,508,357 | $ 15,836,520 |
| | | |
| Change in fair value of credit derivatives: | | |
| Realized gains and other settlements | 2,271,133 | 1,439,138 |
| Unrealized (losses) gains | (17,073,245) | 15,595,809 |
| Net change in fair value of credit derivatives | (14,802,112) | 17,034,947 |
| | | |
| Net investment income | 6,946,061 | 9,266,257 |
| Net realized gains on sale of investments | 737,056 | 2,348,088 |
| | | |
| Total other-than-temporary impairment losses | — | — |
| Portion of impairment losses recognized in other comprehensive (loss) income | — | — |
| Net other-than-temporary impairment losses recognized in earnings | — | — |
| | | |
| Foreign currency gains (losses) | 65,711 | (8,815) |
| **Total revenues** | **14,455,073** | **44,476,997** |
| | | |
| **Expenses:** | | |
| Loss and loss adjustment expenses | 22,051,678 | 26,030,673 |
| Acquisition expenses | 9,114,130 | 10,712,002 |
| Operating expenses | 6,190,372 | 6,835,834 |
| **Total expenses** | **37,356,180** | **43,578,509** |
| | | |
| **Net (loss) income available to common shareholders** | **$ (22,901,107)** | **$ 898,488** |
| | | |
| Net (loss) income per common share: | | |
| Basic | $ (8.60) | $ 0.34 |
| Diluted | $ (8.58) | $ 0.34 |
| Weighted-average number of common shares outstanding: | | |
| Basic | 2,662,318 | 2,642,136 |
| Diluted | 2,669,674 | 2,647,818 |

See Accompanying Notes to Consolidated Financial Statements.

**American Overseas Group Limited**
**Consolidated Statements of Comprehensive (Loss) Income**

| | Years Ended December 31, | |
|---|---|---|
| | **2012** | **2011** |
| **Net (loss) income** | $ (22,901,107) | $ 898,488 |
| **Other comprehensive (loss) income** | | |
| Change in unrealized fair value of investments | (733,658) | 4,429,643 |
| Less: Reclassification adjustment for net realized gains included in net income | (737,056) | (2,348,088) |
| Less: Net other-than-temporary impairment losses recognized in earnings | — | — |
| Portion of impairment losses recognized in other comprehensive income | — | — |
| Other comprehensive (loss) income | (1,470,714) | 2,081,555 |
| **Comprehensive (loss) income available to common shareholders** | **$ (24,371,821)** | **$ 2,980,043** |



See Accompanying Notes to Consolidated Financial Statements.

**American Overseas Group Limited**
**Consolidated Statements of Equity and Retained Deficit**

| | Share capital | Noncontrolling interest | Additional paid-in capital | Accumulated other comprehensive income | Retained deficit | Total |
|---|---|---|---|---|---|---|
| Balance, January 1, 2011 | $ 2,639,456 | $ 7,010,855 | $ 231,339,583 | $ 10,813,318 | $ (154,000,985) | $ 97,802,227 |
| Share issuance | 3,660 | — | (3,660) | — | — | — |
| Share based compensation | — | — | 131,752 | — | — | 131,752 |
| Net income | — | — | — | — | 898,488 | 898,488 |
| Net change in unrealized gains and losses on available-for-sale securities | — | — | — | 2,081,555 | — | 2,081,555 |
| Balance, December 31, 2011 | $ 2,643,116 | $ 7,010,855 | $ 231,467,675 | $ 12,894,873 | $ (153,102,497) | $ 100,914,022 |
| Share issuance | 33,492 | — | (33,492) | — | — | — |
| Share based compensation | — | — | 456,939 | — | — | 456,939 |
| Net loss | — | — | — | — | (22,901,107) | (22,901,107) |
| Net change in unrealized gains and losses on available-for-sale securities | — | — | — | (1,470,714) | — | (1,470,714) |
| Balance, December 31, 2012 | $ 2,676,608 | $ 7,010,855 | $ 231,891,122 | $ 11,424,159 | $ (176,003,604) | $ 76,999,140 |

See Accompanying Notes to Consolidated Financial Statements.

**American Overseas Group Limited**
**Consolidated Statements of Cash Flows**

| | 2012 | 2011 |
|---|---|---|
| Cash flows from operating activities: | | |
| Net (loss) income for the year | $ (22,901,107) | $ 898,488 |
| Adjustments to reconcile net income to net cash used in operating activities: | | |
| Net realized gains on sale of investments | (737,056) | (2,348,088) |
| Foreign currency (gains) losses on revaluation | (197,903) | 11,115 |
| Net unrealized losses (gains) on credit derivatives | 17,073,245 | (15,595,809) |
| Amortization of deferred expenses and depreciation | 106,888 | 106,888 |
| Amortization of bond premium and discount | 673,924 | 610,541 |
| Share based compensation | 456,939 | 131,752 |
| Changes in assets and liabilities: | | |
| Accrued investment income | 403,660 | 224,740 |
| Reinsurance balances receivable, net | 2,141,622 | 4,143,112 |
| Funds withheld | (1,533,086) | — |
| Recoverables on paid losses | (528,898) | 13,073,313 |
| Deferred policy acquisition costs | 13,114,312 | 12,980,368 |
| Other assets | 56,850 | 20,098 |
| Losses and loss adjustment expense reserve | (58,750,990) | 28,586,027 |
| Unearned premiums | (37,648,664) | (23,479,003) |
| Derivative liabilities | (162,930) | 374,373 |
| Accounts payable and accrued liabilities | (422,626) | (127,039) |
| **Net cash (used in) provided by operating activities** | **(88,855,820)** | **19,610,876** |
| | | |
| Cash flows from investing activities: | | |
| Purchases of investments | (52,735,906) | (39,938,438) |
| Proceeds from sales of investments | 53,838,924 | 38,017,156 |
| Proceeds on maturities of investments | 91,535,152 | 37,551,681 |
| Net sales (purchases) of short term investments | 15,004,857 | (14,999,810) |
| Net change in restricted cash | 4,290,023 | (32,706,475) |
| Purchases of fixed assets | (13,210) | — |
| **Net cash provided by (used in) investing activities** | **111,919,840** | **(12,075,886)** |
| | | |
| **Net increase in cash and cash equivalents** | **23,064,020** | **7,534,990** |
| Cash and cash equivalents – Beginning of year | 13,253,185 | 5,718,195 |
| **Cash and cash equivalents – End of year** | **$ 36,317,205** | **$ 13,253,185** |



See Accompanying Notes to Consolidated Financial Statements.

## 1 BACKGROUND

American Overseas Group Limited, formerly RAM Holdings Ltd. ("AOG"), and American Overseas Reinsurance Company Limited, formerly RAM Reinsurance Company Ltd. ("AORE" or the "Operating Subsidiary" and, together with AOG, the "Company", "we", "us" or "our"), were incorporated on January 28, 1998, under the laws of Bermuda.

On May 2, 2006, AOG completed an initial public offering ("IPO"), and AOG's common shares were thereafter traded on the NASDAQ Global Market. Effective May 14, 2009, AOG's common shares were voluntarily delisted from the NASDAQ Global Market and thereafter trade on the Pink Sheets. In addition, AOG obtained a primary listing on the Bermuda Stock Exchange effective May 14, 2009.

On December 7, 2012, AORE re-domesticated to Barbados after receiving approval of the Barbados Financial Services Commission (the "Barbados FSC") for licensing of AORE as an Exempt Insurance Company in accordance with the provisions of the Barbados Exempt Insurance Act 1983. Prior to the re-domestication, AORE received confirmation of a no objection from the Bermuda Monetary Authority's Insurance Division in accordance with the Insurance Act 1978 and filed a notice of discontinuance under the Companies Act 1981 which was approved by the Bermuda Minister of Finance.

AORE is now a Barbados-domiciled company the principal activity of which is the reinsurance of financial guarantees of public finance and structured finance debt obligations insured by monoline financial guaranty companies (the "primary insurers" or the "primaries"). We refer to the primaries that reinsured with AORE as "ceding companies". AORE has provided reinsurance through treaty and facultative agreements that it maintains with each of its remaining ceding companies. Financial guaranty reinsurance written by AORE generally reinsure the ceding company's guarantees of scheduled principal and interest payments on an issuer's obligation in accordance with the obligation's original payment schedule and, in rare circumstances, such amounts are payable on an accelerated basis. AORE no longer writes new financial guaranty business. In 2012, AORE commenced writing short tail non-catastrophic property/casualty reinsurance.

### Business strategy

The unprecedented deterioration in the U.S. housing market which began during the latter half of 2007 and the resulting lack of liquidity in the capital markets had a substantial adverse impact on the financial guaranty industry generally and the Company in particular. As a result of these adverse developments and the downgrades and subsequent withdrawal of AORE's ratings by Standard & Poor's Ratings Services ("S&P") and by Moody's Investors Service ("Moody's"), AORE has not renewed its reinsurance treaties with the primaries or written any new financial guaranty business since 2009.

In response to the economic and rating events referenced above, the Company continued its efforts through 2012, which it began in 2008, to reduce the volatility of its insured portfolio, to reduce its insured risk exposure, to preserve its capital position, to deleverage its balance sheet and to reduce its expenses. Since 2008, the Company has commuted a significant portion of its insured portfolio, including exposures in troubled sectors such as US residential mortgage-backed securities ("RMBS"), asset-backed collateralized debt obligations ("CDOs") backed by RMBS and CDOs backed by commercial mortgage-backed securities ("CMBS"). In addition, the Company has significantly reduced its operating expenses.

At the present time, the Company does not intend to reenter the financial guaranty market. The Company has sought to enhance shareholder value by re-activating AORE in a way that produces incremental cash flow and earnings. In this regard the Barbados FSC has approved AORE's business plan to begin writing property/casualty reinsurance while continuing to run-off its existing financial guaranty reinsurance portfolio.

There can be no assurance that the strategies that have been implemented or that will be pursued in the future will improve the Company's business, financial condition, liquidity or results of operations or will not have a material adverse effect on the Company. Management believes that the Company has sufficient capital resources and liquidity to meet its obligations for at least the next twelve months and therefore that the Company remains a "going concern". See Note 19 – Risks and Uncertainties, for a discussion of the Company's risks and uncertainties and liquidity.

The Company has not renewed financial guaranty reinsurance treaties with any of the primaries in 2011 or 2012 and does not intend to write any new financial guaranty business. This does not reduce our in-force business, unless the business is run off, commuted or recaptured by the primaries. The Company is not competing in the financial guaranty reinsurance market.

## 2 SIGNIFICANT ACCOUNTING POLICIES

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

### (a) Basis of preparation

The consolidated financial statements have been prepared in accordance with accounting principles generally accepted in the United States of America ("US GAAP"). The preparation of financial statements in accordance with generally accepted accounting principles requires management to make estimates and assumptions that affect the amounts reported in the consolidated financial statements and the accompanying notes. Actual results could differ materially from those estimates.

### (b) Basis of consolidation

The consolidated accounts of AOG include those of its subsidiary, AORE. All significant intercompany balances have been eliminated on consolidation.

### (c) Cash and cash equivalents

The Company considers all highly liquid investments, including fixed-interest and money market fund deposits, with a maturity of 90 days or less when purchased, as cash equivalents. Cash equivalents are carried at cost which approximates fair value.

### (d) Investments

The Company has classified its fixed-maturity investments as available-for-sale. Available-for-sale investments are carried at fair value, with unrealized appreciation or depreciation reported as a separate component of accumulated other comprehensive income. The Company's fair values of fixed-maturity and short-term investments are based on prices obtained from nationally recognized independent pricing services. All investment transactions are recorded on a trade date basis. Realized gains and losses on sales of fixed-maturity investments are determined on the basis of amortized cost. Gains and losses on sale of investments are included in "net realized gains on sale of investments" when realized. The cost of securities sold is determined using the specific identification method. Short-term investments are carried at amortized cost, which approximates fair value, and include all securities with maturities of greater than 90 days but less than one year at time of purchase. The Company's investment guidelines require the orderly sale of securities that do not meet investment guidelines due to a downgrade by rating agencies or other circumstances, unless otherwise authorized by management to hold.

**Other-than-temporary Impairments on Investments**

The Company reviews its investment portfolio no less than quarterly in order to determine whether an other-than-temporary impairment ("OTTI") of its fixed-maturity investments classified as available-for-

sale exists. An impairment is considered to be other-than-temporary if the Company (i) intends to sell the security, (ii) more likely than not will be required to sell the security before recovering its cost, or (iii) does not expect to recover the security's entire amortized cost basis (even if the Company does not intend to sell). A "credit loss" is recognized when the present value of cash flows expected to be collected from the fixed-maturity investment is less than the amortized cost basis of the security. If there is an intent to sell the impaired security or it is more likely than not that the Company will be required to sell the security before recovering its cost, then the entire difference between amortized cost and the security's fair value is recognized as an OTTI charge in earnings in the period. If there is no intent to sell the impaired security and it is not more likely than not that the Company will be required to sell the security before recouping its cost but there is a credit loss, then the credit loss portion of the unrealized loss is recognized in earnings with the remainder recognized in other comprehensive income.

Factors considered when assessing impairment include: (i) securities whose market values have declined by 20% or more below amortized cost for a continuous period of at least six months; (ii) credit downgrades by rating agencies; (iii) the financial condition of the issuer; (iv) whether scheduled interest payments are past due; and (v) whether the Company has an intent to sell the security.

(e) **Premium revenue recognition**

The Company recognizes a liability for unearned premium revenue at the inception of a financial guaranty insurance contract equal to the present value of the premiums due or expected to be collected over the period of the contract. If the premium is a single amount received at the inception of the contract (i.e. an upfront premium), then the Company records the unearned premium revenue as the amount received. Where premiums are received in installments over the term of the contract then the Company records the unearned premium revenue and a receivable for future premiums as the present value of premiums expected to be collected over the contract period, using a risk free discount rate. The period of a financial guaranty insurance contract is the expected period of risk, which generally equates to the contract period. However, in some instances, the expected period of risk is significantly shorter than the full contract period due to expected prepayments. The expected period of a contract is only used to determine the present value of unearned premium revenue and receivable for future premiums where (i) the financial guaranty contract insures a homogeneous pool of assets that are contractually prepayable, (ii) prepayments are probable and (iii) the amount and timing of prepayments are reasonably estimable. The Company records the accretion of the discount on installment premiums receivable as premium revenue and discloses the amount recognized in Note 5 – Financial Guaranty Contracts Accounted for as Reinsurance.

The Company recognizes financial guaranty reinsurance contract revenue over the period of the contract in proportion to the amount of insurance protection provided. As premium revenue is recognized, a corresponding adjustment to decrease unearned premium revenue occurs. The amount of insurance protection provided is a function of the insured principal amount outstanding. The premium revenue for each period is therefore determined by applying a constant rate to the insured principal amount outstanding for the period. The constant rate for each financial guaranty policy is determined by the ratio of (a) the total present value of the premium collected or expected to be collected over the period of the contract, to (b) the sum of all insured principal amounts outstanding during each reporting period over the period of the contract. When the financial obligation is retired prior to its scheduled maturity, the financial guaranty insurance contract on the retired financial obligation is extinguished (referred to as a refunding). The Company immediately recognizes any nonrefundable unearned premium revenue related to that contract as premium revenue in the period the contract is extinguished and any associated acquisition costs previously deferred as an expense.

The Company earns property casualty reinsurance premium revenue over the terms of the related reinsurance policies. Unearned premiums represent the unexpired portion of premiums written. Such reserves are computed by pro rata methods and are based on reports received from ceding companies for reinsurance.

(f) **Deferred policy acquisition costs**

Deferred policy acquisition costs comprise those expenses that vary with and are primarily related to the production of business, including ceding commissions paid on reinsurance assumed. They also include a portion of salaries and related costs of underwriting personnel, and certain other underwriting expenses which are essential to a contract transaction and would not have been incurred by the Company had the transaction not occurred. During 2012 and 2011, for financial guaranty reinsurance, no such costs were deferred as no new business was written. During 2012, policy acquisition costs of $0.5 million were deferred with respect to property/casualty reinsurance.

