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**UNITED STATES  
SECURITIES AND EXCHANGE COMMISSION**  
Washington, D.C. 20549

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**FORM 10-Q**

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**QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF**

**THE SECURITIES EXCHANGE ACT OF 1934**

For the quarterly period ended **March 31, 2004**

OR

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

For the transition period from \_\_\_\_\_ to \_\_\_\_\_

Commission file number 1-10804

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**XL CAPITAL LTD**

(Exact name of registrant as specified in its charter)

CAYMAN ISLANDS  
(State or other Jurisdiction of  
incorporation or organization)

98-0191089  
(I.R.S. Employer  
Identification No.)

**XL House, One Bermudiana Road, Hamilton, Bermuda HM 11**  
(Address of principal executive offices and zip code)

**(441) 292-8515**  
(Registrant's telephone number, including area code)

Indicate by check mark whether the registrant: (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes  No

Indicate by check mark whether the registrant is an accelerated filer (as defined in Rule 12b-2 of the Exchange Act). Yes  No

As of May 10, 2004, there were 138,124,185 outstanding Class A Ordinary Shares, \$0.01 par value per share, of the registrant.

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**XL CAPITAL LTD**

**INDEX TO FORM 10-Q**

**PART I. FINANCIAL INFORMATION**

**Page No**

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Item 1.

Financial Statements:

Consolidated Balance Sheets as at March 31, 2004 (Unaudited) and  
December 31, 2003

3

Consolidated Statements of Income for the Three Months Ended March  
31, 2004 and 2003 (Unaudited)

5

Consolidated Statements of Comprehensive Income for the Three Months  
Ended March 31, 2004 and 2003 (Unaudited)

6

	Consolidated Statements of Shareholders' Equity for the Three Months Ended March 31, 2004 and 2003 (Unaudited)	7
	Consolidated Statements of Cash Flows for the Three Months Ended March 31, 2004 and 2003 (Unaudited)	8
	Notes to Unaudited Consolidated Financial Statements	9
Item 2.	Management's Discussion and Analysis of Financial Condition and Results of Operations	19
Item 3.	Quantitative and Qualitative Disclosures About Market Risk	36
Item 4.	Controls and Procedures	41
<b>PART II. OTHER INFORMATION</b>		
Item 1.	Legal Proceedings	42
Item 6.	Exhibits and Reports on Form 8-K	42
Signatures		44

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**PART I — FINANCIAL INFORMATION**

**ITEM 1. FINANCIAL STATEMENTS**

**XL CAPITAL LTD  
CONSOLIDATED BALANCE SHEETS  
(U.S. dollars in thousands, except share amounts)**

	(Unaudited) March 31, 2004	December 31, 2003
	<u>          </u>	<u>          </u>
<b>ASSETS</b>		
Investments:		
Fixed maturities at fair value (amortized cost: 2004, \$19,755,284; 2003, \$18,990,670)	\$ 20,414,803	\$ 19,494,356
Equity securities, at fair value (cost: 2004, \$603,596; 2003, \$473,112)	721,110	583,450
Short-term investments, at fair value (amortized cost: 2004, \$1,021,654; 2003, \$696,798)	1,026,002	697,450
	<u>22,161,915</u>	<u>20,775,256</u>
Total investments available for sale		
Investments in affiliates	2,035,727	1,903,341
Other investments	131,260	142,567
	<u>24,328,902</u>	<u>22,821,164</u>
Total investments		
Cash and cash equivalents	2,646,857	2,403,121
Accrued investment income	274,749	294,615
Deferred acquisition costs	996,477	777,882
Prepaid reinsurance premiums	1,113,821	977,595
Premiums receivable	4,966,109	3,487,322
Reinsurance balances receivable	1,283,692	1,359,486
Unpaid losses and loss expenses recoverable	5,763,149	5,779,997
Goodwill and other intangible assets	1,844,911	1,845,507
Deferred tax asset, net	256,945	310,077
Other assets	694,708	707,449
	<u>44,170,320</u>	<u>40,764,215</u>
Total assets	\$	\$

**LIABILITIES AND SHAREHOLDERS' EQUITY**

Liabilities:

Unpaid losses and loss expenses	\$ 16,718,056	\$ 16,558,788
Deposit liabilities	4,378,401	4,050,334
Future policy benefit reserves	3,262,685	3,233,845
Unearned premiums	6,103,939	4,729,989
Notes payable and debt	2,736,867	1,905,483
Reinsurance balances payable	1,734,589	1,525,739
Net payable for investments purchased	86,577	96,571
Other liabilities	1,722,213	1,666,397
Minority interest	64,266	60,154
	<hr/>	<hr/>
Total liabilities	\$ 36,807,593	\$ 33,827,300

See accompanying Notes to Unaudited Consolidated Financial Statements

3

**XL CAPITAL LTD  
CONSOLIDATED BALANCE SHEETS  
(U.S. dollars in thousands, except share amounts)**

	(Unaudited) March 31, 2004	December 31, 2003
	<hr/>	<hr/>
Commitments and Contingencies		
Shareholders' Equity:		
Series A preference ordinary shares, 9,200,000 authorized, par value \$0.01 Issued and outstanding: 2004 and 2003, 9,200,000	\$ 92	\$ 92
Series B preference ordinary shares, 11,500,000 authorized, par value \$0.01 Issued and outstanding: 2004 and 2003, 11,500,000;	115	115
Series C preference ordinary shares, 20,000,000 authorized, par value \$0.01 Issued and outstanding 2004 and 2003, nil.	—	—
Class A ordinary shares, 999,990,000 authorized, par value \$0.01 Issued and outstanding: 2004, 138,077,156; 2003, 137,343,232	1,380	1,373
Additional paid in capital	3,886,876	3,949,421
Accumulated other comprehensive income	631,982	490,195
Deferred compensation	(84,195)	(46,124)
Retained earnings	2,926,477	2,541,843
	<hr/>	<hr/>
Total shareholders' equity	\$ 7,362,727	\$ 6,936,915
	<hr/>	<hr/>
Total liabilities and shareholders' equity	\$ 44,170,320	\$ 40,764,215

See accompanying Notes to Unaudited Consolidated Financial Statements

4

**XL CAPITAL LTD  
CONSOLIDATED STATEMENTS OF INCOME  
(U.S. dollars and shares in thousands, except per share amounts)**

	(Unaudited) Three Months Ended March 31,
	<hr/>
	2004
	2003

<b>Revenues:</b>		
Net premiums earned — general operations	\$ 1,574,925	\$ 1,431,887
Net premiums earned — life and annuity operations	116,932	92,771
Net premiums earned — financial operations	32,588	26,973
Net investment income — general operations	156,511	149,001
Net investment income — life and annuity operations	63,702	37,459
Net investment income — financial operations	8,133	5,444
Net realized gains (losses) on investments	115,337	(4,663)
Net realized and unrealized gains on derivative instruments	11,597	14,493
Equity in net income of investment affiliates	70,376	26,798
Fee income and other	6,907	12,277
<b>Total revenues</b>	<b>\$ 2,157,008</b>	<b>\$ 1,792,440</b>
<b>Expenses:</b>		
Net losses and loss expenses incurred — general operations and financial operations	\$ 963,944	\$ 885,254
Claims and policy benefits — life and annuity operations	134,063	119,558
Acquisition costs	277,270	240,312
Operating expenses	245,300	190,519
Exchange gains	(10,724)	(2,702)
Interest expense	40,057	46,140
Amortization of intangible assets	3,257	375
<b>Total expenses</b>	<b>\$ 1,653,167</b>	<b>\$ 1,479,456</b>
Income before minority interest, income tax and equity in net loss of insurance and financial affiliates	\$ 503,841	\$ 312,984
Minority interest in net income of subsidiary	4,660	1,862
Income tax	35,357	20,030
Equity in net loss of insurance and financial affiliates	1,575	41,087
<b>Net income</b>	<b>\$ 462,249</b>	<b>\$ 250,005</b>
Preference share dividends	(10,080)	(10,148)
<b>Net income available to ordinary shareholders</b>	<b>\$ 452,169</b>	<b>\$ 239,857</b>
Weighted average ordinary shares and ordinary share equivalents outstanding — basic	137,624	136,216
Weighted average ordinary shares and ordinary share equivalents outstanding — diluted	139,044	137,631
Earnings per ordinary share and ordinary share equivalent — basic	\$ 3.29	\$ 1.76
Earnings per ordinary share and ordinary share equivalent — diluted	\$ 3.25	\$ 1.74