Policy acquisition costs related to financial guaranty insurance contracts are deferred and amortized over the period in which the related premiums are earned. Policy acquisition costs related to financial guaranty contracts written in derivative form are expensed as incurred. Where ceding commissions are paid in installments over the term of the contract, the Company records the deferred acquisition costs and a payable for future ceding commissions as the present value of ceding commissions expected to be paid over the contract period, using a risk free discount rate. The payable on ceding commissions is included within "reinsurance balances receivable, net" on the Consolidated Balance Sheets. Total deferred policy acquisition costs related to financial guaranty reinsurance amortized during 2012 and 2011 were $8.7 million and $10.5 million, respectively.

When assessing the recoverability of deferred policy acquisition costs, the Company considers the future earnings of premiums and anticipated investment income and compares this to the sum of unamortized policy acquisition costs and expected loss and loss adjustment expenses. This comparison is completed by underwriting year and risk type. If a deficiency were calculated, the unamortized acquisition costs would be reduced by a charge to expense. During 2012 and 2011, the Company wrote off $0.1 million and $3.8 million of deferred acquisition costs, respectively, as a result of this assessment.

Commissions and other costs incurred with respect to property/casualty reinsurance are deferred and amortized over the terms of the contracts of reinsurance to which they relate. Losses and expenses expected to be incurred as premiums are earned and anticipated investment income are considered in determining the recoverability or deficiency of deferred acquisition costs. If it is determined that deferred acquisition costs are not recoverable, they are expensed.

(g) **Losses and loss adjustment expenses**

The Company establishes loss reserves based on a review of reserving practices, reported reserves, surveillance reports and other data provided by its ceding companies. In addition, the Company augments the ceding company information with its own research, analysis and modeling.

The Company recognizes a claim liability on a financial guaranty insurance contract (excluding those written in derivative form) when the Company estimates that the present value of expected net cash outflows to be paid under the insurance contract will exceed the unearned premium revenue for that contract. The present value of expected net cash outflows is discounted using a current risk free rate based on the remaining period (contractual or expected as applicable) of the insurance contract. Expected net cash outflows are probability weighted cash flows that reflect the likelihood of possible outcomes, based on all information available to the Company.

The Company updates the discount rate each reporting period and revises expected net cash outflows when increases or decreases in the likelihood of a default and potential recoveries occurs. The discount of the loss and loss expense reserve is accreted through earnings and included in losses and loss adjustment expenses. Changes to the estimate of loss and loss adjustment expenses reserve after initial recognition are recognized in "loss and loss adjustment expenses" in the Consolidated Statements of Operations in the period of the change.

The Company reviews the portfolio on a continuous basis to identify problem credits. Quarterly, the Company's Management Committee reviews reserves. Management establishes reserves that it believes

are adequate to cover the present value of the ultimate liability for claims. The reserves are based on estimates and are substantially dependent on the surveillance activities and reserving policies of the Company's ceding companies and may vary materially from actual results. Adjustments based on actual loss experience are recorded in the Consolidated Statements of Operations in the periods in which they become known.

For property/casualty reinsurance, unpaid losses and loss adjustment expenses include an amount determined from individual case estimates based on reports received from ceding companies for reinsurance ("case-basis loss reserves"), and an amount for losses incurred but not reported. Such liabilities are necessarily based on assumptions and estimates and while management believes the amount is adequate, the ultimate liability may be in excess of or less than the amount provided. The methods for making such estimates and for establishing the resulting liabilities are continually reviewed and adjustments are reflected in the period determined.

(h) **Derivative instruments**

The Company has entered into agreements to reinsure derivative instruments, consisting primarily of credit default swaps that it intends to reinsure for the full term of the contract. While management considers these agreements to be a normal extension of its financial guaranty reinsurance business and reinsurance in substance, certain of these contracts meet the definition of a derivative under Accounting Standards Codification ("ASC") 815 "Derivatives and hedging" ("ASC 815"). ASC 815 establishes accounting and reporting standards for derivative instruments, and requires the Company to recognize the derivative instruments on the Consolidated Balance Sheets at their fair value, under "Derivative assets or liabilities", as applicable, with changes in fair value recognized in earnings. Changes in fair value are recorded in "Net change in fair value of credit derivatives" on the Consolidated Statements of Operations. The "Realized gains (losses) and other settlements" component of this change in fair value includes (i) net premiums earned on credit derivative policies, including current premiums receivable on assumed credit derivative polices, net of ceding commissions, and (ii) loss payments to the reinsured including losses payable upon the occurrence of a credit event. The "Unrealized gains (losses)" component of the "Net change in fair value of credit derivatives" includes all other changes in fair value, including changes in instrument specific credit spreads and reduction in fair values due to commutation of credit derivative policies.

Management uses, as a key input to the estimation of the fair value of our derivatives, the mark–to-market valuation information provided to us by our ceding companies ("the mark"). The Company participates in credit default swaps through a reinsurance treaty with a ceding company and therefore the contract to be valued is a reinsurance contract on a derivative. This contract is not identical to the underlying credit default swaps. In particular, although the Company's contract allows it to share in the economic results of the underlying contracts, it does not provide rights to the same information to which the ceding companies have access. Under ASC 820, "Fair value measurements and disclosures" ("ASC 820"), the fair value of the Company's contract represents the exit price that would be paid to a market participant to assume the reinsurance contract as written; that is, the amount the market participant would require to assume the Company's potential obligations under the contract with the same contractual rights and obligations, including those which limit the information about the ceding companies' underlying contracts that are being reinsured. Given the contractual terms that exist, the Company believes that an exit market participant would look to the information that is available from the ceding companies to determine the exit value of the Company's reinsurance contract. The primary insurers underwrite each of the transactions underlying the reinsurance contract and they have access to all the underlying data related to the transactions. The ceding companies use their own internal valuation models where market prices are not available. The Company employs procedures to test the reasonableness of the mark both in process and absolute terms because we believe that an exit market participant would perform similar procedures when determining an exit price for our reinsurance contract. If it appears that the fair values generated by the ceding companies internal models and reported to the Company are consistent with macro spread movements and general market trends, and the Company believes that the modeling and assumptions that drive the modeling are reasonable (based on the Company's ceding company reviews and review of publicly available information), the Company will use the mark provided by the ceding company as a key input in the determination of the fair value of the reinsurance contract. There is no single accepted model

for fair valuing credit default swaps and there is generally not an active market for the type of credit default swaps insured by ceding companies and reinsured by us. Therefore, due to the limited availability of quoted market prices for these derivative contracts and the inherent uncertainties in the assumptions used in models, different valuation models may produce materially different results and be materially different from actual experience. In addition, due to the complexity of fair value accounting in particular on accounting for derivatives, future amendments or interpretations of these standards may cause us to modify our accounting methodology in a manner which may have an adverse impact on our financial results.

The use of valuation information provided to us by our ceding companies remains appropriate for the reasons described above, as well as the fact that the credit default swaps we reinsure are the same as those valued by our primaries, and the Company views its hypothetical principal market to be the same as that of our primaries, being the financial guaranty insurance and reinsurance market. The Company's fair value on credit derivatives is adjusted for the Company's own non-performance risk in accordance with ASC 820.

**(i) Fair Value Measurements**

ASC 820 provides guidance for fair value measurement of assets and liabilities and associated disclosures about fair value measurement. Under this standard, the definition of fair value focuses on the price that would be received to sell the asset or paid to transfer the liability (an exit price), not the price that would be paid to acquire the asset or received to assume the liability (an entry price). ASC 820 clarifies that fair value is a market-based measurement, not an entity-specific measurement. ASC 820 establishes a fair value hierarchy of inputs in measuring fair value, with the highest level being observable inputs and the lowest being unobservable data as follows:

Level 1 inputs – valuations based on quoted prices in active markets for identical assets or liabilities. Valuations in this level do not entail a significant degree of judgment.

Level 2 inputs – valuations based on quoted prices for similar assets or liabilities in active markets, quoted prices for identical or similar assets or liabilities in markets that are not active and model derived valuations where all significant inputs are observable in active markets.

Level 3 inputs – valuations based on significant inputs that are unobservable.

Disclosures relating to fair value measurements are included in Note 6 – Financial Guaranty Contracts Accounted for as Credit Derivatives and Note 7 – Fair Value of Financial Instruments.

**(j) Recent accounting pronouncements**

Recently adopted accounting pronouncements:

In October 2010, the Financial Accounting Standards Board ("FASB") issued Accounting Standards Update ("ASU") 2010-26, "Financial Services – Insurance (Topic 944)—Accounting for Costs Associated with Acquiring or Renewing Insurance Contracts." This amendment addresses which costs incurred in the acquisition of new and renewal insurance contracts should be capitalized. The Company adopted this guidance on January 1, 2012 on a prospective basis. This adoption did not impact the financial guaranty business as we have not renewed any reinsurance treaties with the primaries or written any new financial guaranty business since 2009. In addition there was no effect on our property/casualty business as acquisition costs have been deferred from inception in accordance with this guidance. There is no change to the amortization requirements due to this update. We deferred $2.2 million of policy acquisition costs in our property casualty business in 2012. We amortized $1.5 million of deferred policy acquisition costs on this business in 2012.

In May 2011, the FASB issued ASU 2011-04, "Fair Value Measurement (Topic 820)—Amendments to Achieve Common Fair Value Measurement and Disclosure Requirements in U.S. GAAP and IFRSs". This amendment results in a consistent definition of fair value and common requirements for measurement of and disclosure about fair value between US GAAP and International Financial Reporting Standards. The

Company adopted this guidance from January 1, 2012; however, it impacted disclosure only and did not have an impact on the Company's consolidated balance sheets, statements of operations or cash flows. See Note 7 – Fair Value of Financial Instruments for these updated disclosures.

Other recent accounting pronouncements:

In December 2011, the FASB issued ASU 2011-11, "Balance Sheet (Topic 210)—Disclosures about Offsetting Assets and Liabilities" ("ASU 2011-11"). ASU 2011-11 creates new disclosure requirements about the nature of the Company's rights of setoff and related arrangements associated with its financial instruments and derivative instruments. The disclosure requirements are effective for the Company beginning in the first quarter of 2013. In January 2013, the FASB issued ASU 2013-01, "Balance Sheet (Topic 210)-Clarifying the Scope of Disclosures about Offsetting Assets and Liabilities" ("ASU 2013-01"). ASU 2013-01 clarifies that these disclosures would apply only to derivatives, repurchase and reverse repurchase agreements, and securities borrowing and securities lending transactions, each to the extent that they met one of the two conditions provided in the initial accounting standard. This guidance is effective on January 1, 2013, with retrospective presentation of the new disclosures required. This standard will only affect the Company's disclosures and will not affect the Company's consolidated balance sheets, results of operations, or cash flows.

In June 2011, the FASB issued ASU 2011-05, "Comprehensive Income (Topic 220)—Presentation of Comprehensive Income" ("ASU 2011-05"). This amendment eliminates the option to report other comprehensive income and its components in the statements of changes in equity. The amendment does not change what constitutes net income and other comprehensive income. The entity is also required to present, on the face of the consolidated financial statements, reclassification adjustments for items that are reclassified from other comprehensive income to net income in the statement(s) in which the components of net income and the components of other comprehensive income are presented. In December 2011, the FASB issued ASU 2011-12 "Comprehensive Income (Topic 220)—Deferral of the Effective Date for Amendments to the Presentation of Reclassifications of Items Out of Accumulated Other Comprehensive Income in Accounting Standards Update No. 2011-05," which defers certain aspects of ASU 2011-05 related to the presentation of reclassification adjustments. The Company adopted the guidance from January 1, 2012; however, it did not have an impact on the Company's disclosure, financial condition or results of operations or cash flows. In February 2013, the FASB issued ASU 2013-02, "Comprehensive Income (Topic 220)-Reporting of Amounts Reclassified Out of Accumulated Other Comprehensive Income" ("ASU 2013-02"). ASU 2013-02 requires an entity to provide information about the amounts reclassified out of accumulated other comprehensive income by component. This guidance does not change the requirements for reporting net income or other comprehensive income in financial statements. These amendments are effective prospectively from January 1, 2013. As this guidance is disclosure-related only, its adoption will not impact the Company's consolidated balance sheets, results of operations, or cash flows.

(k) **Reclassifications**

Certain reclassifications have been made to the prior period amounts to conform to the current period's presentation.

## 3 PLEDGED ASSETS

As of December 31, 2012, and 2011, the Company had restricted cash of \$45.1 million and \$49.4 million, respectively, and investments at fair value of \$99.0 million and \$207.5 million, respectively, in trust and escrow accounts for the benefit of ceding companies. Pursuant to the terms of the reinsurance agreements with ceding companies regulated in the United States, the Company is required to secure its obligations to these ceding companies in accordance with applicable state statutes governing credit for reinsurance, and may not withdraw funds from these trust accounts without the ceding companies' express permission. The trust accounts are required to hold cash and investments equivalent to unearned premiums, case-basis and incurred but not reported loss

reserves, credit impairments (a non GAAP measure representing losses expected to be paid on insured credit derivative policies), and a contingency reserve calculated by the ceding companies. Management reviews these balances for reasonableness quarterly.

## 4 INVESTMENTS

The amortized cost, gross unrealized gains, gross unrealized losses, OTTI and estimated fair value recorded in accumulated other comprehensive income of the Company's available for sale investments at December 31, 2012 and 2011, were as follows:

| | | Included in Accumulated Other Comprehensive income ("AOCI") | | | |
|---|---|---|---|---|---|
| | | | Gross Unrealized Losses | | |
| | **Amortized Cost** | **Gross Unrealized Gains** | **Related to Changes in Estimated Fair Value** | **OTTI Included in Other Comprehensive Income [(1)]** | **Estimated Fair Value** |
| **2012:** | | | | | |
| **Fixed-maturity investments:** | | | | | |
| Agencies | $ 17,622,501 | $ 1,171,526 | $ — | $ — | $ 18,794,027 |
| U.S. government obligations[(2)] | 22,815,969 | 2,187,773 | — | — | 25,003,742 |
| Corporate debt securities | 35,805,735 | 2,674,467 | 1,051 | — | 38,479,151 |
| Municipal securities | 6,729,666 | 1,255,303 | — | — | 7,984,969 |
| Mortgage-backed securities: | | | | | |
| RMBS | 43,075,613 | 2,523,902 | — | 14 | 45,599,501 |
| CMBS | 11,273,359 | 1,250,443 | — | — | 12,523,802 |
| Asset -backed securities | 17,011,283 | 361,810 | — | — | 17,373,093 |
| Total fixed- maturity investments | $ 154,334,126 | $ 11,425,224 | $ 1,051 | $ 14 | $ 165,758,285 |
| Short term investments | — | — | — | — | — |
| **Total investment portfolio** | **$ 154,334,126** | **$ 11,425,224** | **$ 1,051** | **$ 14** | **$ 165,758,285** |

| | Amortized Cost | Included in Accumulated Other Comprehensive income ("AOCI") — Gross Unrealized Gains | Gross Unrealized Losses — Related to Changes in Estimated Fair Value | Gross Unrealized Losses — OTTI Included in Other Comprehensive Income (1) | Estimated Fair Value |
|---|---|---|---|---|---|
| **2011:** | | | | | |
| **Fixed-maturity investments:** | | | | | |
| Agencies | $ 20,579,226 | $ 1,788,345 | $ — | $ — | $ 22,367,571 |
| U.S. government obligations[2] | 87,925,883 | 2,865,839 | — | — | 90,791,722 |
| Corporate debt securities | 36,845,679 | 2,502,560 | 382,240 | — | 38,965,999 |
| Municipal securities | 6,729,842 | 1,057,919 | — | — | 7,787,761 |
| Mortgage-backed securities: | | | | | |
| RMBS | 72,956,393 | 3,377,380 | — | 10,910 | 76,322,863 |
| CMBS | 13,758,509 | 1,204,047 | 3,002 | — | 14,959,554 |
| Asset-backed securities | 8,118,614 | 494,935 | — | — | 8,613,549 |
| Total fixed-maturity investments | $ 246,914,146 | 13,291,025 | 385,242 | 10,910 | 259,809,019 |
| Short term investments | 14,999,875 | — | — | — | 14,999,875 |
| **Total investment portfolio** | **$ 261,914,021** | **$ 13,291,025** | **$ 385,242** | **$ 10,910** | **$ 274,808,894** |

(1) Represents the amount of OTTI losses in accumulated other comprehensive income ("AOCI"), since adoption of the accounting guidance for OTTI.

(2) Including US Government temporary liquidity guarantee program securities.

The Company did not have an aggregate investment in a single entity, other than U.S. Treasury securities, in excess of 10% of total investments at December 31, 2012 and 2011. The Company had no material investments in securities guaranteed by third parties and had no direct investments in financial guarantors as at December 31, 2012 and 2011.

The amortized cost and estimated fair value of fixed-maturity securities classified as available-for–sale, as of December 31, 2012 and 2011, by contractual maturity, are shown below. Expected maturities differ from contractual maturities because borrowers may have the right to call or repay obligations with or without call or prepayment penalties.

| | December 31, 2012 | | December 31, 2011 | |
|---|---|---|---|---|
| | Amortized Cost | Estimated Fair Value | Amortized Cost | Estimated Fair Value |
| Less than one year | $ 23,343,692 | $ 23,479,675 | $ 66,148,405 | $ 66,676,102 |
| Due after one year through five years | 36,338,618 | 39,374,456 | 54,958,540 | 57,371,843 |
| Due after five years through ten years | 14,804,287 | 16,820,920 | 20,590,881 | 23,008,224 |
| Due after ten years | 8,487,274 | 10,586,838 | 10,382,804 | 12,856,884 |
| Mortgage-backed securities: | | | | |
| RMBS | 43,075,613 | 45,599,501 | 72,956,393 | 76,322,863 |
| CMBS | 11,273,359 | 12,523,802 | 13,758,509 | 14,959,554 |
| Asset-backed securities | 17,011,283 | 17,373,093 | 8,118,614 | 8,613,549 |
| **Total** | $ 154,334,126 | $ 165,758,285 | $ 246,914,146 | $ 259,809,019 |

The investments that have unrealized loss positions as of December 31, 2012 and 2011, aggregated by investment category and the length of time they have been in a continuous unrealized loss position, are as follows:

| | Less Than 12 Months | | 12 Months or More | | Total | |
|---|---|---|---|---|---|---|
| | Fair Value | Unrealized Loss | Fair Value | Unrealized Loss | Fair Value | Unrealized Loss |
| **2012:** | | | | | | |
| **Fixed-maturity investments:** | | | | | | |
| Agencies | $ — | $ — | $ — | $ — | $ — | $ — |
| U.S. government obligations | — | — | — | — | — | — |
| Corporate debt securities | 498,880 | 1,051 | | | 498,880 | 1,051 |
| Municipal securities | — | — | — | — | — | — |
| Mortgage -backed securities: | | | | | | |
| RMBS | 98,333 | 14 | — | — | 98,333 | 14 |
| CMBS | — | — | — | — | — | — |
| Asset-backed securities | — | — | | | | — |
| Total temporarily impaired securities | $ 597,213 | $ 1,065 | $ — | $ — | $ 597,213 | $ 1,065 |

| | Less Than 12 Months | | 12 Months or More | | Total | |
|---|---|---|---|---|---|---|
| | Fair Value | Unrealized Loss | Fair Value | Unrealized Loss | Fair Value | Unrealized Loss |
| **2011:** | | | | | | |
| **Fixed-maturity investments:** | | | | | | |
| Agencies | $ — | $ — | $ — | $ — | $ — | $ — |
| U.S. government obligations | — | — | — | — | — | — |
| Corporate debt securities | 8,457,579 | 382,240 | — | — | 8,457,579 | 382,240 |
| Municipal securities | — | — | — | — | — | — |
| Mortgage -backed securities: | | | | | | |
| RMBS | — | — | 87,436 | 10,910 | 87,436 | 10,910 |
| CMBS | 3,495,228 | 3,002 | — | — | 3,495,228 | 3,002 |
| Asset-backed securities | — | — | — | — | — | — |
| Total temporarily impaired securities | $ 11,952,807 | $ 385,242 | $ 87,436 | $ 10,910 | $ 12,040,243 | $ 396,152 |

As of December 31, 2012, 2 out of 95 securities were in unrealized loss positions compared to 8 out of 122 securities as of December 31, 2011. As at December 31, 2012, the Company's gross unrealized loss position was immaterial compared to $0.4 million at December 31, 2011. The decrease in the unrealized losses as at December 31, 2012 was attributable to a decrease in the Company's fixed maturity investment portfolio and declines in interest rates. Management does not believe these investments to be other than temporarily impaired, except as noted below, and has no intention to sell the securities. Unrealized gains and losses relating to investments, excluding any credit loss portion, are currently recorded in accumulated other comprehensive income in shareholders' equity as the Company generally holds these investments to maturity. The unrealized gains and losses are expected to decrease as the investment approaches maturity and the Company expects to realize a value substantially equal to amortized cost. None of the securities has been in an unrealized loss position for 12 months or more as of December 31, 2012. Of the two securities currently in an unrealized loss position, only one security has previously had the credit portion

of the OTTI written off against earnings and the Company's analysis does not indicate any further credit loss on this security. Therefore, although the security may be other than temporarily impaired, there is no further credit loss to take to income at this time and the remaining unrealized loss on this security is recorded in AOCI.

During the years ended December 31, 2012 and 2011, the Company recognized no other than temporary impairments. There was no movement in the amount of OTTI recognized in other comprehensive income during such years and the closing balance of OTTI was $5.9 million, as of December 31, 2012 and 2011.

As of December 31, 2012 and 2011, an immaterial and $0.1 million of net unrealized gains were recorded in accumulated other comprehensive income on securities which have previously had a credit loss written off to earnings, respectively.

Proceeds from maturities and sales of investments in fixed-maturity securities available for sale during 2012 and 2011 were $145,374,076 and $75,568,837, respectively. Gross gains of $739,433 and $2,518,985 in 2012 and 2011, respectively, and gross losses of $2,377 and $170,897 in 2012 and 2011, respectively, were realized on those sales.

Major categories of net investment income are summarized as follows for the years ended December 31, 2012 and 2011:

| | 2012 | 2011 |
|---|---|---|
| Interest from fixed-maturity securities | $ 7,335,214 | $ 9,686,356 |
| Interest from cash equivalents | 11,668 | 11,917 |
| Investment expense | (400,821) | (432,016) |
| Net investment income | $ 6,946,061 | $ 9,266,257 |

## 5 FINANCIAL GUARANTY CONTRACTS ACCOUNTED FOR AS REINSURANCE

The underwriting of insured risks and the reporting of underwriting results to the Company are the responsibility of the primary insurers under the treaties. The Company does not "re-underwrite" the transactions ceded under the treaties. The Company's business model has always been that of a reinsurer in which the Company leverages and relies on the operations and reporting of the primary insurers. As a result of this model, the Company is highly dependent on the operating and reporting of the ceding companies. The ceding companies use complex financial models, which have been internally developed, to produce the earnings and run off for their financial guaranty policies in accordance with US GAAP. Management assesses the reasonableness of the ceding companies' reporting by i) discussing with primary insurers their earnings methodology, ii) reviewing the primaries' publicly available information regarding their accounting policies and methodologies, iii) comparing the primary reported information to the results of the Company's own basic model and iv) performing analytical reviews on the Company's underwriting results. Where a ceding company does not report all balances required, the Company makes estimates of the necessary information for a period based on internal models and calculations. This estimation process was not required as of December 31, 2012.

The following tables present a roll forward of the Company's premiums receivable on installment policies for the years ended December 31, 2012 and 2011:

| (dollars in thousands) | | Premiums receivable |
|---|---|---|
| Premiums receivable January 1, 2012 | $ | 22,325 |
| Add: Premiums on new policies in 2012 | | – |
| Accretion of premiums receivable discount | | 511 |
| Adjustments for changes in expected term of policies (including early terminations) | | (387) |
| Adjustments for policies commuted in the period | | (3,370) |
| Add: Foreign exchange movement | | 284 |
| Less: Premiums received | | (2,391) |
| Balance as of December 31, 2012 | $ | 16,972 |

| (dollars in thousands) | | |
|---|---|---|
| Premiums receivable January 1, 2011 | $ | 31,547 |
| Add: Premiums on new policies in 2011 | | — |
| Accretion of premiums receivable discount | | 634 |
| Adjustments for changes in expected term of policies (including early terminations) | | (503) |
| Adjustments for policies commuted in the period | | (5,897) |
| Add: Foreign exchange movement | | (10) |
| Less: Premiums received | | (3,446) |
| Balance as of December 31, 2011 | $ | 22,325 |

As of December 31, 2012 and 2011, the Company had $17.0 million and $22.3 million, respectively, of premiums receivable, which represents the present value of future expected premiums on contracts where installments are collected over the term of the policy. This amount is included within "Reinsurance balances receivable, net" on the Consolidated Balance Sheets, net of the related ceding commissions payable as of December 31, 2012 and 2011 of $7.2 million and $9.0 million, respectively. As of December 31, 2012 and 2011, $(0.7) million and $(0.2) million, respectively, of paid losses (recoverable)/due to ceding companies was netted off "Reinsurance balances receivable, net" on the Consolidated Balance Sheets where the right of offset with a ceding company exists.

AORE experienced a number of downgrades, commencing in the middle of 2008, by both Moody's and S&P. On May 19, 2009, Moody's downgraded AORE to Ba3 and, at the same time, withdrew the rating at the Company's request. On August 31, 2009, S&P downgraded AORE's financial strength rating to BB with negative outlook and, at the same time, withdrew the rating at the Company's request. As a result of these downgrades, since 2008 certain of the ceding companies have a right under some of our treaty agreements to increase the ceding commission charged to AORE on the U.S. statutory unearned premium balance, as well as premiums payable after the downgrade. This increase applies to all financial guaranty and derivative policies covered by the relevant treaties. The additional ceding commissions charged to the Company have been paid or accrued and deferred and are being expensed in proportion to the earning of the remaining unearned premium, except for credit derivative policies where they are expensed as incurred. As of December 31, 2012 and 2011, additional ceding commissions due on the present value of premiums receivable on installment policies are netted off the premiums receivable within "Reinsurance balances receivable, net".

The accretion of premiums receivable discount is included in earned premiums in the Company's consolidated statements of operations. As of December 31, 2012 and 2011, the weighted average risk-free rate used to discount the premiums receivable was 3.37% and 3.20%, respectively. The weighted average expected period of future premiums used to estimate the premiums receivable was 8.9 years and 9.5 years as of such dates, respectively. As of December 31, 2012 and 2011, the unearned premiums on these installment policies were $16.5 million and $22.7 million, respectively, and were included in "Unearned premiums" on the Consolidated Balance Sheets.

The following table presents the future amount of undiscounted premiums expected to be collected on installment policies and the period in which those collections are expected to occur. These amounts are based on the Company's estimates as of December 31, 2012, utilizing information as reported by the ceding companies, and any changes to the underlying information on insured obligations could cause actual results to be materially different from the amounts below:

| **(dollars in thousands)** | | **Premiums Expected to be collected** |
|---|---|---|
| Three months ended: | | |
| March 31, 2013 | $ | 498 |
| June 30, 2013 | | 534 |
| September 30, 2013 | | 483 |
| December 31, 2013 | | 490 |
| | | |
| Twelve months ended: | | |
| December 31, 2014 | | 1,931 |
| December 31, 2015 | | 2,522 |
| December 31, 2016 | | 1,733 |
| December 31, 2017 | | 1,580 |
| | | |
| Five years ended: | | |
| December 31, 2022 | | 6,734 |
| December 31, 2027 | | 2,883 |
| December 31, 2032 | | 1,471 |
| December 31, 2037 | | 713 |
| December 31, 2042 | | 539 |
| December 31, 2047 | | 338 |
| After 2047 | | 247 |

The following table presents the expected unearned premium revenue and the schedule of total expected future premium earnings revenue on upfront and installment policies. These amounts are based on the Company's estimates as of December 31, 2012, utilizing information as reported by the ceding companies, and any changes to the underlying information on insured obligations could cause actual results to be materially different from the amounts below:

**(dollars in thousands)**

| Three months ended: | Change in Unearned Premiums | Accretion | Total Expected Future Earned Premiums |
|---|---|---|---|
| March 31, 2013 | $ 1,562 | $ 136 | $ 1,698 |
| June 30, 2013 | 1,546 | 133 | 1,679 |
| September 30, 2013 | 1,513 | 131 | 1,644 |
| December 31, 2013 | 1,498 | 129 | 1,627 |
| | | | |
| Twelve months ended: | | | |
| December 31, 2014 | 5,818 | 486 | 6,304 |
| December 31, 2015 | 5,406 | 468 | 5,874 |
| December 31, 2016 | 5,030 | 410 | 5,440 |
| December 31, 2017 | 4,545 | 369 | 4,914 |
| | | | |
| Five years ended: | | | |
| December 31, 2022 | 20,391 | 1,518 | 21,909 |
| December 31, 2027 | 10,436 | 653 | 11,089 |
| December 31, 2032 | 6,204 | 346 | 6,550 |
| December 31, 2037 | 2,778 | 208 | 2,986 |
| December 31, 2042 | 1,360 | 132 | 1,492 |
| December 31, 2047 | 892 | 72 | 964 |
| After 2047 | 878 | 36 | 914 |

Accelerated premium revenue for refunded obligations for the years ended December 31, 2012 and 2011, was approximately $6.4 million and $4.1 million, respectively, and represents the earning of the unearned premiums associated with the unscheduled prepayment of the underlying obligations.

The estimated premiums written for the years ended December 31, 2012 and 2011, were $(24.8) million and $(7.6) million, respectively; see Note 11 – Commutations and Other Settlements for details of commutations in the period included within these numbers. Included in premiums written in 2012 and 2011 was estimated accretion of the premiums receivable of $0.5 million and $0.6 million, respectively. Accretion of the ceding commissions payable of $0.2 million and $0.2 million, respectively, was included in acquisition expenses for such years.

## 6 FINANCIAL GUARANTY CONTRACTS ACCOUNTED FOR AS CREDIT DERIVATIVES

The Company has entered into agreements to reinsure derivative instruments, consisting primarily of credit default swaps ("CDS"), that it intends to reinsure for the full term of the contract, unless commuted early in the normal course of business. While management considers these agreements to be a normal extension of its financial guaranty reinsurance business and reinsurance in substance, these transactions reinsured by the Company meet the definition of a derivative under ASC 815. The Company is required to recognize all derivatives as either assets or liabilities in the Consolidated Balance Sheets and measure those instruments at fair value. The gain or loss on credit derivatives will change at each measurement date based on the underlying assumptions and information used in the estimate of fair value. Such fair value changes may not be indicative of ultimate claims. The credit derivative contracts the Company has reinsured require the Company to make payments upon the occurrence of certain defined credit events relating to an underlying obligation. Credit derivative exposures are substantially similar to financial guaranty insurance contracts and provide for credit protection against payment default, are generally held to maturity, and the unrealized gains and losses on derivative financial instruments will approach zero as the exposure approaches its maturity date, unless there is a credit impairment. Since these derivative instruments are considered a normal extension of the Company's financial guaranty business, the Company monitors the risks associated with

these policies in accordance with its normal risk management activities as discussed in Note 8 - Losses and Loss Expense Reserve.