See accompanying Notes to Unaudited Consolidated Financial Statements

5

**XL CAPITAL LTD**  
**CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME**  
(U.S. dollars in thousands)

(Unaudited)  
Three Months Ended  
March 31,

2004                      2003

Net income	\$ 462,249	\$ 250,005
Change in net unrealized appreciation of investments	115,205	65,226
Foreign currency translation adjustments	26,582	(4,179)
Comprehensive income	\$ 604,036	\$ 311,052

See accompanying Notes to Unaudited Consolidated Financial Statements  
6

**XL CAPITAL LTD**  
**CONSOLIDATED STATEMENTS OF SHAREHOLDERS' EQUITY**  
**(U.S. dollars in thousands)**

	(Unaudited) Three Months Ended March 31,	
	2004	2003
<b>Series A and B Preference Ordinary Shares:</b>		
Balance—beginning of year	\$ 207	\$ 207
Issue of shares	—	—
Balance—end of period	\$ 207	\$ 207
<b>Class A Ordinary Shares:</b>		
Balance—beginning of year	\$ 1,373	\$ 1,360
Issue of shares	6	4
Exercise of stock options	1	1
Repurchase of shares	—	—
Balance—end of period	\$ 1,380	\$ 1,365
<b>Additional Paid in Capital:</b>		
Balance—beginning of year	\$ 3,949,421	\$ 3,979,979
Issue of shares	42,634	28,992
Stock option expense	2,399	800
Exercise of stock options	4,723	2,344
Repurchase of shares	—	(76)
Issue of debt related to equity security units (Note 5)	(112,301)	—
Balance—end of period	\$ 3,886,876	\$ 4,012,039
<b>Accumulated Other Comprehensive Income:</b>		
Balance—beginning of year	\$ 490,195	\$ 184,814
Net change in unrealized gains on investment portfolio, net of tax	110,876	66,449
Net change in unrealized gains on investment portfolio of other investments, net of tax	4,329	(1,223)
Currency translation adjustments	26,582	(4,179)
Balance—end of period	\$ 631,982	\$ 245,861
<b>Deferred Compensation:</b>		
Balance—beginning of year	\$ (46,124)	\$ (31,282)

Issue of restricted shares	(42,857)	(28,323)
Amortization	4,786	3,524
Balance—end of period	\$ (84,195)	\$ (56,081)
<b>Retained Earnings:</b>		
Balance—beginning of year	\$ 2,541,843	\$ 2,434,511
Net income	462,249	250,005
Dividends on Series A and B preference ordinary shares	(10,080)	(10,148)
Dividends on Class A ordinary shares	(67,535)	(65,380)
Repurchase of ordinary shares	—	(134)
Balance—end of period	\$ 2,926,477	\$ 2,608,854
<b>Total Shareholders' Equity</b>	<b>\$ 7,362,727</b>	<b>\$ 6,812,245</b>

See accompanying Notes to Unaudited Consolidated Financial Statements

7

**XL CAPITAL LTD**  
**CONSOLIDATED STATEMENTS OF CASH FLOWS**  
(U.S. dollars in thousands)

	(Unaudited) Three Months Ended March 31,	
	2004	2003
<b>Cash flows provided by operating activities:</b>		
Net income	\$ 462,249	\$ 250,005
Adjustments to reconcile net income to net cash provided by operating activities:		
Net realized (gains) losses on sales of investments	(115,337)	4,663
Net realized and unrealized (gains) on derivative instruments	(11,597)	(14,493)
Amortization of discounts on fixed maturities	21,883	1,304
Amortization of intangible assets	3,257	375
Amortization of deferred compensation	4,786	3,524
Accretion of convertible debt	6,381	6,202
Accretion of deposit liabilities	19,416	24,123
Equity in net (income) loss of investment, financial and insurance affiliates	(68,801)	14,289
Unpaid losses and loss expenses	159,268	294,139
Unearned premiums	1,373,950	1,143,116
Premiums receivable	(1,478,787)	(914,328)
Unpaid losses and loss expenses recoverable	16,848	146,205
Future policy benefit reserves	28,840	—
Prepaid reinsurance premiums	(136,226)	(256,832)
Reinsurance balances receivable	75,794	(72,705)
Reinsurance balances payable	208,850	(45,524)
Deferred acquisition costs	(218,595)	(134,257)
Deferred tax asset	53,132	6,134
Other	121,322	123,299
Total adjustments	\$ 64,384	\$ 329,234
Net cash provided by operating activities	\$ 526,633	\$ 579,239
<b>Cash flows used in investing activities:</b>		

Proceeds from sale of fixed maturities and short-term investments	5,685,716	14,733,198
Proceeds from redemption of fixed maturities and short-term investments	305,168	4,903
Proceeds from sale of equity securities	67,274	341,262
Purchases of fixed maturities and short-term investments	(7,119,358)	(15,739,201)
Purchases of equity securities	(126,914)	(316,207)
Investments in affiliates, net of dividends received	(51,654)	5,666
Other investments	1,671	(992)
	<u>                    </u>	<u>                    </u>
Net cash used in investing activities	\$ (1,238,097)	\$ (971,371)
	<u>                    </u>	<u>                    </u>
<b>Cash flows provided by (used in) financing activities:</b>		
Proceeds from exercise of stock options	4,724	3,145
Repurchase of shares	—	(209)
Dividends paid	(77,615)	(75,528)
Proceeds from notes payable and issue of equity units	800,195	—
Deposit liabilities	225,088	60,176
	<u>                    </u>	<u>                    </u>
Net cash provided by (used in) financing activities	952,392	(12,416)
	<u>                    </u>	<u>                    </u>
Effects of exchange rate changes on foreign currency cash	2,808	(939)
	<u>                    </u>	<u>                    </u>
Increase (decrease) in cash and cash equivalents	243,736	(405,487)
<b>Cash and cash equivalents — beginning of period</b>	<u>2,403,121</u>	<u>3,557,815</u>
	<u>                    </u>	<u>                    </u>
<b>Cash and cash equivalents — end of period</b>	\$ <u>2,646,857</u>	\$ <u>3,152,328</u>

See accompanying Notes to Unaudited Consolidated Financial Statements

8

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**XL CAPITAL LTD**  
**NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS**

**1. Basis of Preparation and Consolidation**

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

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

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

**2. Significant Accounting Policies**

Effective January 1, 2003, the Company has adopted the fair value recognition provisions of FASB 123, as amended by FAS 148, under the prospective method for options granted subsequent to January 1, 2003. Prior to 2003, the Company accounted for options under the disclosure-only provisions of FASB 123 and no stock-based employee compensation cost was included in net income as all options granted had an exercise price equal to the market value of the Company’s ordinary shares on the date of the grant. Awards under the Company’s plans vest over periods ranging from three to four years. If the fair value based method had been applied to all awards since the original effective date of Statement 123, the cost related to employee stock-based compensation included in the determination of net income would have been higher. The following table illustrates the net effect on net income and earnings per share if the fair value method had been applied to all outstanding and unvested awards in each period:

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

(Unaudited)  
Three Months Ended  
March 31,

	2004	2003
Net income available to ordinary shareholders— as reported	\$ 452,169	\$ 239,857
Add: Stock based employee compensation expense included in reported net income, net of related tax	2,399	800
Deduct: Total stock based employee compensation expense determined under fair value based method for all awards , net of related tax effects	(12,786)	(11,290)
Pro forma net income available to ordinary shareholders	\$ 441,782	\$ 229,367
Earnings per share:		
Basic – as reported	\$ 3.29	\$ 1.76
Basic – pro forma	\$ 3.21	\$ 1.68
Diluted – as reported	\$ 3.25	\$ 1.74
Diluted – pro forma	\$ 3.18	\$ 1.67

9

**XL CAPITAL LTD**  
**NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS (continued)**

**3. Recent Accounting Pronouncements**

In January 2003, FASB issued Interpretation No. 46, "Consolidation of Variable Interest Entities" ("FIN 46"). The objective of FIN 46 is to improve financial reporting by companies involved with variable interest entities. This new model for consolidation applies to an entity in which either (1) the powers or rights of the equity holders do not give them sufficient decision making ability; (2) the equity investment at risk is insufficient to finance that entity's activities without receiving additional subordinated financial support from other parties or (3) the equity investment at risk does not absorb the expected losses or residual returns of the entity. FIN 46 requires a variable interest entity to be consolidated by the company that is subject to a majority of the risk of loss from the variable interest entity's activities or that is entitled to receive a majority of the entity's residual returns or both. In December 2003, FASB issued a revision to FIN 46 ("FIN 46-R") which clarified several provisions of FIN 46, superseded the related FASB Staff Positions ("FSPs"), and amended the effective date and transition of the pronouncement, except for certain types of entities. The Company must apply the provisions of FIN 46-R to those variable interest entities that are not considered to be special purpose entities no later than March 31, 2004 and was required to apply the provisions of FIN 46 or FIN 46-R to those entities that are considered to be special purpose entities as at December 31, 2003. The adoption of this standard did not have a material effect on the Company's financial condition and results of operations.

In July 2003, the Accounting Standards Executive Committee of the American Institute of Certified Public Accountants ("AICPA") issued Statement of Position ("SOP") 03-01, "Accounting and Reporting by Insurance Enterprises for Certain Nontraditional Long-Duration Contracts and for Separate Accounts." The AcSEC has developed the SOP to address the evolution of product designs since the issuance of SFAS No. 60, "Accounting and Reporting by Insurance Enterprises," and SFAS No. 97, "Accounting and Reporting by Insurance Enterprises for Certain Long-Duration Contracts and for Realized Gains and Losses from the Sale of Investments" and the need for interpretive guidance to be developed in three areas: separate account presentation and valuation; the accounting for sales inducements to contract holders; and the classification and valuation of certain long-duration contract liabilities. The provisions of the SOP are effective for fiscal years beginning after December 15, 2003. The adoption of this SOP did not have a material effect on the Company's financial condition or results of operations.

In April 2004, the FASB issued FASB Staff Position No. FAS 129-1, "Disclosure Requirements under FASB Statement 129, *Disclosure of Information about Capital Structure*, Relating to Contingently Convertible Securities" ("FSP"). The purpose of this FSP is to interpret how the disclosure provisions of Statement 129 apply to contingently convertible securities and to their potentially dilutive effects on EPS. The Company has provided the required disclosures related to its contingently convertible securities that are required by the FSP in its December 31, 2003 financial statements.

In March 2004, the FASB ratified Emerging Issues Task Force ("EITF") Issue No. 03-16, "Accounting for Investments in Limited Liability Companies" (the "Issue"). In EITF Abstracts, Topic No. D-46, "Accounting for Limited Partnership Investments," the SEC staff clarified its view that investments of more than 3 to 5 percent are considered to be more than minor and, therefore, should be accounted for using the equity method. Limited liability companies ("LLCs") have characteristics of both corporations and partnerships, but are dissimilar from both in certain respects. Due to those similarities and differences, diversity in practice exists with respect to accounting for noncontrolling investments in LLCs. This EITF addresses whether an LLC should be viewed as similar to a corporation or similar to a partnership for purposes of determining whether a noncontrolling investment should be accounted for using the cost method or the equity method of accounting. The EITF reached a consensus that an investment in an LLC that maintains a "specific ownership account" for each investor—similar to a partnership capital account structure—should be viewed as similar to an investment in a limited partnership for purposes of determining whether a noncontrolling investment in an LLC should be accounted for using the cost method or the equity method. This EITF applies to all investments in LLCs and is effective for reporting periods beginning after June 15, 2004. The adoption of this Issue will not have a material effect on the Company's financial condition or results of operations.

10

**XL CAPITAL LTD**  
**NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS (continued)**

**4. Segment Information**



The Company is organized into three operating segments — insurance, reinsurance and financial products and services — in addition to a corporate segment that includes the general investment and financing operations of the Company. General, life and annuity and financial operations are disclosed separately by segment. General operations include property and casualty lines of business.

The Company evaluates the performance of each segment based on underwriting results for general operations, net income from life and annuity operations and contribution from financial operations. Other items of revenue and expenditure of the Company are not evaluated at the segment level. In addition, the Company does not allocate assets by segment for its general operations. Investment assets related to the Company's life and annuity and financial operations are held in separately identified portfolios. Net investment income from these assets is included in net income from life and annuity operations and contribution from financial operations, respectively.

Certain lines of business within general operations written by the Company have loss experience generally characterized as low frequency and high severity. This may result in volatility in both the Company's results and operational cash flows.

**XL CAPITAL LTD**  
**NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS (continued)**

The following is an analysis of results by segment together with a reconciliation to net income:

**Quarter Ended March 31, 2004:**  
**(U.S. dollars in thousands, except ratios)**  
**(Unaudited)**

	Insurance	Reinsurance	Financial Products and Services	Total
<b>General Operations:</b>				
Net premiums earned	\$ 885,324	\$ 689,601	\$ —	\$ 1,574,925
Fee income and other	2,331	3,910	—	6,241
Net losses and loss expenses	544,926	416,822	—	961,748
Acquisition costs	119,723	144,228	—	263,951
Operating expenses (1)	128,989	43,755	—	172,744
Exchange losses (gains)	1,580	(11,463)	—	(9,883)
<b>Underwriting profit</b>	<b>\$ 92,437</b>	<b>\$ 100,169</b>	<b>\$ —</b>	<b>\$ 192,606</b>
<b>Life and Annuity Operations:</b>				
Life premiums earned	—	\$ 95,239	\$ 21,693	\$ 116,932
Fee income and other	—	46	69	115
Claims and policy benefits	—	116,176	17,887	134,063
Acquisition costs	—	7,683	2,708	10,391
Operating expenses (1)	—	2,964	3,257	6,221
Exchange losses (gains)	—	(841)	—	(841)
Net investment income	—	45,411	18,291	63,702
Interest expense	—	138	10,258	10,396
<b>Net income from life and annuity operations</b>	<b>\$ —</b>	<b>\$ 14,576</b>	<b>\$ 5,943</b>	<b>\$ 20,519</b>
<b>Financial Operations:</b>				
Net premiums earned			\$ 32,588	\$ 32,588
Fee income and other			551	551
Net losses and loss expenses			2,196	2,196
Acquisition costs			2,928	2,928
Operating expenses (1)			16,794	16,794
<b>Underwriting profit</b>			<b>\$ 11,221</b>	<b>\$ 11,221</b>
Investment income — financial guaranty			\$ 8,133	\$ 8,133
Net realized and unrealized losses on weather and energy derivatives			(4,664)	(4,664)
Net realized and unrealized gains on credit derivatives			13,360	13,360