The following table provides the components of "Net change in fair value of credit derivatives" included in the Company's Consolidated Statements of Operations related to our credit derivative policies:

| | Years ended December 31, | |
|---|---|---|
| | 2012 | 2011 |
| **Change in fair value of credit derivatives:** | | |
| Credit derivative premiums received and receivable | $ 3,609,978 | $ 5,958,756 |
| Expenses on credit derivatives | (1,254,972) | (2,101,950) |
| Losses and loss adjustment expenses [1] | (83,873) | (2,417,668) |
| **Realized gains and other settlements** | 2,271,133 | 1,439,138 |
| **Unrealized (losses) gains** [1] | (17,073,245) | 15,595,809 |
| **Net change in fair value of credit derivatives** | $ (14,802,112) | $ 17,034,947 |

(1) See Note 11 – Commutations and Other Settlements, for details of the effect of the commutations on the above balances.

**Determining Fair Value**

In accordance with ASC 820, fair value is defined as the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date. Fair value is determined based on quoted market prices, if available. Financial guarantors sell credit protection in CDS form to financial institutions in a principal-to-principal market in which transactions are highly customized and negotiated independently. A CDS contract written by a financial guarantor differs from typical CDS contracts entered into by parties that are not financial guarantors because:

- CDS contracts written by financial guarantors are neither held for trading purposes (i.e., a short-term duration contract written for the purpose of generating trading gains) nor used as hedging instruments. Instead they are written with the intent to provide protection for the stated duration of the contract, similar to the financial guarantor's intent with regard to a financial guaranty contract.

- Financial guarantors are not entitled to terminate a CDS contract they write that is "in-the-money" and realize a profit on such a position.

- The liquidity risk present in most CDS contracts sold outside the financial guaranty industry, i.e., the risk that the CDS writer would be required to make cash payments, is typically not present in a CDS contract written by a financial guarantor. Terms are designed to replicate the payment provisions of financial guaranty contracts in that (a) losses, if any, are generally paid over time, and (b) the financial guarantor is generally not required to post collateral to secure its obligation under the CDS contract (the financial guarantor may be required to post collateral on their downgrade).

As a result of these differences, we believe there have been few, if any, relevant third-party exit transactions for CDS contracts written by financial guarantors. In the absence of a principal exit market, a financial guarantor determines the fair value of a CDS contract it writes by using internally developed models, as more fully discussed below.

**Fair Value Modeling**

The Company's CDS policies are not readily tradable as there is no active market for them. Therefore, the Company views its principal market as the financial guaranty insurance and reinsurance market, whose participants would hypothetically be able to assume this business if the Company were to hypothetically transfer a policy.

Each ceding company uses its own internal valuation models where market prices are not available. The primary insurers underwrite each of the transactions underlying the reinsurance contract and they have access to all the underlying data related to the transactions. In addition, they have sophisticated modeling capabilities and services (i.e. Loan Performance and Intex) that allow them to evaluate the performance of all of the underlying credits in a transaction. Given the contractual terms of the Company's reinsurance that limit its access to the terms of the underlying credit derivatives, which are highly individualized, and the underlying loan level data, the Company believes that an exit market participant would look to the information that is available from the ceding companies to determine the exit value of the Company's reinsurance contract, as discussed above. Therefore, the Company, in determining the fair value of derivative instruments, uses credit derivative contract valuations from its ceding companies as a key input. Management then assesses the reasonableness of the ceding companies' valuations by i) discussing with primary insurers their mark-to-market valuation methodology including the nature of changes in key assumptions, ii) reviewing the primaries' publicly available information regarding their mark-to-market process, including methodology and key assumptions, and iii) analyzing the movement of individual derivative policies compared to observable market data, including credit spread movements. Spreads and the related movements, quarter to quarter, are identified from observable market information such as indices, including the CDX, ABX, CMBX and LCDX indices, as related to specific types of derivative contracts. Overall, the relationship between the widening of credit spreads and fair value is not a linear one due to the mix of policy types (duration, rating, and maturities) within the portfolio. Therefore, it is difficult to calculate the actual magnitude of any increase/decrease in the unrealized gain/(loss) with the movement of spreads alone. Additionally, there are many other assumptions that drive the ceding companies' ultimate fair value assessment namely asset recovery assumptions, correlation across asset assumptions, discount rate used, time to maturity, timing of default assumptions, and collateral posting requirements, where applicable. So while spreads are a significant driving factor in models of fair value, they are not the only variables. Changes in correlation and recovery assumptions can result in valuations moving more or less than the absolute movement of spreads. If it appears that the marks are consistent with macro spread movements, and general market trends and the Company believes that the modeling and assumptions that drive the modeling are reasonable (based on the Company's ceding company reviews and review of publicly available information), the Company will use the mark provided by the ceding company as a key input in the determination of the fair value of its reinsurance contracts on credit derivatives. These fair values are based on estimates and are sensitive to selected assumptions and changes to assumptions could lead to materially different results.

Fair values from the ceding companies' models may differ from values calculated by companies outside of the financial guaranty industry because, according to the ceding companies, the terms of the CDS contracts insured generally differ from other non-insured CDS contracts. Because of these terms and conditions, the fair value of the ceding companies' credit derivatives may not reflect the same prices observed in an actively traded market of CDS that do not contain terms and conditions similar to those observed in the financial guaranty market. These models and the related assumptions are continuously reevaluated by the ceding companies and enhanced, as appropriate, based upon improvements in modeling techniques and availability of market information.

As of December 31, 2012 and 2011, included in the Company's outstanding par exposure was $2.1 billion and $2.6 billion, respectively, of CDS that have been fair valued. These derivative instruments had a remaining average legal term to maturity of 14.9 years and 14.1 years, as of December 31, 2012 and 2011, respectively.

The following tables set forth the Company's exposure to credit derivatives by major asset type as at December 31, 2012 and 2011:

| December 31, 2012 Asset Type [1] | | Net Par Outstanding ($ in millions) | Weighted Average Credit rating [2] | Remaining Weighted Average legal contract term [3] |
|---|---|---|---|---|
| HY | $ | 1,490.1 | AA | 10.2 |
| IG | | 69.7 | AAA | 4.4 |
| Other CDO | | 278.6 | A | 41.7 |
| **Total CDO** | | 1,838.4 | | |
| RMBS | | 94.0 | BIG [4] | 30.5 |
| Other | | 166.9 | BBB | 8.3 |
| **Grand Total** | $ | 2,099.3 | | |

| December 31, 2011 Asset Type [1] | | Net Par Outstanding ($ in millions) | Weighted Average Credit rating [2] | Remaining Weighted Average legal contract term [3] |
|---|---|---|---|---|
| HY | $ | 1,838.7 | AA | 10.3 |
| IG | | 89.6 | AAA | 4.3 |
| Other CDO | | 382.4 | AA | 31.0 |
| **Total CDO** | | 2,310.7 | | |
| RMBS | | 109.0 | BIG [4] | 31.4 |
| Other | | 227.6 | BBB | 11.8 |
| **Grand Total** | $ | 2,647.3 | | |

(1) The definitions of the CDO types in the above table are as follows:

**HY** – Non-investment grade corporates, predominantly Collateralized Loan Obligations ("CLOs") backed by corporate loans.

**IG** – Investment grade corporate securities (predominantly corporate, may include limited asset-backed securities ("ABS")).

**Other CDO** – includes Double-Wrap CDO's, Emerging markets sovereign debt obligations and Multi-sector collateral, primarily CMBS.

(2) For the year ending December 31, 2012, these ratings are current as of March 14, 2013 (for the year ending December 31, 2011, ratings were as of February 24, 2012). These ratings are assigned by AORE based on management's judgment and take into consideration the ratings assigned by the ceding companies and the rating agencies. AORE undertakes no obligation to update its ratings, and such ratings do not constitute investment advice.

(3) Actual maturity of CDS is generally expected to be significantly less than the legal term.

(4) BIG – Below Investment Grade.

In compliance with the requirements of ASC 820, the Company considers its own non-performance risk when measuring the fair value of a liability.

There is no observable credit spread for AORE or AOG, and as such there is inherently a significant amount of judgment, subjectivity and uncertainty involved in the estimation of the adjustment for the Company's non-

performance risk. Management has used inputs that reflect assumptions market participants may use in pricing the Company's creditworthiness. In determining the Company's own non-performance risk when measuring the fair value of a liability, the Company uses an implied market price for buying credit protection on the Company and a cash flow model, which models a CDS contract, to calculate a price based on those spreads and cash flows. The Company identifies comparable entities with active CDS markets to estimate credit spreads for the Company. Such identification focuses on the nature of risk positions (primarily public finance and structured products), ratings and approximate capital adequacy as depicted by publicly available information. Based on this information, as at December 31, 2012 and 2011, the Company estimated its credit spread to be approximately 2,200 and 2,840 basis points, respectively. An approximation of a CDS contract is made based on a 5-year insured CDS contract, an assumption of a 4.5 year weighted average life (5.5 years in 2011), and an assumption for par, coupon, duration and the appropriate discount rate based on a 5-year swap rate. The Company believes that these data points may be considered by hypothetical market participants in determining the Company's creditworthiness. The Company also considers other data points that may be relevant. These data points include transactions involving the Company's debt or preferred shares, if any, during the financial statement period. The Company assesses the interrelationship of market prices for these transactions with the results of applying the implied credit spreads described above. Furthermore, the Company considers the interrelationship between observed market prices for similar buyback transactions of other industry participants and their credit spreads and non-performance risk adjustments. These interrelationships are not always intuitive, nor are they necessarily consistent across all observed market participants. As a result, the Company has not directly incorporated these data points into the calculation of the non-performance risk adjustment, but rather has utilized them as a point of reference in assessing the reasonableness of the results of the Company's estimate of the non-performance risk adjustment. The Company will continue to evaluate the significance of any future transactions in the determination of our own credit worthiness.

The effect of applying this requirement of ASC 820 was a reduction in the Company's derivative liability at December 31, 2012 and 2011, of approximately $69.9 million and $97.8 million, respectively. As noted above, this calculation is based on estimates, involves a significant degree of management judgment and is sensitive to selected assumptions. Changes to the assumptions used in this valuation could lead to materially different results. For example, a change in the Company's estimated spread would have a significant impact on the amount of the adjustment for the Company's own non-performance risk. Adjustments to the Company's non-performance risk will be recorded in the periods in which they become known or estimable by the Company.

The following table summarizes the estimated changes in fair value of our credit derivatives assuming immediate changes in the Company's non-performance credit risk at specified levels at December 31, 2012:

| **Change in Credit Spreads** | **Estimated Net Fair Value of Derivative Liability** | **Impact of Change on Net Income** |
|---|---|---|
| | ($ in millions) | |
| 1000 basis point narrowing | $ (95.4) | $ (30.2) |
| 500 basis point narrowing | (78.7) | (13.5) |
| 100 basis point narrowing | (67.7) | (2.5) |
| Base scenario | (65.2) | - |
| 100 basis point widening | (62.8) | 2.4 |
| 500 basis point widening | (54.3) | 10.9 |
| 1000 basis point widening | (45.6) | 19.7 |

The Company believes that the above hypothetical spread movements used in the sensitivity analysis of 100, 500, and 1000 basis points are supported by previous large spread changes that have occurred during 2012 and 2011 in our primaries' spreads. Therefore, the Company believes it is not unreasonable for the Company to use these spread movements in the sensitivity analysis. This calculation is based on estimates, involves a significant degree of management judgment and is sensitive to selected assumptions. Changes to assumptions used in this valuation could lead to materially different results.

Our credit derivative policies are classified as Level 3 in the fair value hierarchy in Note 7 since the inputs provided to us by our ceding companies and our own non-performance risk adjustments are from valuation models which

place reliance on at least one significant unobservable input. Consistent with the requirements of ASC 820, we believe these models use observable market data when available.

The following table presents changes in the net credit derivative liabilities balance for which fair value was measured under Level 3 for the years ended December 31, 2012 and 2011:

**Fair value measurement using significant unobservable inputs (Level 3)**

| | Years Ended December 31, | | | |
|---|---|---|---|---|
| | | 2012 | | 2011 |
| Balance, beginning of period | $ | (48,303,395) | $ | (63,524,831) |
| Total unrealized (losses) gains included in earnings [1] | | (17,073,245) | | 15,595,809 |
| Total realized gains included in earnings [2] | | 2,271,133 | | 1,439,138 |
| Purchases, issuances, sales and settlements: | | | | |
| Purchases | | — | | — |
| Issuances | | — | | — |
| Sales | | — | | — |
| Settlements [3] | | (2,108,203) | | (1,813,511) |
| Transfers in and/or out of Level 3 | | — | | — |
| Balance, end of period | $ | (65,213,710) | $ | (48,303,395) |
| Change in unrealized gains and losses relating to assets held at the reporting date [1] | $ | (17,065,992) | $ | 13,352,502 |

(1) Included in “Unrealized (losses) gains” within “Net change in fair value of credit derivatives”.
(2) Included in “Realized gains and other settlements” within “Net change in fair value of credit derivatives”.
(3) Settlements include all ongoing contractual cash payments inclusive of payments to commute credit derivatives (see Note 11 – Commutations and Other Settlements for details of commutations in the years ended December 31, 2012 and 2011).

## 7 FAIR VALUE OF FINANCIAL INSTRUMENTS

### Fair Value Measurements

The Company follows the guidance of ASC 820 for fair value measurement of financial instruments. ASC 820 establishes a hierarchy of inputs in measuring fair value, with the highest level being observable inputs and the lowest being unobservable data, with the standard requiring that the use of observable inputs is maximized (see Note 2(i) - Significant Accounting Policies – Fair Value Measurements for a description of each of the three levels).

The following table presents the fair value measurement levels for assets and liabilities, which the Company has recorded at fair value as of December 31, 2012 and 2011. As required by ASC 820, items are classified in their entirety based on the lowest level of input that is significant to the fair value measurement:

| | Fair Value Measurements at Reporting Date Using | | | |
|---|---|---|---|---|
| | **Balance as of December 31, 2012** | **Quoted Prices in Active Markets for Identical Assets (Level 1)** | **Significant Other Observable Inputs (Level 2)** | **Significant Unobservable Inputs (Level 3)** |
| **Financial Assets:** | | | | |
| Fixed-maturity investments | | | | |
| Agencies | $ 18,794,027 | $ — | $ 18,794,027 | $ — |
| U.S. government obligations | 25,003,742 | 25,003,742 | - | — |
| Corporate debt securities | 38,479,151 | — | 38,479,151 | — |
| Municipal securities | 7,984,969 | — | 7,984,969 | — |
| Mortgage -backed securities: | | | | |
| RMBS | 45,599,501 | — | 45,599,501 | — |
| CMBS | 12,523,802 | — | 12,523,802 | — |
| Asset-backed securities | 17,373,093 | — | 17,373,093 | — |
| Total fixed-maturity investments | 165,758,285 | 25,003,742 | 140,754,543 | |
| Short Term Investments | — | — | — | — |
| Cash and Cash Equivalents | 36,317,205 | 36,317,205 | — | — |
| Restricted Cash | 45,138,700 | 45,138,700 | — | — |
| **% of assets at fair value** | **100%** | **43%** | **57%** | **0%** |
| | | | | |
| **Financial Liabilities:** | | | | |
| Derivative Liabilities [1] | $ 65,213,710 | $ — | $ — | $ 65,213,710 |
| **% of liabilities at Fair value** | **100%** | | | **100%** |

| | Fair Value Measurements at Reporting Date Using | | | |
|---|---|---|---|---|
| | **Balance as of December 31, 2011** | **Quoted Prices in Active Markets for Identical Assets (Level 1)** | **Significant Other Observable Inputs (Level 2)** | **Significant Unobservable Inputs (Level 3)** |
| **Financial Assets:** | | | | |
| Fixed-maturity investments | | | | |
| Agencies | $ 22,367,571 | $ — | $ 22,367,571 | $ — |
| U.S. government obligations | 90,791,722 | 33,970,027 | 56,821,695 | — |
| Corporate debt securities | 38,965,999 | — | 38,965,999 | — |
| Municipal securities | 7,787,761 | — | 7,787,761 | — |
| Mortgage -backed securities: | | | | |
| RMBS | 76,322,863 | — | 76,322,863 | — |
| CMBS | 14,959,554 | — | 14,959,554 | — |
| Asset-backed securities | 8,613,549 | — | 8,613,549 | — |
| Total fixed-maturity investments | 259,809,019 | 33,970,027 | 225,838,992 | — |
| Short Term investments | 14,999,875 | — | 14,999,875 | — |
| Cash and Cash Equivalents | 13,253,185 | 13,253,185 | — | — |
| Restricted Cash | 49,428,723 | 49,428,723 | — | — |
| **% of assets at fair value** | **100%** | **29%** | **71%** | **0%** |
| **Financial Liabilities:** | | | | |
| Derivative Liabilities [1] | $ 48,303,395 | — | — | $ 48,303,395 |
| **% of liabilities at Fair value** | **100%** | **—** | **—** | **100%** |

[1] See Note 6 – Financial Guaranty Contracts Accounted for as Credit Derivatives for further disclosure on the application of ASC 820 to the Company's derivative liabilities.

**Fixed-maturity investments**

The Company's fair values of fixed-maturity and short-term investments are based on prices obtained from nationally recognized independent pricing services. Where available, the prices are obtained from market quotations in active markets. Where there is no quoted price for an identical security, then the pricing service may use matrix pricing or model processes, such as the option adjusted spread model, to estimate the fair value of a security. The matrix pricing or model processes consist primarily of observable inputs, which may include: benchmark yields, reported trades, broker/dealer quotes, issuer spreads, two-sided markets, benchmark securities, bids, offers and reference data. The Company receives at least one fair value price for each of its investment securities and has not adjusted any of the prices received from the pricing services. At December 31, 2012 and 2011, all of the Company's investments were valued using the independent pricing services.

There were no transfers into or out of Level 1 or 2 during the years ended December 31, 2012 and 2011.

As management is ultimately responsible for determining the fair value measurements for all securities, the Company assesses the reasonableness of the fair values received by comparing them to other pricing information readily available and management's knowledge of the current markets. The Company also assesses the pricing methodologies and related inputs used by the pricing services to estimate fair value. Any prices that, in management's opinion, may not be representative of fair value are challenged with the pricing service. Based on the

information obtained from the above reviews, the Company evaluated the fixed-maturity securities in the investment portfolio to determine the appropriate fair value hierarchy level in accordance with ASC 820. Based on the Company's evaluation, each security was classified as Level 1, 2, or 3. Prices with observable market inputs were classified as Level 2, prices on money market funds and US treasuries were classified as Level 1, and valuations with no significant observable inputs were classified as Level 3 as of December 31, 2012 and 2011. There were no assets and liabilities measured at fair value on a recurring basis using unobservable measurements other than those dealt with in Note 6 – Financial Guaranty Contracts Accounted for as Credit Derivatives.

**Other fair value disclosures**

Management has estimated the fair value of certain financial instruments based upon market information using appropriate valuation methodologies. Fair value estimates are not necessarily indicative of the amount the Company could realize in a current market exchange.

The Company considers carrying amounts of cash and cash equivalents, interest, other assets, reinsurance balances receivable, funds withheld, accounts payable and accrued liabilities to be reasonable estimates of their fair values.

As of December 31, 2012 and 2011, the fair value of the Company's $59.7 million redeemable Series A Preference Shares was approximately $6.0 million and $3.4 million, respectively. These fair value estimates are based on the present value of expected cashflows and past trades in our Series A Preference Shares during 2012 and 2011, together with the Company's best estimate of fair value of this instrument. The fair value measurement was classified as Level 3 in the fair value hierarchy.

As of December 31, 2012 and 2011, the carrying amount of unearned premiums represented the sum of unearned premium collected at inception for policies where premiums are paid upfront and the present value of premiums expected to be collected for policies where the premiums are received in installments, discounted at a risk free rate. The fair value of the unearned premiums is the value the Company would receive to transfer those obligations. The Company's market would be the financial guaranty insurance and reinsurance industry participants, similar to that used in the calculation of fair value of insured CDS contracts. Unearned premiums are generally collateralized by the Company by placing assets in trust for the benefit of the ceding company. The Company perceives the fair value to approximate the carrying value. The Company classified this fair value measurement as Level 3.

Our ability to accurately estimate the fair value of our non−derivative financial guarantees is limited. There are no observable market data points as a result of the disruption in the credit markets and significant rating agency downgrades. We believe that in the absence of a principal market, our estimate of fair value described above in a hypothetical market provides the most relevant information with respect to disclosed fair value estimates given the information currently available to us. The carrying value of our non−derivative financial guaranty liabilities consists of unearned premiums, premiums receivable, deferred policy acquisition costs, and reserve for losses and loss adjustment expenses ("LAE") as reported on our Consolidated Balance Sheets. The fair value for financial guaranty insurance contracts includes consideration of our credit quality, limited by the collateral which is available to the ceding companies in the trust accounts. The Company accordingly classified this fair value measurement as Level 3.

The following table sets out the carrying amounts and the estimated fair values of the Company's financial instruments at December 31, 2012 and 2011:

| | Years Ended December 31, | | | |
|---|---|---|---|---|
| | 2012 | | 2011 | |
| | Carrying Amount | Fair Value | Carrying Amount | Fair Value |
| **Financial Assets:** | | | | |
| Fixed-maturity investments | $ 165,758,285 | $ 165,758,285 | $ 259,809,019 | $ 259,809,019 |
| Short term investments | — | — | 14,999,875 | 14,999,875 |
| Cash and cash equivalents | 36,317,205 | 36,317,205 | 13,253,185 | 13,253,185 |
| Restricted cash | 45,138,700 | 45,138,700 | 49,428,723 | 49,428,723 |
| Accrued investment income | 1,189,414 | 1,189,414 | 1,593,075 | 1,593,075 |
| Reinsurance balances receivable | 11,561,369 | 11,561,369 | 13,505,088 | 13,505,088 |
| Funds withheld | 1,533,086 | 1,533,086 | — | — |
| **Financial Liabilities:** | | | | |
| Losses and loss expense reserves net of recoveries | 15,559,804 | 15,559,804 | 74,839,692 | 74,839,692 |
| Unearned premiums, net of reinsurance | 72,538,525 | 72,538,525 | 110,187,189 | 110,187,189 |
| Derivative liabilities | 65,213,710 | 65,213,710 | 48,303,395 | 48,303,395 |
| Redeemable preference shares | 59,700,000 | 6,000,000 | 59,700,000 | 3,400,000 |

## 8 LOSSES AND LOSS EXPENSE RESERVE

The Company's loss and loss expense reserve as of December 31, 2012, represented case basis loss reserves, or claim liability. Refer to Note 2 - Significant Accounting Policies for a description of the Company's accounting policy for insurance losses.

A summary of the movement in the provision for losses and LAE for the years ended December 31, 2012 and 2011 is presented in the following table:

| | 2012 | 2011 |
|---|---|---|
| Losses and loss expense reserve: | | |
| Balance – Beginning of year | $ 80,997,653 | $ 52,411,626 |
| Less: Recoverables on paid losses | (6,157,961) | (19,231,274) |
| Net balance – Beginning of year | 74,839,692 | 33,180,352 |
| Incurred related to: | | |
| Current year | 4,762,823 | — |
| Prior years | 17,288,855 | 26,030,673 |
| | 22,051,678 | 26,030,673 |
| Net losses paid related to: | | |
| Current year | 2,362,659 | — |
| Prior years | 78,968,907 | (15,628,667) |
| Total paid | 81,331,566 | (15,628,667) |
| Net balance – End of year | 15,559,804 | 74,839,692 |
| Add: Recoverables on paid losses | 6,686,859 | 6,157,961 |
| **Balance – End of year** | 22,246,663 | 80,997,653 |

For the year ended December 31, 2012, the Company incurred loss and LAE of $22.1 million. Included in the $22.1 million of loss and LAE is $11.5 million relating to commutation payments (see Note 11 – Commutations and Other Settlements for further details of these commutations). Incurred losses during the period ending December 31, 2012 were primarily a result of (i) the Company's reserving with respect to its property and casualty operations resulting in incurred losses of $4.8 million, and (ii) further adverse development on US RMBS exposure of $2.2 million, including increased reserves due to declining discount rates used to discount loss reserves. The $81.3 million in loss and LAE payments are primarily as a result of Financial Guaranty Insurance Company ("FGIC") loss payments of $11.5 million and payments of $48.4 million on the FGIC commutation and $3.9 million on other commutations (see Note 11 – Commutations and Other Settlements for further details); and $9.1 million on the Company's exposure to Greek sovereign debt.

For the year ended December 31, 2011, the Company incurred loss and LAE of $26.0 million. Included in the $26.0 million of loss and LAE is $(15.6) million in loss and LAE payments (recoveries), net of $0.7 million relating to commutation payments (see Note 11 – Commutations and Other Settlements for further details of these commutations). Incurred losses since January 1, 2011 were primarily a result of (i) further adverse development on US RMBS exposure of $7.2 million, including increased reserves due to declining discount rates used to discount loss reserves, (ii) the Company's exposure to Greek sovereign debt resulting in incurred losses of $8.7 million, (iii) incurred losses of $3.1 million on the Chapter 9 Bankruptcy filing of Jefferson County, Alabama and (iv) $5.9 million of incurred losses due to declining revenues in a print-media whole business securitization. US RMBS incurred losses consisted of $(15.9) million of loss and LAE payments (recoveries), including $0.7 million of commutation payments, and $23.2 million of change in case reserves. The $15.6 million in loss and LAE payments (recoveries) are primarily as a result of recoveries of $(23.9) million on the Assured settlement with the Bank of America Corporation (See Note 11 – Commutations and Other Settlements for further details). Excluding these recoveries, paid losses were $8.3 million.

The ongoing deterioration in the US residential mortgage markets which began in 2007 resulted in a significant amount of case-basis loss reserves being recorded on the RMBS policies that have defaulted or have a high probability of defaulting. The Company's US RMBS exposure includes obligations backed by Alt-A, subprime, closed-end second mortgage loans and home equity lines of credit. Alt-A and subprime mortgage loans tend to be first lien products, while closed-end second and home equity lines of credit mortgages tend to be second lien products. Throughout 2012, the Company's US RMBS exposures continued to experience losses primarily due to actual loss and LAE payments on insured obligations, particularly second lien US RMBS, along with declining interest rates leading to increases in the Company's reserves. The Company's estimate of loss reserves related to US RMBS exposure represents management's best estimate of total future losses for these exposures, but actual losses may differ materially from these estimates. The Company continues to monitor the performance of these exposures and will update estimates of loss as new information reflecting future performance is available and any changes will be recorded in the period in which they occur.

As of December 31, 2012 and 2011, the Company gave credit of $5.2 million and $7.7 million, respectively, in its case reserves for the benefit of expected recoveries in US RMBS transactions resulting from required repurchases by the originators due to contractual breaches of representations and warranties in the RMBS securitization agreements. The credit given for such repurchase recoveries at year-end 2012 and 2011 approximates the credit reported to the Company by the ceding companies in their ceded reserves, as that is the Company's best estimate of the remediation benefit at this time. The ceding companies performed detailed examinations of sampled RMBS loan files to determine whether the loans conformed to the representations and warranties made by the sponsors of the RMBS. The sampled loans were either in later stages of delinquency or had been charged off. Those loans that showed a material breach of representations and warranties are in the process of being put back to the sponsors for repurchase. The Company views the obligation to repurchase as a standard provision of RMBS securitizations that has been enforced for many years. Thus, the Company views the inclusion of the credit taken by the primaries in its own case reserves to be appropriate and generally assumes its proportionate share of the credit given by the ceding companies when establishing its case reserves as of year-end 2012 and 2011.

To determine the adequacy of its aggregate reserves, the Company considers the loss reserves established by its ceding companies for the exposures it has reinsured as well as the methodologies used by the ceding companies to calculate such ceded loss reserves. To further evaluate the ceded reserve amounts established by the ceding companies, the Company uses its own expected loss forecasting methodologies. Ultimately, the Company decides

on an individual credit-by-credit basis whether to establish the ceding company's reserve as its own or to use its own forecast methodology to determine the reserve for such credit. As of December 31, 2012 and 2011, the Company's recorded loss and LAE reserves for financial guaranty contracts were approximately $12.2 million and $14.5 million higher than the reserves reported by the primaries, respectively.

The Company uses one of two approaches to perform its own forecast of expected losses. The first approach is a statistical expected loss approach, which considers the likelihood of alternative outcomes. The statistical expected loss is a function of: (i) the net par outstanding on the credit; (ii) internally developed historical default assumptions (taking into consideration internal ratings and remaining term to maturity of an obligation); (iii) internally developed loss severities; and (iv) a discount factor. The loss severities and default assumptions are based on rating agency information, are specific to each bond type and are established and approved by the Company's Management Committee. For certain credit exposures, the Company's surveillance activities may provide information relevant to adjust the estimate of the statistical expected losses. As such, the default probability or loss severity for such exposures under certain probabilistic scenarios may be adjusted based on the judgment of senior management.

The second approach entails the use of more precise estimates of expected net cash outflows (future claim payments, net of potential recoveries, expected to be paid to the holder of the insured financial obligation). The Company's risk management staff considers the likelihood of alternative possible outcomes and develops alternative loss scenarios, in conjunction with a review of historical performance data of the collateral pools. In this approach, a probability-weighted expected loss estimate is developed based on assigning probabilities to multiple net claim payment scenarios and applying an appropriate discount factor. For RMBS, the Company takes into account the first loss protective features inherent in the structure of the insured exposure, collateral losses to date, current delinquency rates and loan product characteristics such as loan-to-value ratio and credit score. The first loss protection in most of the Company's RMBS transactions is provided by excess spread, overcollateralization, subordination, and in some cases mortgage pool insurance.

A loss reserve is recorded for the excess, if any, of estimated expected losses (net cash outflows) over unearned premium reserve ("UPR"). For certain policies, estimated potential recoveries exceed estimated future claim payments because all or a portion of such recoveries relate to claims previously paid. The expected net cash inflows for these policies are recorded as a recoverable asset.

The discount factor applied is based on a risk-free discount rate corresponding to the remaining expected weighted-average life of the exposure or based on multiple risk-free discount rates related to the timing of individual claims payments. The discount factors are updated for the current risk-free rates each reporting period. As of December 31, 2012, the Company used risk free rates ranging from 0.15% to 3.39% to discount reserves for loss and loss adjustment expenses. As of December 31, 2011, the Company used risk free rates ranging from 0.11% to 3.26% to discount reserves for loss and loss adjustment expenses.

The Company's Management Committee establishes reserves that it believes are adequate to cover the present value of ultimate liability for losses and loss adjustment expenses, net of UPR. These reserves are based on estimates and may vary materially from actual results.

The Company also identifies problem credits through information provided by the ceding companies at least on a quarterly basis. Such information generally consists of surveillance and underwriting reports and quarterly correspondence and/or conference calls with the ceding companies' analysts. The risk management staff supplements this input with their own research to identify and assess the status of individual credits. Research performed includes reviews of rating agency and fixed income research publications and analysis of historical performance data. Each of the ceding companies maintains a "watch list" for credits that have been identified as requiring a greater than usual level of ongoing scrutiny and/or intervention. The ceding companies notify the Company when any ceded exposure has been placed on such a watch list. The Management Committee is comprised of the Company's senior officers and meets quarterly to formally review the Company's Watch List and approve reserves.