Operating expenses — weather and energy (1)	7,936	7,936
Equity in net loss of financial affiliates	(2,590)	(2,590)
Minority interest	4,660	4,660
<b>Contribution from financial operations</b>	<b>\$ 12,864</b>	<b>\$ 12,864</b>
<b>Net investment income — general operations</b>	<b>12</b>	<b>\$ 156,511</b>

**XL CAPITAL LTD**  
**NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS (continued)**

**Quarter Ended March 31, 2004: (Continued)**  
**(U.S. dollars in thousands, except ratios)**  
**(Unaudited)**

	Insurance	Reinsurance	Financial Products and Services	Total
Net realized and unrealized gains on investments and derivative instruments (3)				\$ 118,238
Equity in net income of investment and insurance affiliates				71,391
Interest expense (2)				29,661
Amortization of intangible assets				3,257
Corporate operating expenses				41,605
Income tax				35,357
<b>Net Income</b>				<b>\$ 462,249</b>

**General Operations:**

Loss and loss expense ratio (4)	61.6%	60.4%	61.1%
Underwriting expense ratio (4)	28.0%	27.3%	27.7%
Combined ratio (4)	89.6%	87.7%	88.8%

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

(2) Interest expense excludes interest expense related to life and annuity operations, shown separately.

(3) This includes net realized gains on investments of \$115.0 million and net realized and unrealized gains on investment derivatives of \$3.0 million.

(4) Ratios are based on net premiums earned from general operations, excluding fee income and other. The underwriting expense ratio excludes exchange gains and losses.

**Quarter Ended March 31, 2003:**  
**(U.S. dollars in thousands, except ratios)**  
**(Unaudited)**

	Insurance	Reinsurance	Financial Products and Services	Total
<b>General Operations:</b>				
Net premiums earned	\$ 881,227	\$ 550,660	\$ —	\$ 1,431,887

Fee income and other	2,148	11,450	—	13,598
Net losses and loss expenses	521,285	350,506	—	871,791
Acquisition costs	124,450	104,649	—	229,099
Operating expenses (1)	98,096	34,560	—	132,656
Exchange losses (gains)	7,717	(10,125)	—	(2,408)
<b>Underwriting profit</b>	<b>\$ 131,827</b>	<b>\$ 82,520</b>	<b>\$ —</b>	<b>\$ 214,347</b>

**Life and Annuity Operations:**

Life premiums earned	\$ —	\$ 83,237	\$ 9,534	\$ 92,771
Fee income and other	—	—	21	21
Claims and policy benefits	—	110,472	9,086	119,558
Acquisition costs	—	6,953	1,057	8,010

13

**XL CAPITAL LTD**  
**NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS (continued)**

**Quarter Ended March 31, 2003: (Continued)**  
**(U.S. dollars in thousands, except ratios)**  
**(Unaudited)**

	Insurance	Reinsurance	Financial Products and Services	Total
Operating expenses (1)	\$ —	\$ 2,265	\$ 2,433	\$ 4,698
Exchange losses (gains)	—	(294)	—	(294)
Net investment income	—	31,548	5,911	37,459
Interest expense (2)	—	—	2,136	2,136
<b>Net (loss) income from life and annuity operations</b>	<b>\$ —</b>	<b>\$ (4,611)</b>	<b>\$ 754</b>	<b>\$ (3,857)</b>
<b>Financial Operations:</b>				
Net premiums earned			\$ 26,973	\$ 26,973
Fee income and other			(1,342)	(1,342)
Net losses and loss expenses			13,463	13,463
Acquisition costs			3,203	3,203
Operating expenses (1)			13,287	13,287
<b>Underwriting loss</b>			<b>\$ (4,322)</b>	<b>\$ (4,322)</b>
Investment income — financial guaranty			\$ 5,444	\$ 5,444
Net realized and unrealized gains on weather and energy derivatives			10,410	10,410
Net realized and unrealized losses on credit derivatives			(567)	(567)
Operating expenses — weather and energy (1)			5,571	5,571
Equity in net income of financial affiliates			518	518
Minority interest			2,070	2,070
<b>Contribution from financial operations</b>			<b>\$ 3,842</b>	<b>\$ 3,842</b>
Net investment income-general operations				\$ 149,001
Net realized and unrealized losses on investments and derivative instruments (3)				(13)
Equity in net loss of investment and insurance affiliates				(14,807)
Interest expense (2)				44,004
Amortization of intangible assets				375

Corporate operating expenses (1)			34,307
Minority interest			(208)
Income tax			20,030
<b>Net Income</b>			<b>\$ 250,005</b>

**General Operations:**

Loss and loss expense ratio (4)	59.2%	63.7%	60.9%
Underwriting expense ratio (4)	25.2%	25.2%	25.2%
Combined ratio (4)	84.4%	88.9%	86.1%

**XL CAPITAL LTD**  
**NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS (continued)**

**Quarter Ended March 31, 2003: (Continued)**

- (1) Operating expenses exclude corporate operating expenses, shown separately.
- (2) Interest expense excludes interest expense related to life and annuity operations, shown separately.
- (3) This includes net realized losses on investments of \$4.7 million and net realized and unrealized gains on investment derivatives of \$4.7 million.
- (4) Ratios are based on net premiums earned from general operations, excluding fee income and other. The underwriting expense ratio excludes exchange gains and losses.

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

**Quarter Ended March 31, 2004:**  
**(U.S. dollars in thousands)**  
**(Unaudited)**

	Insurance	Reinsurance	Financial Products and Services
<b>General Operations:</b>			
Professional liability	\$ 273,587	\$ —	\$ —
Casualty	223,931	285,654	—
Property catastrophe	11,573	64,988	—
Other property	122,246	192,386	—
Marine, energy, aviation and satellite	220,850	54,317	—
Accident and health	1,413	10,393	—
Other (1)	31,724	81,863	—
<b>Total general operations</b>	<b>885,324</b>	<b>689,601</b>	<b>—</b>
<b>Life and Annuity Operations</b>	<b>—</b>	<b>95,239</b>	<b>21,693</b>
<b>Financial Operations</b>	<b>—</b>	<b>—</b>	<b>32,588</b>
<b>Total</b>	<b>\$ 885,324</b>	<b>\$ 784,840</b>	<b>\$ 54,281</b>

- (1) Other, includes political risk, surety, bonding, warranty and other lines.

**Quarter Ended March 31, 2003:**  
**(U.S. dollars in thousands)**  
**(Unaudited)**

	Insurance	Reinsurance	Financial Products and Services
<b>General Operations:</b>			
Professional liability	\$ 212,823	\$ —	\$ —
Casualty	224,743	219,678	—
Property catastrophe	—	58,536	—
Other property	157,973	176,284	—
Marine, energy, aviation and satellite	178,335	49,866	—
Accident and health	18,780	5,550	—
Other (1)	88,573	40,746	—
<b>Total general operations</b>	<b>881,227</b>	<b>550,660</b>	<b>—</b>
<b>Life and Annuity Operations</b>	<b>—</b>	<b>83,237</b>	<b>9,534</b>
<b>Financial Operations</b>	<b>—</b>	<b>—</b>	<b>26,973</b>
<b>Total</b>	<b>\$ 881,227</b>	<b>\$ 633,897</b>	<b>\$ 36,507</b>

(1) Other, includes political risk, surety, bonding, warranty and other lines.

**XL CAPITAL LTD**  
**NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS (continued)**

**5. Notes Payable and Debt and Financing Arrangements**

In March, 2004 the Company issued 33 million 6.5% Equity Security Units (“Units”) in a public offering. The Company received approximately \$800.2 million in proceeds from the sale of the Units after deducting underwriting discounts. The Company intends to use the net proceeds from the sale of the Units for general corporate purposes.

Each Unit has a stated amount of \$25 and consists of (a) a purchase contract pursuant to which the holder agreed to purchase, for \$25, a variable number of shares of the Company’s Class A Ordinary Shares on May 15, 2007 and (b) a one-fortieth, or 2.5%, ownership interest in a senior note issued by the Company due May 15, 2009 with a principal amount of \$1,000. The senior notes are pledged by the holders to secure their obligations under the purchase contract. The number of shares issued under the purchase contract is contingently adjustable based on, among other things, the share price of the Company on the stock purchase date and the dividend rate of the Company. The Company will make quarterly payments at the annual rate of 3.97% and 2.53% under the purchase contracts and senior notes, respectively. The Company may defer the contract payments on the purchase contract, but not the senior notes, until the stock purchase date. In May 2007, the senior notes will be remarketed whereby the interest rate on the senior notes will be reset in order to generate sufficient remarketing proceeds to satisfy the Unit holder’s obligation under the purchase contract. If the senior notes are not successfully remarketed, then the Company will exercise its rights as a secured party and may retain or dispose of the senior notes to satisfy in full the holders’ obligation to purchase its ordinary shares under the purchase contracts.

In connection with this transaction, \$88.6 million, which is the estimated fair value of the purchase contract was charged to “Additional paid in capital” and a corresponding liability was established. Of the total costs associated with the issuance of the Units of \$26.8 million, \$23.7 million was charged to “Additional paid in capital” with the remainder deferred and amortized over the term of the senior debt. The number of ordinary shares to be issued under each purchase contract depends on, among other things, the average market price of the ordinary shares. The maximum number of ordinary shares to be issued under the purchase contracts is approximately 11 million. The Company accounts for the effect on the number of weighted average ordinary shares, assuming dilution, using the treasury stock method. The purchase contract component of the Units will have no effect on the number of weighted average ordinary shares, assuming dilution, except when the average market price of the Company’s ordinary shares is above the threshold appreciation price of \$93.99 per share. Because the average market price of the Company’s ordinary shares during the period the Units were outstanding was below this price, the shares issuable under the purchase contracts were excluded from the computation of net income (loss) per ordinary share assuming dilution for the three month period ended March 31, 2004.

The Company has entered into three new bilateral unsecured letter of credit facilities in 2004 to provide additional capacity to support the Company’s U.S. non-admitted business. The new facilities total \$125.0 million of which \$50.0 million was utilized at March 31, 2004.

**6. Exposures under Guaranties**

The Company provides and reinsures financial guaranties issued to support public and private borrowing arrangements. Financial guaranties are conditional commitments that guaranty the performance of an obligor to a third party, typically the timely repayment of principal and interest. The Company’s potential liability in the event of non-payment by the issuer of the insured obligation is represented by its proportionate share of the aggregate outstanding principal and interest payable on such insured obligation. In synthetic transactions, the Company guarantees payment obligations of counterparties under credit default swaps. The Company does not record a carrying value for future installment premiums on financial guaranties as they are recognized over the term of the contract.

The net outstanding exposure as at March 31, 2004 of financial guaranty aggregate insured portfolios was \$57.3 billion, which includes credit default swap exposures of \$10.0 billion. The net liability for these credit default swaps has a carrying value of \$106.2 million.

**XL CAPITAL LTD**  
**NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS (continued)**

**7. Derivative Instruments**

The Company enters into investment and weather and energy derivative instruments for both risk management and trading purposes. The Company enters into credit derivatives in connection with its financial guaranty business and the Company intends to hold these contracts to maturity. The Company is exposed to potential loss from various market risks and manages its market risks based on guidelines established by senior management. These derivative instruments are carried at fair value with the resulting gains and losses recognized in income in the period in which they occur.

The following table summarizes the net realized and unrealized gains on derivative instruments included in net income for the three months ended March 31, 2004 and 2003:

(U.S. dollars in thousands)	(Unaudited) Three Months Ended March 31,	
	2004	2003
Credit default swaps	\$ 13,053	\$ (567)
Weather and energy risk management products	(4,664)	10,410
Investment derivatives	3,208	4,650
Net realized and unrealized gains on derivatives	\$ 11,597	\$ 14,493

**8. XL Capital Finance (Europe) plc**

XL Capital Finance (Europe) plc ("XLFE") is a wholly owned finance subsidiary of the Company. In January 2002, XLFE issued \$600.0 million par value 6.5% Guaranteed Senior Notes due January 2012. These Notes are fully and unconditionally guaranteed by the Company. The Company's ability to obtain funds from its subsidiaries is subject to certain contractual restrictions, applicable laws and statutory requirements of the various countries in which the Company operates including Bermuda, the U.S. and the U.K., among others. Required statutory capital and surplus for the principal operating subsidiaries of the Company was \$3.0 billion as of December 31, 2003.

**9. Computation of Earnings Per Ordinary Share and Ordinary Share Equivalent**

(U.S. dollars and shares in thousands, except per share amounts)	(Unaudited) Three Months Ended March 31,	
	2004	2003
<b>Basic earnings per ordinary share:</b>		
Net income	\$ 462,249	\$ 250,005
Less: preference share dividends	(10,080)	(10,148)
Net income available to ordinary shareholders	\$ 452,169	\$ 239,857
Weighted average ordinary shares outstanding (2)	137,624	136,216
Basic earnings per ordinary share	\$ 3.29	\$ 1.76
<b>Diluted earnings per ordinary share:</b>		
Net income	\$ 462,249	\$ 250,005
Less: preference share dividends	(10,080)	(10,148)
Net income available to ordinary shareholders	\$ 452,169	\$ 239,857

## 9. Computation of Earnings Per Ordinary Share and Ordinary Share Equivalent (continued)

(U.S. dollars and shares in thousands, except per share amounts)	(Unaudited) Three Months Ended March 31,	
	2004	2003
Weighted average ordinary shares outstanding—basic (2)	137,624	136,216
Average stock options outstanding (1)	1,420	1,415
Weighted average ordinary shares outstanding—diluted (2)	139,044	137,631
Diluted earnings per ordinary share	\$ 3.25	\$ 1.74
<b>Dividends per ordinary share</b>	<b>\$ 0.49</b>	<b>\$ 0.48</b>

(1) Net of shares repurchased under the treasury stock method.