The Company maintains its own Watch List to identify those transactions requiring increased monitoring. The Company typically places a transaction on the Watch List if the ceding company places a transaction on its watch

list, and the Company generally employs a mapping of each watch list category of each ceding company to the Company's own Watch List categories. Risk management also surveys market segments on an as-needed basis based on market trends, and may add transactions to the Watch List as a result of such survey even if the ceding company has not added the transaction to its watch list.

Transactions on the Company's Watch List are divided into four categories generally based upon the following definitions:

- Category 1 includes transactions for which performance of the issue or that of an issuance participant is sufficiently below expectations where increased monitoring is required; however, the risk of loss remains remote.

- Category 2 transactions include those for which performance of an issue or that of an issuance participant is sufficiently below expectations where increased monitoring is required and remedial intervention by the ceding company is either planned or already in progress. Performance issues occur when the performance of an issue does not stabilize or improve over the intermediate term and concerns about the transaction's ability to meet its debt service obligations may arise.

- Category 3 includes transactions where performance has deteriorated to the point where concerns about continued ability to meet debt service requirements on a timely basis are substantial. Also included are transactions where claims have been paid but recoveries are forecast for the claims.

- Category 4 transactions include those for which ultimate net loss (net of recoveries and premium receivable) is expected in the most-probable scenarios.

Each transaction in Category 3 or 4 of the Watch List is generally reviewed quarterly to determine whether material changes are noted by the ceding company or by the Company's risk management staff. If material adverse changes are identified, surveillance reports are requested from the ceding company and discussions are held to assess the deterioration and outlook for the credit.

The Company does not perform loss mitigation activities and instead relies on the loss mitigation efforts of the ceding companies, that report the Company's proportionate share of the expenses incurred and liability arising from such activities. The Company pays the ceding companies a ceding commission for all policies reinsured. The ceding commission represents the Company's portion of the cost to the ceding companies to write the transaction, perform ongoing surveillance and to undertake loss mitigation activities. Ceding commissions are deferred and expensed as each policy's exposure matures and are included as an asset in deferred policy acquisition costs and as acquisition expenses in the statement of operations. The Company reports loss expenses associated with claims as a liability in losses and loss expense reserves on the Consolidated Balance Sheets and in loss and loss adjustment expenses in the Consolidated Statements of Operations.

The following table provides information about the financial guaranty policies and related loss reserves in each of the Company's Watch List categories as of December 31, 2012:

| (dollars in millions) | Deals not on watch list | Category 1 | Category 2 | Category 3 | Category 4 | Total |
|---|---|---|---|---|---|---|
| | | | Surveillance Categories | | | |
| Number of policies | 11 | 18 | 20 | 22 | 67 | 138 |
| Remaining weighted average contract period (in yrs) | 12 | 20 | 18 | 21 | 20 | 18 |
| Insured contractual payments outstanding: | | | | | | |
| Principal | $ 72.0 | $ 94.3 | $ 265.4 | $ 50.1 | $ 133.6 | $ 615.4 |
| Interest | 31.3 | 81.3 | 94.0 | 15.1 | 47.2 | 268.9 |
| Total | $ 103.3 | $ 175.6 | $ 359.4 | $ 65.2 | $ 180.8 | $ 884.3 |
| Gross Claim Liability | $ 1.3 | $ 1.7 | $ 3.8 | $ 2.7 | $ 22.5 | $ 32.0 |
| Less: | | | | | | |
| Gross potential recoveries | (1.2) | (0.0) | (0.0) | (6.3) | (4.4) | (11.9) |
| Discount, net | (0.1) | (0.2) | (0.2) | (0.1) | (0.7) | (1.3) |
| Net Claim Liability | $ 0.0 | $ 1.5 | $ 3.6 | $ (3.7) | $ 17.4 | $ 18.8 |
| Unearned premium revenue[1] | $ 1.0 | $ 0.7 | $ 2.4 | $ 0.9 | $ 0.6 | $ 5.6 |
| Net Claim liability reported in the Balance Sheet related to financial guaranty | | | | | | $ 13.2 |
| Reinsurance recoverables | | | | | | — |

The following table provides information about the financial guaranty policies and related loss reserves in each of the Company's Watch List categories as of December 31, 2011:

| (dollars in millions) | Deals not on watch list | Category 1 | Category 2 | Category 3 | Category 4 | Total |
|---|---|---|---|---|---|---|
| | | | Surveillance Categories | | | |
| Number of policies | 20 | 29 | 19 | 20 | 57 | 145 |
| Remaining weighted average contract period (in yrs) | 17 | 20 | 19 | 23 | 25 | 20 |
| Insured contractual payments outstanding: | | | | | | |
| Principal | $ 155.4 | $ 212.1 | $ 418.7 | $ 67.1 | $ 261.9 | $ 1,115.2 |
| Interest | 68.7 | 130.6 | 255.7 | 20.9 | 109.8 | 585.7 |
| Total | $ 224.1 | $ 342.7 | $ 674.4 | $ 88.0 | $ 371.7 | $ 1,700.9 |
| Gross Claim Liability | $ 1.2 | $ 2.9 | $ 4.7 | $ 9.2 | $ 93.8 | $ 111.8 |
| Less: | | | | | | |
| Gross potential recoveries | (1.7) | — | — | (4.1) | (14.6) | (20.4) |
| Discount, net | (0.0) | (0.1) | (0.4) | 0.1 | (8.2) | (8.8) |
| Net Claim Liability | $ (0.6) | $ 2.7 | $ 4.3 | $ 5.2 | $ 71.0 | $ 82.6 |
| Unearned premium revenue[1] | $ 0.7 | $ 1.6 | $ 2.8 | $ 0.4 | $ 2.4 | $ 7.8 |
| Net Claim liability reported in the Balance Sheet related to financial guaranty | | | | | | $ 74.8 |
| Reinsurance recoverables | | | | | | — |

(1) On policies with a loss reserve but excluding those policies with a recoverable as of December 31, 2012 and 2011, respectively.

Categories 1 to 4 in the above table include all financial guaranty contracts on the Company's Watch List at December 31, 2012 and 2011, whether or not they have reserves on them. The column entitled "Deals not on Watch List" includes only financial guaranty exposures for which the Company has established reserves. Policies written in credit derivative form are not included in the above tables. Due to rounding, the numbers in the above tables may not add up to the totals.

## 9 OUTSTANDING EXPOSURE

The Company's business consists of financial guaranty reinsurance, the purpose of which is to indemnify a primary financial guarantor, referred to as the "primary insurer" or "ceding company", against the portion of any loss it may sustain under financial guaranty policies it has ceded to the Company. The Company reinsures policies covering both U.S. and international exposures. The Company's portfolio as of December 31, 2012, was diversified by geographic and bond market sector, with no single obligor representing more than 2% of the Company's total outstanding ("OS") par insured.

The following table presents the Company's net par outstanding by credit sector and type of guaranty as of December 31, 2012 and 2011:

| **(dollars in millions)** | **2012** | | **2011** | |
|---|---|---|---|---|
| **US Public Finance** | **Total OS Par** | **% of total** | **Total OS Par** | **% of total** |
| General Obligation and Lease | $ 2,855 | 30.9 | $ 5,383 | 34.4 |
| Tax backed | 430 | 4.7 | 877 | 5.6 |
| Transportation | 899 | 9.7 | 1,844 | 11.8 |
| Healthcare | 452 | 4.9 | 621 | 4.0 |
| Utility | 790 | 8.5 | 1,766 | 11.3 |
| Higher Education | 193 | 2.1 | 384 | 2.5 |
| Other | 100 | 1.1 | 245 | 1.6 |
| **Total US Public Finance** | **$ 5,719** | **61.9%** | **$ 11,120** | **71.0%** |
| **US Structured Finance** | | | | |
| Commercial ABS and CDOs | $ 1,388 | 15.0 | $ 1,948 | 12.4 |
| RMBS | 245 | 2.7 | 386 | 2.5 |
| Other Structured Finance & Corporate | 65 | 0.7 | 93 | 0.6 |
| **Total US Structured Finance** | **$ 1,698** | **18.4%** | **$ 2,427** | **15.5%** |
| **International** | | | | |
| Asset-backed | $ 769 | 8.3 | $ 853 | 5.4 |
| Public Finance | 554 | 6.0 | 752 | 4.8 |
| Investor Owned Utilities and Other | 505 | 5.4 | 515 | 3.3 |
| **Total International** | **$ 1,828** | **19.7%** | **$ 2,120** | **13.5%** |
| **Total** | **$ 9,245** | **100.0%** | **$ 15,668** | **100.0%** |

Due to rounding the numbers in the above tables may not add up to the totals.

Net outstanding par reinsured at December 31, 2012 and 2011, by geographic location was as follows:

| (dollars in millions) | 2012 OS Par | 2012 % | 2011 OS Par | 2011 % |
|---|---|---|---|---|
| International | $ 1,828 | 19.8 | $ 2,120 | 13.5 |
| Multi-state | 1,683 | 18.2 | 2,411 | 15.4 |
| California | 1,103 | 11.9 | 2,091 | 13.3 |
| New York | 602 | 6.5 | 1,225 | 7.8 |
| Illinois | 509 | 5.5 | 804 | 5.1 |
| Massachusetts | 343 | 3.7 | 544 | 3.5 |
| Other U.S. States | 3,177 | 34.4 | 6,473 | 41.4 |
| **Total** | **$ 9,245** | **100.0 %** | **$ 15,668** | **100.0%** |

The above outstanding par amounts are inclusive of outstanding par on credit derivative policies. See Note 6 – Financial Guaranty Contracts Accounted for as Credit Derivatives for further information on the outstanding par relating to credit derivative policies.

## 10 PENSION PLANS

On May 1, 2010, the Company entered into a management agreement ("the Management Agreement") with Reid Street Services Ltd. ("RSSL"), see Note 20 – Related Party Transactions for a description of this agreement. Prior to this date, the Company maintained qualified and non-qualified, non-contributory, defined contribution pension plans for the benefit of eligible employees and senior management received a cash pension benefit in lieu of a contribution to a deferred compensation plan. The plans were administered by a third party. The Company's contributions are based upon a fixed percentage of employee compensation. Pension expense (inclusive of executives' cash contributions), which is funded as accrued, for the years ended December 31, 2012 and 2011 was $0.1 million and $0.1 million, respectively.

During 2011, the Company established a Simplified Employee Pension – Individual Retirement Account ("SEP IRA") for the benefit of its U.S citizen executive. During the year ended December 31, 2012 and 2011, the maximum allowed under the plan was contributed to this scheme and is included within the above pension expense.

## 11 COMMUTATIONS AND OTHER SETTLEMENTS

Effective November 2, 2012, the Operating Subsidiary entered into two Commutation, Reassumption and Release Agreements with one of the ceding companies. These agreements provided, among other things, for the Operating Subsidiary to make a $4.2 million net commutation payment to terminate the reinsurance with respect to certain policies previously assumed, with par in-force of $12.5 million (the "Released Risks"). In return, each party was released from all liabilities and obligations with respect to the Released Risks. The effect of these agreements on the Company's results of operations was to (i) reduce gross written premiums and unearned premiums by $0.9 million, resulting in no impact on earned premiums, and (ii) decrease losses and loss adjustment expenses by $1.7 million, resulting in an overall gain to net income at the time of termination of $1.7 million.

Effective October 22, 2012, the Operating Subsidiary completed a Settlement, Commutation and Release Agreement with FGIC. This agreement provided, among other things, for the Operating Subsidiary to make a $64.8 million commutation payment to terminate the entire $4.4 billion portfolio of financial guaranty reinsurance business it had previously assumed. In return, each party was released from all of their respective rights, obligations and liabilities, both present and future with respect to the original reinsurance agreements. The effect of this agreement on the Company's results of operations was to (i) reduce gross written premiums and unearned premiums by $25.0 million, resulting in no impact on earned premiums, and (ii) increase losses and loss adjustment expenses by $13.2 million, resulting in an overall loss to net income at the time of termination of $13.2 million.

Effective September 14, 2011, the Operating Subsidiary entered into a Settlement Agreement with one of the ceding companies from its financial guaranty business line. The agreement provided, among other things, for the Operating Subsidiary to make a $1.2 million commutation payment to terminate the reinsurance with respect to certain policies previously assumed, with par in-force of $26.2 million (the "Released Risks"). In return, each party was released from all liabilities and obligations with respect to the Released Risks. In addition, this agreement included agreements regarding certain retained risk that will continue to be covered under the existing treaty. The effect of this agreement on the Company's results of operations was to (i) reduce gross written premiums and unearned premiums by $0.9 million, resulting in no impact on earned premiums, and (ii) decrease losses and loss adjustment expenses by $0.1 million, resulting in an overall gain to net income at the time of termination of $0.1 million.

Effective June 30, 2011, the Operating Subsidiary entered into a Termination and Release Agreement with one of its ceding companies (the "Cedent"). The agreement provided, among other things, for the Operating Subsidiary to make a $0.7 million payment to terminate the reinsurance with respect to several policies previously assumed from the Cedent, with par in-force of $300.4 million, and to mutually terminate all liabilities and obligations with respect to that reinsurance. The effect of the termination on the Company's results of operations was to (i) reduce gross written premiums and unearned premiums by $6.9 million, resulting in no impact on earned premiums, and (ii) decrease losses and loss adjustment expenses by $0.5 million, resulting in an overall gain to net income at the time of termination of $0.5 million.

Effective April 15, 2011, the Operating Subsidiary, entered into a Settlement Agreement (the "Settlement Agreement") with one of its ceding companies. The Settlement Agreement provided, among other things, for the Operating Subsidiary to make a $2.3 million payment to commute the reinsurance with respect to certain policies written in credit derivative form, with par in-force as of December 31, 2010 of $129.8 million. Under the Settlement Agreement, each party was released from all liabilities and obligations under the commuted reinsurance. The effect of the Settlement Agreement on the Company's results of operations was to decrease the net change in fair value of credit derivatives by a loss of $1.4 million.

On April 15, 2011, Assured Guaranty Ltd. and its subsidiaries ("Assured") announced that they had reached a settlement with Bank of America Corporation and its subsidiaries (the "Assured Settlement") regarding their liabilities with respect to various RMBS transactions insured by Assured, including claims relating to reimbursement for breaches of representations and warranties. A number of the Operating Subsidiary's policies assumed from Assured are affected by this settlement. During 2011, the Operating Subsidiary has received and accrued $23.9 million from Assured in relation to this settlement.

## 12 SEGMENT INFORMATION

The determination of reportable segments is based on how senior management monitors the Company's underwriting operations. Management monitors the performance of its underwriting operations based on the markets and customers served and the type of accounts written. The Company is currently organized into two operating segments: financial guaranty and property/casualty reinsurance. All product lines fall within these classifications. The financial guaranty segment includes the Company's financial guaranty operations which are in run-off and which the Company has no plans to re-enter. During the year ended December 31, 2012, our major customers were the following primary monoline financial guaranty insurers: Assured and FGIC.

The property/casualty segment provides reinsurance primarily related to US short-tail personal lines.

Because the Company does not manage its assets by segment, investment income, interest expense, operating expenses and total assets are not allocated to individual reportable segments.

The following tables provide a summary of the segment results:

| (dollars in thousands) | December 31, 2012 Property/Casualty | Financial Guaranty | Total |
|---|---|---|---|
| Net premiums earned | $ 6,007 | $ 15,501 | 21,508 |
| Change in fair value of credit derivatives: | | | |
| Realized gains (losses) and other settlements | | 2,271 | 2,271 |
| Unrealized gains (losses) | — | (17,073) | (17,073) |
| Net change in fair value of credit derivatives | — | (14,802) | (14,802) |
| Losses and loss adjustment expenses | (4,763 ) | (17,289 ) | (22,052) |
| Acquisition expenses | (1,722 ) | (7,392 ) | (9,114) |
| (Loss) per segment | (478 ) | (23,982 ) | (24,460) |
| Net investment income | | | 6,946 |
| Net realized gains on sales of investments | | | 737 |
| Total other-than-temporary losses | | | — |
| Portion of impairment losses recognized in other comprehensive income | | | — |
| Net other-than-temporary losses recognized in earnings | | | — |
| Foreign currency gains | | | 66 |
| Operating expense | | | (6,190) |
| Net loss available to common shareholders | $ (478) | (23,982) | (22,901) |

## 13 COMMITMENTS AND CONTINGENCIES

In the ordinary course of its business, AORE engages in arbitrations under its treaty agreements.