(2) Future weighted average number of shares outstanding may be affected by the convertible debt issued during 2001. Due to the contingent nature of the conversion features of the debt, there was no effect on diluted earnings per share for the three months ended March 31, 2004 and March 31, 2003.

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

### General

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

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

This discussion and analysis should be read in conjunction with the "Management's Discussion and Analysis of Financial Condition and Results of Operations", and the audited Consolidated Financial Statements and notes thereto, presented under Item 7 and Item 8, respectively, of the Company's Form 10-K for the year ended December 31, 2003.

### Executive Overview

See Executive Overview in Item 7 of the Company's Form 10-K for the year ended December 31, 2003.

### Results of Operations

The following table presents an analysis of the Company's net income available to ordinary shareholders and other financial measures (described below) for the three months ended March 31, 2004 and 2003.

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

	(Unaudited) Three Months Ended March 31,	
	2004	2003
Net income available to ordinary shareholders	\$ 452,169	\$ 239,857
Earnings per ordinary share— basic	\$ 3.29	\$ 1.76
Earnings per ordinary share— diluted <sup>(1)</sup>	\$ 3.25	\$ 1.74

Weighted average number of ordinary shares and ordinary share equivalents—basic	137,624	136,216
Weighted average number of ordinary shares and ordinary share equivalents—diluted <sup>(1)</sup>	139,044	137,631

(1) Average stock options outstanding have been excluded where anti-dilutive to earnings per ordinary share.

The Company's net income and other financial measures as shown below for the three months ended March 31, 2004 have been affected, among other things, by the following significant items:

- 1) A competitive underwriting environment in certain product lines.
- 2) Stable reported losses with low levels of catastrophe losses in the quarter.
- 3) Growing asset base and positive performance from investment affiliates.

### 1. A competitive underwriting environment.

Overall market conditions remain strong although increased competition has begun to cause moderation in pricing. Given the differing dynamics of the markets in which the Company operates moderation of pricing is taking place at a different pace in different markets. For instance the Company is seeing quite different patterns in Europe compared with the U.S. Market conditions vary considerably by geographic region and product line. While moderate price increases continue to be seen in the casualty lines, competitive pressures have reduced the growth in rates. Property lines have begun to see rate decreases as certain competitors pursue premium growth. Based on continued solid demand and the benefits of price increases and improved terms achieved over the last several renewals, the Company believes that business in the insurance and reinsurance markets remains adequately priced. Performance by segment is further discussed in the segment analysis below.

### 2. Stable reported losses with low levels of catastrophe losses in the quarter.

The Company's loss and loss expense ratio on general business for the quarter ended March 31, 2004 was 61.1% compared with 60.9% for the same period in 2003, primarily due to the low level of catastrophic losses in the quarter. This is further discussed in the segment analysis below.

### 3. Growing asset base and positive performance from investment affiliates.

Total net investment income from assets in all business lines has increased from \$191.9 million for the three months ended March 31, 2003 to \$228.3 million in 2004. This growth has been based primarily on strong cash flows. Earnings from equity in investment affiliates in the first quarter of 2004 were \$70.4 million compared to \$26.8 million in the comparable period last year. These results reflect positive performance in the Company's alternatives portfolio, as well as positive financial results within many of the investment managers where the Company has a minority equity stake. This is further discussed within the investment activities analysis below.

## Financial Measures

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

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

	(Unaudited) Three Months Ended March 31,	
	2004	2003
Underwriting (loss) profit – general operations	\$ 192,606	\$ 214,347
Combined ratio – general operations	88.8%	86.1%
Investment income – general operations	\$ 156,511	\$ 149,001
Annualized return on average ordinary shareholders' equity	27.3%	15.5%

(Unaudited) March 31, 2004	December 31, 2003
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Book value per ordinary share	\$	49.58	\$	46.74
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*Underwriting profit - general operations*

One way that the Company evaluates the performance of its property and casualty insurance and reinsurance general operations is the underwriting profit or loss. The Company does not measure performance based on the amount of gross premiums written. Underwriting profit or loss is calculated from premiums earned and fee income, less net losses incurred and expenses related to the underwriting activities. Underwriting profits in the three months ended March 31, 2004 are reflective of the combined ratio discussed below.

20

*Combined ratio – general operations*

The combined ratio for general operations is used by the Company and many other property and casualty insurance and reinsurance companies as another measure of underwriting profitability. The combined ratio is calculated from the net losses incurred and underwriting expenses as a ratio of the net premiums earned for the Company's general insurance and reinsurance operations. A combined ratio of less than 100% indicates an underwriting profit and over 100% reflects an underwriting loss. Increases in the Company's combined ratio for the quarter ended March 31, 2004 compared to the same quarter in the previous year are a result of a slightly increased loss and loss expense ratio combined with an increase in the underwriting expense ratio. The increase in loss and loss expense ratio is primarily due to a change in the mix of overall business written. The increase in the underwriting expense ratio is primarily due to the establishment of additional infrastructure to support growth across the Company, work related compliance with the Sarbanes-Oxley Act and foreign exchange impacts.

*Net investment income— general operations*

Net investment income from the Company's general operations is an important measure which affects the Company's overall profitability. The largest liability of the Company relates to its unpaid loss reserves and the Company's investment portfolio provides liquidity for claims settlements of these reserves as they become due. A significant part of the portfolio is in fixed income securities. Net investment income is affected by overall market interest rates and also the size of the portfolio. The average investment portfolio outstanding during the quarter ended March 31, 2004 has increased as compared to the same period in 2003 due to positive cash flows combined with capital raising activities. Total investments as at March 31, 2004 were \$24.3 billion as compared to \$19.1 billion as at March 31, 2003.

*Book value per ordinary share*

Management also views the Company's book value per ordinary share as an additional measure of the Company's performance. Book value per share is calculated by dividing ordinary shareholders' equity by the number of outstanding ordinary shares at any period end. Book value per ordinary share is affected primarily by the Company's net income and also by any changes in the net unrealized gains and losses on its investment portfolio. Both net income and the overall net unrealized gain position of the investment portfolio have increased significantly during the first quarter of 2004.

*Return on average ordinary shareholders' equity*

Return on average ordinary shareholder's equity ("ROE") is a widely used measure of a company's profitability. It is calculated by dividing the net income for any period by the average of the opening and closing ordinary shareholder's equity. The Company establishes target ROE's for its total operations, segments and lines of business. If the Company's ROE return targets are not met with respect to any line of business over time, the Company seeks to reevaluate these lines. In addition, the Company's compensation of its senior officers is significantly dependant on the achievement of the Company's performance goals to enhance shareholder value, including ROE. The improvement in this financial measure is due to the key operating factors noted above combined with a 7% increase in return related specifically to the net realized gains recognized in the period.

**Other Key Focuses of Management**

See the discussion of the Other Key Focuses of Management in Item 7 of the Company's Form 10-K for the year ended December 31, 2003.

**Critical Accounting Policies and Estimates**

See the discussion of the Company's Critical Accounting Policies and Estimates in Item 7 of the Company's Form 10-K for the year ended December 31, 2003.

**Variable Interest Entities and Other Off-Balance Sheet Arrangements**

See the discussion of the Company's Variable Interest Entities and other Off-Balance Sheet Arrangements in Item 7 of the Company's Form 10-K for the year ended December 31, 2003.

21

**Segments**

***Insurance***

General insurance business written includes risk management and specialty lines. Risk management products are comprised of global property and casualty insurance programs for large multinational companies, including umbrella liability, integrated risk and primary master property and liability coverages. Specialty lines products include directors' and officers' liability insurance, environmental liability insurance, political risk insurance, professional liability, aviation and satellite insurance, employment practices liability insurance, surety, marine, specie, bloodstock and

certain other insurance coverages including program business.

A large part of the Company's casualty insurance business written has loss experience that is low frequency and high severity. As a result, large losses, though infrequent, can have a significant impact on the Company's results of operations, financial condition and liquidity. The Company attempts to mitigate this risk by using strict underwriting guidelines and various reinsurance arrangements.

The following table summarizes the underwriting results for this segment:

**(U.S. dollars in thousands)**

	(Unaudited) Three Months Ended March 31,		
	2004	2003	% Change
<i>General:</i>			
Gross premiums written	\$ 1,720,245	\$ 1,477,254	16.5%
Net premiums written	1,295,923	1,088,405	19.1%
Net premiums earned	885,324	881,227	0.5%
Fee income and other	2,331	2,148	8.5%
Net losses and loss expenses	544,926	521,285	4.5%
Acquisition costs	119,723	124,450	(3.8)%
Operating expenses	128,989	98,096	31.5%
Exchange losses	1,580	7,717	(79.5)%
<b>Underwriting profit</b>	<b>\$ 92,437</b>	<b>\$ 131,827</b>	<b>(29.9)%</b>

Gross and net premiums written increased by 16.5% and 19.1%, respectively, in the quarter ended March 31, 2004 compared with the quarter ended March 31, 2003. This increase is primarily due to new business written across most lines and favorable foreign exchange movements. The most significant growth due to new business was seen in casualty and marine lines of business combined with several new product offerings in the professional liability and property catastrophe lines. The new insurance initiatives added approximately \$64 million to gross written premium. The weakening of the U.S. dollar against U.K. sterling and the Euro since the first quarter of 2003 accounted for approximately 6% of the increase in gross premiums written in the three months ended March 31, 2004. Partially offsetting the growth in net premiums written in 2004 were moderate rate reductions in certain property lines and growing rate pressures on most casualty lines.

Net premiums earned in the quarter ended March 31, 2004 were flat when compared to the same quarter in 2003. Increases in net premiums written in the current and prior year were offset by the commutation in the quarter of certain political risk policies and a change in estimate related to the level of ceded premium in certain Lloyd's portfolios. Net premiums earned also reflects a decrease over the same quarter prior year related to previously non-renewed portfolios (specialty workers compensation, certain Lloyd's international programs, and accident & health) as the earned premium impact of the non-renewed business cited above lags the written premium impact.

Exchange losses in the quarter ended March 31, 2004 were primarily due to the strengthening of U.K. sterling against the Euro. These losses were offset by the strengthening of the U.S. dollar in the first quarter of 2004 against the Euro in those entities whose functional currency is the Euro and which are exposed to net U.S. dollar liabilities.

The decrease in the underwriting profit in the first quarter of 2004 as compared with the very strong performance in the first quarter of 2003 was also reflective of the combined ratios as shown below.

The following table presents the ratios for this segment:

	(Unaudited) Three Months Ended March 31,	
	2004	2003
Loss and loss expense ratio	61.6%	59.2%
Underwriting expense ratio	28.0%	25.2%
<b>Combined ratio</b>	<b>89.6%</b>	<b>84.4%</b>

The loss and loss expense ratio includes net losses incurred for both the current year and any adverse or favorable prior year development of loss and loss reserves held at the beginning of the year. The loss ratio for the three months ended March 31, 2004 increased compared with the three months ended March 31, 2003 largely due to the outstanding performance in the prior year. There has been favorable prior year net loss development in the quarter ended March 31, 2004 primarily in property lines.

Higher premium rates on the current quarter earned premiums have maintained the low loss and loss expense ratio achieved by favorable prior period loss development in the same period in 2003.

The increase in the underwriting expense ratio in the three months ended March 31, 2004 compared to the same period in 2003 was due to an increase in the operating expense ratio of 3.5 points (14.6% as compared to 11.1%) partially offset by a reduction in the acquisition expense ratio of 0.6 points (13.5% as compared to 14.1%). The increase in the operating expense ratio was due primarily to the increased costs associated with supporting new business growth in the segment operations globally in particular the start up operations, and an allocation of certain corporate expenses to the segment. The reduction in the acquisition expense ratio is due primarily to a change in the mix of business earned during the quarter compared to the same quarter in the prior year.

## Reinsurance

### Reinsurance — General Operations

General reinsurance business written includes casualty, property, accident and health and other specialty reinsurance on a global basis. The Company's reinsurance property business generally has loss experience characterized as low frequency and high severity that can have a negative impact on the Company's results of operations, financial condition and liquidity. The Company endeavors to manage its exposures to catastrophic events by limiting the amount of its exposure in each geographic zone worldwide and requiring that its property catastrophe contracts provide for aggregate limits and varying attachment points.

The following table summarizes the underwriting results for the general operations of this segment:

(U.S. dollars in thousands)

	(Unaudited) Three Months Ended March 31,		
	2004	2003	% Change
<i>General:</i>			
Gross premiums written	\$ 1,680,437	\$ 1,513,795	11.0%
Net premiums written	1,488,838	1,259,370	18.2%
Net premiums earned	689,601	550,660	25.2%
Fee income and other	3,910	11,450	(65.9)%

23

	(Unaudited) Three Months Ended March 31,		
	2004	2003	% Change
Net losses and loss expenses	416,822	350,506	18.9%
Acquisition costs	144,228	104,649	37.8%
Operating expenses	43,755	34,560	26.6%
Exchange gains	11,463	10,125	13.2%
<b>Underwriting profit</b>	<b>\$ 100,169</b>	<b>\$ 82,520</b>	<b>21.4%</b>

Gross and net premiums written increased 11.0% and 18.2%, respectively, in the first quarter of 2004 as compared to the first quarter of 2003. The growth in gross written premiums was due to a combination of new and renewal business growth (including rate changes and increased line shares) of approximately 8% and premium adjustments in respect of prior year business of 3%. Net written premiums reflect the above gross changes, together with higher retentions, including approximately \$40.0 million of quota share premiums from Le Mans Re previously ceded but now retained within the group. Favorable foreign exchange movements have also contributed to the growth in gross written premiums. The net increase in new and renewed business written reflects underlying rate improvements in the range of 10%-15% on the U.S. and London casualty portfolio and rate decreases generally in the range of up to 15% across U.S. property lines. Some international property rates also saw reductions but generally remained reasonably firm. Rate decreases also occurred in the marine, aviation and satellite lines. The first quarter is the major renewal season for the Company's general reinsurance business and generated between 40% and 45%, of the full year's gross written premiums for 2002 and 2003.

Net premiums earned in the first quarter of 2004 increased 25.2% as compared to the first quarter of 2003, due primarily to the earning of net written premium growth in the last 12 months. Casualty reinsurance net premiums earned were \$285.6 million in the first quarter of 2004 as compared to \$219.7 million in the same period in 2003.

Fee income and other relates primarily to fees earned on deposit liability contracts which are earned based on individual underlying contractual terms and conditions. The decrease in fee income is in line with management expectations given those terms and conditions.