Litigation

On April 11, 2011, a civil suit was filed with the United States District Court, Central District of California, Southern Division, by Twenty-Nine Palms Enterprises Corporation ("29 Palms"), one of the holders of the Class B Preference Shares of the Operating Subsidiary. The complaint alleged certain violations of the Securities Exchange Act of 1934, Rule 10b-5 thereunder and certain California securities laws, and fraud. The complaint sought undisclosed monetary damages, rescission, punitive damages and attorneys' fees. Effective October 4, 2011, a Tolling Agreement (the "Tolling Agreement") was entered into between AOG, the Operating Subsidiary and 29 Palms. The Tolling Agreement provides that, within five business days of the effective date of the Tolling Agreement, 29 Palms will dismiss the actions against AOG and the Operating Subsidiary without prejudice and that, should 29 Palms subsequently seek to assert claims against the Operating Subsidiary and/or AOG related to such actions, neither the Operating Subsidiary nor AOG will oppose the claims based on the statute of limitations or any other time-based defense, based upon the passage of time from April 11, 2011 to the date that such claim is filed. The Operating Subsidiary also agreed not to oppose such claims based on lack of personal jurisdiction or improper venue. The Tolling Agreement is effective until October 4, 2013 and can be terminated by any party with 60 days' notice. On October 6, 2011, 29 Palms filed a voluntary dismissal of the actions against the Operating Subsidiary and AOG without prejudice.

## 14 REDEEMABLE PREFERENCE SHARES

On December 14, 2006, AOG issued 75,000 Series A Preference Shares at $1,000 per share for total consideration of $75.0 million. The Series A Preference Shares have a par value of $0.10 per share and a redemption value of $1,000 per share. Until December 15, 2016, the Series A Preference Shares bear a non-cumulative, non mandatory dividend rate of 7.50%, which is payable semi-annually on June 15 and December 15 each year upon declaration by the Board of Directors. After December 15, 2016, if the Series A Preference Shares have not been redeemed or repurchased, they bear a non-cumulative, non-mandatory dividend rate of Three-Month LIBOR (as defined in the Series A Certificate of Designations) plus 3.557%, which is payable quarterly on the 15th day of March, June, September and December of each year, beginning on March 15, 2017, upon declaration by the Board of Directors. Unless previously redeemed, the Series A Preference Shares have a mandatory redemption date of December 15, 2066. AOG can redeem the Series A Preference Shares at any time from December 15, 2016 with no penalty to AOG. Prior to December 15, 2016, AOG can redeem the preference shares at the redemption price and a make-whole amount, amounting to dividends for the remainder of the period to December 15, 2016.

On May 12, 2009, the Board determined to suspend payment of dividends on the Series A Preference Shares; therefore, during the year ended December 31, 2012 and 2011, there were no dividends declared or paid. The payment of preference share dividends is classified as interest expense. On March 10, 2010, AOG completed a tender offer for the Series A Preference Shares, pursuant to which 15,300 shares, or 20.40% of the 75,000 shares previously outstanding were validly tendered. The Company accepted for purchase all such Series A Preference Shares that were validly tendered as of the applicable expiration date and paid $3.8 million for all such Series A Preference Shares realizing a gain of $11.5 million. Following the settlement of the tender offer and as of December 31, 2012 and 2011, 59,700 shares of AOG's Series A Preference Shares remain outstanding.

## 15 NONCONTROLLING INTEREST – Class B Preference Shares

On December 23, 2003, the Operating Subsidiary entered into a $50.0 million soft capital facility whereby it was granted the right to exercise perpetual put options in respect of its Class B Preference Shares against the counterparty to the option agreement, in return for which it paid the counterparty a floating put option fee through February 17, 2009. The counterparty was a trust established by an investment bank. The trust was created as a vehicle for providing capital support to the Operating Subsidiary by allowing it to obtain, at its discretion and subject to the terms of the option agreement, access to new capital through the exercise of a put option and the subsequent purchase by the trust of the Operating Subsidiary's Class B Preference Shares. On February 17, 2009, the Operating Subsidiary exercised the put option in the soft capital facility and issued 500.01 Class B Preference Shares to the trust in exchange for $50,001,000 of proceeds. On March 16, 2009, the Operating Subsidiary elected to pay a fixed rate dividend on the Class B Preference Shares, as a result of which the Class B Preference Shares were distributed to the holders of the trust's securities, and the trust is now in the process of dissolution. As a result of the fixed rate election, if declared by the board, dividends are payable on the Class B Preference Shares every 90 days at a rate of 6.276%. The Class B Preference Shares give investors the rights of a preferred equity investor in the Operating Subsidiary. Such rights are subordinate to insurance claims, as well as the general unsecured creditors of the Operating Subsidiary. The Class B Preference Shares are not rated by S&P since the Operating Subsidiary requested the withdrawal of its ratings during 2009 and have not been rated by Moody's. The Operating Subsidiary has the option to redeem the Class B Preference Shares, subject to certain specified terms and conditions.

The fair value of the put option at the exercise date was $41.9 million and therefore the value of the Class B Preference Shares on that date was $8.1 million, being the difference between the proceeds received and the fair value of the put option on the date of exercise. On March 9, 2010, the Operating Subsidiary completed a tender offer for the Class B Preference Shares, pursuant to which 68.00 shares, or 13.60%, were tendered out of the 500.01 shares outstanding. The Operating Subsidiary accepted for purchase all such Class B Preference Shares that were validly tendered as of the applicable expiration date and paid $1.7 million for all such Class B Preference Shares on March 10, 2010. Following the settlement of the tender offer, 432.01 shares of Class B Preference Shares remain outstanding. The value of the Class B Preference Shares of $7.0 million is included as a "Noncontrolling interest" in the Company's Consolidated Balance Sheets as of December 31, 2012 and 2011.

On May 12, 2009, the Board of Directors of AORE determined to pay dividends for the period up to June 15, 2009, and suspend dividend payments thereafter on these Class B Preference Shares. Dividends on the Class B Preference Shares are currently non-cumulative. Dividends on the Class B Preference Shares are only cumulative if the Operating Subsidiary pays dividends on its common shares without paying accrued and unpaid dividends on the Class B Preference Shares. The terms of the Operating Subsidiary's Class B Preference Shares restrict the Operating Subsidiary's ability to pay dividends on its common shares unless all accrued and unpaid dividends on the Class B Preference Shares for the then current dividend period have been declared and paid or a sum sufficient for payment thereof set apart. There is an exception however that permits the Operating Subsidiary to declare dividends on its common shares in such amounts as are necessary for AOG (i) to service indebtedness for borrowed money as such payments become due (or to satisfy any of its guaranty obligations made in respect of indebtedness of the Operating Subsidiary or AOG) or (ii) to pay its operating expenses.

If the Operating Subsidiary fails to pay dividends in full on the Class B Preference Shares for eighteen consecutive months then the number of members on the Board of Directors of the Operating Subsidiary is automatically increased by two with the holders of the Class B Preference Shares having the ability to elect the two additional directors. In accordance with this provision, the Board of Directors of the Operating Subsidiary was increased by two on December 15, 2010 and a special general meeting of holders of the Class B Preference Shares was held on February 14, 2011. Two directors were appointed to the Board of Directors of the Operating Subsidiary at the special general meeting of holders of the Class B Preference Shares, one of whom subsequently declined to accept the appointment, with no further nomination made by the holders of the Class B Preference Shares.

## 16 SHARE CAPITAL

As at December 31, 2012 and 2011, authorized common share capital was $9,000,000. As at December 31, 2012 and 2011, there were 10,000,000 authorized undesignated preference shares with a par value of $0.10 each.

Common shares outstanding as at December 31, 2012 and 2011, were 2,676,608 and 2,643,116, respectively. During the years ended December 31, 2012 and 2011, 5,225 and 3,595 restricted share units were vested and common shares were issued in respect of said restricted share units on a one for one basis, increasing the common shares issued and outstanding. On September 5, 2012, the Board of AOG approved the payment of director's fees, effective July 1, 2012, to non executive directors in the form of AOG shares. Each of the non executive directors entered into a Share Purchase Agreement with Calliope Investments Ltd. ("Calliope"), a substantial shareholder in AOG, pursuant to which upon receipt of the shares, the non executive directors immediately sold such common shares to Calliope. On September 6, 2012 AOG issued 22,729 common shares in lieu of cash for director's fees. AOG also issued 5,538 common shares on October 23, 2012 to the CEO and President in lieu of a short term incentive award.

On November 8, 2011, as previously approved by AOG's shareholders, AOG effected a reverse stock split of its issued common shares (the "Consolidation"). AOG's issued common shares of par value US$0.10 each were consolidated into common shares of par value US$1.00 each on a 1 for 10 basis. After the Consolidation, a portion of AOG's additional paid in capital account was capitalized in order to issue fractions of common shares to any common shareholder who held a fraction of a common share as a result of the Consolidation, in order to round up any fractional shares to the next whole share. A total of 65.1 common shares were issued to effect this round up of fractional shares.

## 17 SHARE BASED COMPENSATION

In accordance with ASC 718, the Company recognizes compensation costs based on the estimated fair value at the grant date of the award. For both the twelve month periods ended December 31, 2012 and 2011, the Company recognized no compensation expense for share options with an exercise price less than the market value of the underlying common shares on the date of the grant.

As of April 26, 2006, the Company adopted the 2006 Equity Plan (the "Plan"). The number of common shares that may be issued under the Plan may not exceed 247,000. In the event of certain transactions affecting the common

shares of the Company, the number or type of shares subject to the Plan, the number and type of shares subject to outstanding awards under the Plan, and the exercise price of awards under the Plan will be adjusted in accordance with the terms of the Plan. The Plan authorizes the grant of share options, share appreciation rights, share awards, restricted share units, performance units, or other awards that are based on AOG's common shares. The awards granted are contingent on the achievement of service conditions during a specified period, and may be subject to a risk of forfeiture or other restrictions that will lapse upon the achievement of one or more goals relating to completion of service by the participant. Awards under the Plan may accelerate and become vested upon a change in control of the Company. The Plan is administered by the governance committee of the Board of Directors. The Plan is subject to amendment or termination by the board.

The Consolidation discussed in Note 16 – Share Capital, is considered a modification of the stock option and restricted share unit awards. Adjustments were made to the stock option and restricted share unit awards to reflect the effects of the Consolidation. The restricted share units were consolidated on a 1 for 10 basis and the stock options were consolidated on a 1 for 10 basis with the exercise price of the stock options being multiplied by 10. Any fractional awards resulting from the Consolidation were rounded up to the next whole unit. The modification in the awards did not result in a material change to the compensation expense relating to these awards. As a result of the Consolidation, information disclosed below in relation to the awards includes the effects of the modification, if subsequent to the date of the Consolidation. However, because this is a modification of an award, the comparative information, and any other information prior to the date of Consolidation, has not been restated to include the effects of the Consolidation.

As at December 31, 2012, outstanding awards under the Plan consisting of 69,172 share options and 31,428 restricted share units had been granted to the Company's directors, officers and employees. Each of the options vest in equal annual installments over a four-year period and will expire at the earlier of the seventh anniversary of the date of grant or the expiration of the Plan. The grant price is the average of the highest and lowest quoted selling price on the grant date. The exercise price of the options at December 31, 2012 ranges from $6.75 to $162.00. Restricted share units vest in equal annual installments over a four-year period.

***Stock Options***

The Company has used the Black-Scholes option pricing model to estimate the fair value of stock options using the following weighted average assumptions during the periods ending December 31, 2012 and 2011:

| | 2012 | 2011 |
|---|---|---|
| Dividend yield | 0% | 0% |
| Expected volatility | 138.48% | 147.35% |
| Risk-free interest rate | 0.60% | 1.40% |
| Expected life of options (in years) | 4.0 | 4.0 |
| Weighted-average grant-date fair value (1) | $7.33 | $14.60 |

(1) 2011's weighted-average grant-date fair value was adjusted to $14.60 from $1.46, reflected in the prior year's financial statements, in order to reflect the value of the award after the Consolidation.

These assumptions are based on a number of factors as follows: (i) dividend yield was determined based on AOG's historical dividend payments which have been nil and expected dividend payments in the future which are also expected to be nil, (ii) expected volatility was determined using the historical volatility of the share price of AOG , (iii) the expected term of the options is based on the period of time that the options granted are expected to be outstanding and (iv) the risk-free rate is the U.S. Treasury rate effective at the time of grant for the duration of the options granted. Compensation cost is recognized on a straight-line basis over the vesting period and is net of estimated pre-vesting forfeitures of 10% for both periods. The estimated forfeiture rate is based on future forfeiture expectations.

The Company expensed $0.1 million in compensation expense related to the stock options for each of the years ended December 31, 2012 and 2011. As at December 31, 2012, there was $0.2 million of unrecognized

compensation expense related to the stock options granted subsequent to January 1, 2006, which is expected to be recognized over the weighted average remaining service period of 1.43 years.

The following tables summarize the stock option activity for the years ended December 31, 2012 and 2011:

| **Year ended December 31, 2012** | **Number of shares** | **Weighted average exercise price per share** | **Weighted average Remaining Contractual Life** | **Aggregate Intrinsic Value** [1] |
|---|---|---|---|---|
| **Options** | | | | |
| Outstanding – beginning of year | 68,339 | 60.18 | | |
| Granted | 18,643 | 8.77 | | |
| Forfeited | - | - | | |
| Outstanding – end of year | 86,982 | 49.16 | 2.61 | $ 217,241 |
| Exercisable – end of year | 55,702 | 71.35 | 2.45 | $ 49,271 |
| Weighted average fair value per share of options granted during the period | | $ 7.33 | | |

| **Year ended December 31, 2011** | **Number of shares** | **Weighted average exercise price per share** | **Weighted average Remaining Contractual Life** | **Aggregate Intrinsic Value** [1] |
|---|---|---|---|---|
| **Options** | | | | |
| Outstanding – beginning of year | 919,903 | 8.11 | | |
| Granted | 88,470 | 1.46 | | |
| Forfeited | (325,000) | 10.71 | | |
| Subtotal prior to Consolidation [2] | 683,373 | | | |
| Reverse stock split 1 for 10 basis | (615,034) | N/A | | |
| Outstanding – end of year | 68,339 | 60.18 | 3.41 | $ 18,000 |
| Exercisable – end of year | 45,529 | 84.54 | 4.34 | $ 4,500 |
| Weighted average fair value per share of options granted during the period [3] | | $ 12.61 | | |

(1) The aggregate intrinsic value was calculated based on the market value of $15.00 and $8.50 as at December 31, 2012 and 2011, respectively, and is calculated as the difference between the market value and the exercise price of the underlying options.

(2) Amounts and prices prior to the Consolidation effective date discussed above are not adjusted for the effects of the Consolidation.

(3) After taking effect of the Consolidation.

***Restricted Share Units***

AOG has granted restricted share units to directors, employees and consultants of the Company and of Reid Street Services Ltd. See Note 20 – Related Party Transactions. Restricted share units vest annually over a four-year period.

The following table summarizes the restricted share unit activity for the years ended December 31, 2012 and 2011:

| 12 months ended December 31, 2012<br>Restricted Share Units | Number of share units | Weighted average grant date fair value per share |
|---|---|---|
| Non-vested – beginning of year | 16,705 | 10.67 |
| Granted | 19,948 | 8.93 |
| Vested | (5,225) | 10.46 |
| Forfeited | - | - |
| Non-vested – End of year | 31,428 | 9.60 |

| 12 months ended December 31, 2011<br>Restricted Share Units | Number of share units | Weighted average grant date fair value per share |
|---|---|---|
| Non-vested – beginning of year | 126,789 | 1.06 |
| Granted | 76,580 | 1.46 |
| Vested | (35,945) | 1.86 |
| Forfeited | (375) | 1.45 |
| Subtotal prior to Consolidation [1] | 167,049 | |
| Reverse stock split 1 for 10 basis | (150,344) | N/A |
| Non-vested – End of year | 16,705 | 10.67 |

[1] Number and prices prior to the Consolidation discussed above are not adjusted for the effects of the Consolidation.

The Company expensed $0.1 million in compensation expense related to the restricted share units for both the years ended December 31, 2012 and 2011. The compensation expense for restricted share units is expensed on a prorated basis over the vesting period. At December 31, 2012, there is unrecognized compensation expense related to the non-vested restricted share units of $0.1 million, which will be recognized over the weighted average remaining service period of 2.79 years.

## 18 EARNINGS/(LOSS) PER SHARE

Basic earnings per share is computed by dividing net income (loss) available to common shareholders by the weighted average number of common shares outstanding during the period. Diluted earnings per share shows the dilutive effect of all stock options and restricted share units outstanding during the period that could potentially result in the issuance of common shares. The calculation of diluted loss per share excludes the dilutive effect of stock options and restricted share awards outstanding because it would otherwise have an anti-dilutive effect on net loss per share.

As of December 31, 2012 and 2011, there were 84,875 and 67,764, respectively, of stock options excluded from the diluted earnings per share calculation because they were anti-dilutive. At December 31, 2012, and 2011, there were 5,249 and 5,107 restricted share units, respectively, included in the diluted earnings per share calculations.

The following table sets forth the computation of basic and diluted earnings per share for the years ended December 31, 2012 and 2011:

| | 2012 | 2011 |
|---|---|---|
| Net (loss) income available to common shareholders | $ (22,901,107) | $ 898,488 |
| Basic weighted-average shares | 2,662,318 | 2,642,136 |
| Effect of stock options | — | — |
| Effect of restricted share units | 7,356 | 5,682 |
| Diluted weighted-average shares | 2,669,674 | 2,647,818 |
| Basic (loss) earnings per share | $ (8.60) | $ 0.34 |
| Diluted (loss) earnings per share | $ (8.58) | $ 0.34 |

## 19 RISKS AND UNCERTAINTIES

The Company has not renewed its reinsurance treaties with any of the financial guaranty primaries or otherwise written any new financial guaranty business in 2012 or 2011. While the Company does not expect to write any new financial guaranty business, this does not reduce the Company's in-force business, unless the business is commuted or recaptured by the primaries.

The Company continues to evaluate its financial condition and capital adequacy and may pursue a different set of strategies in the future. In 2012, the Company commenced writing short-tail, non-catastrophe, property/casualty reinsurance business. There can be no assurance that the strategies that have been implemented or that will be pursued in the future in connection with this evaluation will improve the Company's business, financial condition, liquidity or results of operations or will not have a material adverse effect on the Company. Management believes that the Company has sufficient capital resources and liquidity to meet its obligations for at least the next twelve months and therefore that the Company remains a "going concern".

At December 31, 2012, the Company had $247.2 million of cash and investments of which $144.1 million was held in trust for the benefit of our ceding companies and $1.0 million in escrow accounts, leaving $102.1 million cash and investments available for the cost of ongoing business. See Note 3 – Pledged Assets, for further information regarding these trust accounts. Currently, losses are paid out of AORE's unrestricted cash rather than AORE's trust accounts which reduces available cash until the trust accounts are adjusted. AORE is not permitted to withdraw funds from these trust accounts without the ceding companies' express permission. The ceding companies are allowed to withdraw funds from the trust account under certain conditions as specified in the trust agreements.

AOG is a holding company and therefore its liquidity, both on a short-term basis (for the next twelve months) and a long-term basis (beyond the twelve months), is largely dependent upon (1) the ability of AORE to pay dividends or make other payments to AOG and (2) its ability to access debt and equity markets, which is unlikely in the near term given current market conditions and AOG's current share valuation. AOG's principal uses of liquidity are for payment of operating expenses, capital investments in AORE and for non-mandatory dividends on its Series A Preference Shares if declared by the Board of Directors of AOG. As of December 31, 2012, AOG has $6.8 million of cash and investments and believes that it will have sufficient liquidity to meet its requirements over at least the next twelve months. AORE's ability to declare and pay dividends to AOG may be influenced by a variety of factors such as adverse loss development, amount and timing of claims payments, the amounts required to be held in trust

for the benefit of its ceding companies, adverse market changes, insurance regulatory changes, changes in general economic conditions beyond the next twelve months and Barbados law. Further increases in loss reserves and credit impairments would require AORE to deposit additional collateral in the applicable trust account(s) and resulting claims payments in respect of those losses and impairments would increase cash outflows and could decrease the size of AORE's investment portfolio, in turn decreasing income from investments. Although AOG believes that it will continue to have sufficient liquidity to meet its obligations over the long term, it cannot guaranty that AORE will be able to dividend amounts sufficient to satisfy all its obligations, and there can be no assurance that dividends will be declared or paid in the future.

The principal sources of AORE's liquidity are premiums net of acquisition expenses, scheduled investment maturities, and net investment income. The principal uses of AORE's liquidity are for the payment of operating expenses, claims, ceding commissions, and for purchases of new investments and more recently funding commutation agreements. The Company believes that AORE's expected operating liquidity needs can be funded from its operating and investing cash flows for the next twelve months. See Note 15 – Noncontrolling Interest and Note 22 – Statutory Requirements, for further information regarding AORE's ability to pay dividends.

As at December 31, 2012, AORE is not rated by any agency after having requested the withdrawal of ratings from both S&P and Moody's during 2009 following a number of downgrades. The downgrade of AORE's ratings had a material adverse effect on AORE's ability to compete in the financial guaranty reinsurance industry and significantly decreased the value of the reinsurance provided. Due to the above mentioned downgrades, certain ceding companies have the right to increase the ceding commission, as stipulated in the treaties, or terminate the treaties and recapture the business previously ceded to AORE whether written in financial guaranty or credit derivative form. To the extent policies are recaptured, AORE must forfeit to the ceding company an amount determined by formula under each treaty which generally consists of AORE's allocated share of the U.S. statutory unearned premium, net of the ceding commission paid by AORE to the ceding company (subject to a penalty amount in some cases), and loss reserves established with respect to the policies ceded, as applicable. U.S statutory premiums earn on a different basis than GAAP premiums and do not currently include the present value of future installment premiums. The U.S. statutory unearned premiums were approximately $1.7 million lower than GAAP unearned premiums at December 31, 2012, including unearned premiums on credit derivatives. To date, none of the primaries have recaptured any business. The commutations negotiated during the years 2012 and 2011 were not a result of these treaty terms. See Note 5 – Financial Guaranty Contracts Accounted for as Reinsurance, for disclosure on the financial statement effect of increased ceding commission relating to these downgrades.

Some of the exposures the Company reinsures have been written by ceding companies as credit derivative contracts rather than financial guaranty insurance policies. Traditional financial guaranty insurance provides an unconditional and irrevocable guaranty of payment to the holder of a municipal finance or structured finance obligation of principal and interest on that obligation in the event of a non-payment by the issuer. In contrast, credit derivatives provide protection from the occurrence of specified credit events, which frequently include non-payment of principal and interest ("failure to pay"), but may also include other terms such as settlement of individual referenced collateral losses in excess of policy specific deductibles or subordination amounts. The credit derivatives that protect against failure to pay usually have settlement terms that require the ceding company to pay interest and principal shortfalls as they occur (referred to as "pay-as-you-go"). The Company may be deemed to have assumed reinsurance on credit derivative exposures that have other than "pay-as-you-go" terms. Although the Company considers the occurrence of such payments to be unlikely, the Company is at risk of unanticipated loss payments under insured credit derivative policies that could have an adverse effect on the Company's liquidity. Further, the ceding companies write credit derivatives that are governed by standard International Swaps and Derivatives Association ("ISDA") documentation which can include various events of default related to the primary insurer itself, such as insolvency of or a failure to pay by the primary insurer on any credit derivative with a particular counterparty, which would not typically trigger a payment obligation under traditional financial guaranty. If a credit derivative (or group of credit derivatives) is terminated upon an event of default, the primary could be required to make a mark-to-market payment(s) as determined under the ISDA documentation. While the Company does not believe that its reinsurance contracts obligate it to indemnify the primary insurers for mark-to-market payments resulting from their default under the ISDA documentation, the primary insurer or its regulator may allege that the Company is liable for its pro rata share of such payments and withdraw funds to pay such claims from the trust account for the benefit of that primary insurer.

The underwriting of insured risks and the reporting of underwriting results to the Company are the responsibility of the primary insurers under the treaties. The Company leverages and relies on the operations and reporting of the primary insurers. As a result of this model, the Company is highly dependent on the operating and reporting of the ceding companies. The ceding companies often use complex financial models, which have been internally developed, to produce their results. The Company performs its own assessment of the reasonableness of the information provided by ceding companies (See Note 6 – Financial Guaranty Contracts Accounted for as Credit Derivatives, Note 5 - Financial Guaranty Policies Accounted for as Reinsurance and Note 8 – Losses and Loss Expense Reserve, for details of the work completed by the Company on this information). However, depending on the nature of the information provided by the ceding company, the Company may not be able to identify errors in the reported information in the period in which it is reported, which may be material, as indicated by corrections of errors in primary reported information in prior period financial statements.

If AOG is considered a passive foreign investment company, or a PFIC, for U.S. federal income tax purposes, a U.S. Person who owns directly or, in some cases, indirectly (e.g. through a foreign partnership) any AOG shares may be subject to adverse U.S. federal income tax consequences, including subjecting the investor to a greater tax liability than might otherwise apply or, if certain elections are made, subjecting the investor to a tax on amounts in advance of when such tax would otherwise be imposed, in which case the investor's investment could be materially adversely affected. In addition, if AOG were considered a PFIC, unless certain elections are made, upon the death of any U.S. individual owning common shares, such individual's heirs or estate would not be entitled to a "step-up" in the basis of the common shares which might otherwise be available under U.S. federal income tax laws. AOG believes that it is not, and it currently does not expect to become, a PFIC for U.S. federal income tax purposes; however, there can be no assurances that AOG will not be deemed a PFIC by the IRS. There are currently no definitive regulations regarding the application of the PFIC classification provisions to an insurance company. New regulations or pronouncements interpreting or clarifying these rules may be forthcoming. AOG cannot predict what impact, if any, such guidance would have on an investor that is subject to U.S. federal income taxation.

## 20 RELATED PARTY TRANSACTIONS

On May 1, 2010, the Company entered into a management agreement (the "Management Agreement") with Reid Street Services Ltd. ("RSSL"), which is a wholly-owned subsidiary of Orpheus Group Ltd. ("Orpheus") which indirectly owns approximately 43.1% of the outstanding common shares of AOG. As of December 31, 2012, three directors of AOG and AORE were also directors of Orpheus and two of those directors held a beneficial interest in Orpheus. RSSL is an insurance management company and provides insurance management services to its affiliate entities. Pursuant to the terms of the Management Agreement, RSSL employs all of the former employees of the Company with the exception of the Chief Executive Officer. RSSL provides professional services to the Company, which principally comprises: policyholder and related services; maintenance of books and records; drafting of financial and quarterly reports; production of government reports; the maintenance of the investments and bank accounts; and the provision of office facilities. For its services, the Company is required to pay RSSL a service fee equivalent to the sum of leasehold costs and employee costs based on a prescribed formula. During the years ended December 31, 2012 and 2011, the Company incurred \$1.6 million and \$1.9 million in services fees, respectively, from RSSL which amounts are included in operating expenses in the Company's Consolidated Statements of Operations. As at December 31, 2012 and 2011, immaterial amounts remained outstanding and were included in accounts payable and accrued liabilities in the Company's Consolidated Balance Sheet.

## 21 TAXATION

The Company has received an undertaking from the Bermuda government exempting it from all local income, withholding and capital gains taxes until March 31, 2035. At the present time, no such taxes are levied in Bermuda.

AORE is registered as an Exempt Insurance Company carrying on general insurance business in accordance with the provisions of the Barbados Exempt Insurance Act 1983 ("Exempt Insurance Act"). AORE, as an Exempt Insurance Company, has received an undertaking exempting it from corporate taxation for the first fifteen financial years, commencing with 2012. After the first fifteen financial years AORE will be subject to corporate tax of 2% on the first \$0.13 million of its profits and 0% on any excess. AORE is further exempt from all other direct or indirect

Barbados taxes on its profits and transfers of assets and securities, withholding taxes on dividends, interest or other returns payable to its shareholders.

The Company does not consider itself to be engaged in trade or business in the U.S. and, accordingly, does not expect to be subject to U.S. taxation.

## 22 STATUTORY REQUIREMENTS

The Exempt Insurance Act requires that AORE maintain (among other things) a minimum level of solvency. As at December 31, 2012, the minimum surplus of assets over liabilities was $2.1 million. AORE's actual surplus was $129.6 million as of December 31, 2012. For the purpose of compliance with the solvency criteria under the Exempt Insurance Act, assets and liabilities are calculated in accordance with US GAAP.

AORE also must comply with the provisions of the Barbados Companies Act regulating the payment of dividends and making of distributions from contributed surplus. A company is prohibited from declaring or paying a dividend, if there are reasonable grounds for believing that: (a) the company is, or would after the payment be, unable to pay its liabilities as they become due or (b) the realizable value of the Company's assets would thereby be less than the aggregate of its liabilities and stated capital.

Prior to its re-domestication, AORE was registered as a Class 3A insurer and was regulated as such under the Bermuda Insurance Act 1978, amendments thereto and related regulations (the "Bermuda Insurance Act"). The Bermuda Insurance Act required that AORE maintain (among other things) minimum levels of solvency and liquidity. As at December 31, 2011, the minimum required statutory capital and surplus was $12.5 million and actual statutory capital and surplus was $150.7 million. Statutory income was $0.5 million for the year ended December 31, 2011.

In addition to the solvency margin, the Bermuda Insurance Act required AORE to comply with a liquidity ratio whereby the value of its relevant assets must be not less than 75% of the amount of its relevant liabilities. The minimum required level of liquid assets was $146.8 million and actual liquid assets were $346.4 million as of December 31, 2011.

In the event AORE failed to meet its relevant margins on the last day of any financial year, it could not without the approval of the Bermuda Monetary Authority (the "BMA"), declare or pay any dividend during the next financial year. Further to this, Class 3A insurers must obtain the BMA's prior approval before reducing total statutory capital, as shown on their respective previous financial year's statutory balance sheets, by 15% or more. Based upon this test for a Class 3A insurer, without obtaining approval from the BMA, the maximum amount that would have been available during 2012, prior to the re-domestication, for the reduction to capital by AORE, was approximately $52.9 million.

AOG must comply with the provisions of the Bermuda Companies Act regulating the payment of dividends and making of distributions from contributed surplus. A company is prohibited from declaring or paying a dividend, or making a distribution out of contributed surplus, if there are reasonable grounds for believing that: (a) the company is, or would after the payment, be unable to pay its liabilities as they become due or (b) the realizable value of the company's assets would thereby be less than its liabilities. The Board of Directors of AOG will evaluate any dividends in accordance with this test (and any other restrictions as discussed in Note 15 – Noncontrolling Interest) at the time such dividends are declared.

## 23 SUBSEQUENT EVENTS

Subsequent events have been evaluated through May 1, 2013, which is the date the financial statements were issued.