The following table presents the ratios for this segment:

(Unaudited) Three Months Ended March 31,	
2004	2003

Loss and loss expense ratio	60.4%	63.7%
Underwriting expense ratio	27.3%	25.2%
<b>Combined ratio</b>	<b>87.7%</b>	<b>88.9%</b>

The loss and loss expense ratio includes net losses incurred for both the current year and any adverse or favorable prior year development of loss reserves held at the beginning of the year.

There were no significant catastrophic loss events affecting the Company in the first quarter of 2004 or 2003. The decrease in the loss and loss expense ratio in the quarter ended March 31, 2004 compared to the same quarter in 2003 primarily reflected lower than expected incurred loss development in the quarter and price improvements on earned premiums from prior periods in first quarter of 2004. Losses related to a Lloyd's stop loss cover impacted the quarter ended March 31, 2003.

The Company continues to monitor the development of the NAC Re 1997-2001 portfolio, which was the subject of the detailed Claims Audit Review ("CAR") project in the fourth quarter of 2003. Based on the Company's current analysis, actual loss emergence is in line with expectations.

The increase in the underwriting expense ratio in the first quarter of 2004 as compared with the first quarter of 2003 was primarily due to an increase in the acquisition expense ratio to 20.9% as compared to 19.0% in the first quarter of 2003. This increase was mainly due to increased profit commission and that certain reinstatement premiums assumed in 2003 are not subject to acquisition costs. The operating expense ratio remained relatively consistent increasing to 6.4% for the first quarter of 2004 from 6.3% in the same quarter in 2003.

Exchange gains in the three months ended March 31, 2004 were mainly attributable to a strengthening in the value of U.K. sterling in the quarter in those operations with U.S. dollars as their functional currency and net U.K. sterling assets.

#### **Reinsurance — Life and Annuity Operations**

Life business written by the reinsurance operations is primarily European life reinsurance. This includes term assurances, group life, critical illness cover, immediate annuities and disability income business. Due to the nature of these contracts, premium volume may vary significantly from period to period.

The following summarizes net (loss) income from life operations:

**(U.S. dollars in thousands)**

<i>Life and Annuity:</i>	(Unaudited) Three Months Ended March 31,		
	2004	2003	% Change
Gross premiums written	\$ 94,269	\$ 93,137	1.2%
Net premiums written	94,191	86,189	9.3%
Net premiums earned	95,239	83,237	14.4%
Fee income and other	46	—	NM
Claims and policy benefits	116,176	110,472	5.2%
Acquisition costs	7,683	6,953	10.5%
Operating expenses	2,964	2,265	30.9%
Net investment income	45,411	31,548	43.9%
Interest expense	138	—	NM
Exchange gains	841	294	186.1%
<b>Net income (loss) from life and annuity operations</b>	<b>\$ 14,576</b>	<b>\$ (4,611)</b>	<b>NM</b>

\* NM — Not Meaningful

All of the above items increased moderately in the first quarter of 2004 as compared to the first quarter of 2003 as a result of new business written and earned as the Company continues to expand its life reinsurance operations worldwide. In particular, the Company wrote several new regular premium term assurance contracts in the fourth quarter of 2003, which were generating further written premiums in the current and subsequent quarters. The increase in net premiums written and earned relative to gross premiums written was primarily due to the termination of a retrocession agreement with an insurance affiliate in the third quarter of 2003.

Claims and policy benefits also increased in line with the growth in net premiums earned and include the movement in policy benefit reserves related to contracts where investment assets are acquired with the assumption of the policy benefit reserves at the inception of the

contract.

Acquisition costs, operating expenses and net investment income increased in the first quarter of 2004 as compared to the first quarter of 2003 in line with the expansion of this business.

Net investment income is included in the calculation of net income from life operations as it relates to income earned on portfolios of separately identified and managed life investment assets and other allocated assets. A large annuity contract was written in the fourth quarter of 2003, which significantly increased the life business invested assets.

**Financial Products and Services**

**Financial Products and Services – Financial Operations**

Financial Products and Services – Financial Operations business written includes insurance, reinsurance and derivative solutions for complex financial risks including financial guaranty insurance and reinsurance and weather and energy risk management products. Many of these transactions are unique and tailored to the specific needs of the insured or user.

Financial guaranty insurance and reinsurance generally guarantees payments of interest and principal on an issuer's obligations when due. Obligations guaranteed or enhanced by the Company range in duration and premiums are received either on an installment basis or upfront. Guaranties written in credit default swap form provide coverage for losses upon the occurrence of specified credit events set forth in the swap documentation.

The Company's weather and energy risk management products are customized solutions designed to assist corporate customers, primarily energy companies and utilities, to manage their financial exposure to variations in underlying weather conditions and related energy markets. The Company attempts to hedge a significant portion of these risks written within the capital markets.

The following table summarizes the underwriting results for this segment:

**(U.S. dollars in thousands)**

	(Unaudited) Three Months Ended March 31,		
	2004	2003	% Change
<i>General:</i>			
Gross premiums written	\$ 56,889	\$ 44,766	27.1%
Net premiums written	52,334	43,996	19.0%
Net premiums earned	32,588	26,973	20.8%
Fee income and other	551	(1,342)	NM
Net losses and loss expenses	2,196	13,463	(83.7)%
Acquisition costs	2,928	3,203	(8.6)%
Operating expenses	16,794	13,287	26.4%
<b>Underwriting profit (loss)</b>	<b>\$ 11,221</b>	<b>\$ (4,322)</b>	<b>NM</b>
Investment income - financial guaranty	8,133	5,444	49.4%
Net realized and unrealized (losses) gains on weather and energy derivative instruments	(4,664)	10,410	(144.8)%
Operating expenses –weather and energy	7,936	5,571	42.5%
Equity in net (loss) income of financial affiliates	(2,590)	518	NM
Minority interest	4,660	2,070	125.1%
Net realized and unrealized gains (losses) on credit default swaps	13,360	(567)	NM
<b>Net contribution from financial operations</b>	<b>\$ 12,864</b>	<b>\$ 3,842</b>	<b>234.7%</b>

\* NM — Not Meaningful

Gross and net premiums written primarily relate to the financial guaranty line of business and reflect premiums received and accrued for in the period and do not include the present value of future cash receipts expected from installment premium policies written in the period. Increases in gross and net premiums written of 27.1% and 19.0% respectively, in the first quarter of 2004 as compared to the same period in 2003 are primarily due to increased installments on new financial guaranty business written in 2003 and in the quarter ended March 31, 2004.

The growth in net premiums earned in the first quarter of 2004 as compared to the same period in 2003 was greater than the increase in net premiums written over the same period. This is because these premiums earn out over the life of the underlying exposures, which are typically longer than the risk periods related to the Company's insurance and reinsurance general operations.

As with the Company's property and casualty insurance and reinsurance operations, net losses and loss expenses include current year net losses incurred and adverse or favorable development of prior year net loss and loss expenses reserves. Net losses and loss expenses in the quarter ended March 31, 2004 decreased substantially compared to the first quarter of 2003. This decrease is primarily a result of financial guaranty exposures written in prior periods being less than originally reserved for, resulting in a release of prior period financial guaranty reserves of \$6.2 million.

In the three months ended March 31, 2004, acquisition costs as a percentage of net premiums earned decreased as compared to the first quarter of 2003, due to a change in the average term over which the acquisition costs were being expensed which more accurately reflects the life of the exposures.

Operating expenses increased in the first quarter of 2004 as compared to the first quarter of 2003 due to expansion of all activities in the segment.

Net investment income related to the financial guaranty business increased in 2004 due to the larger investment portfolio created by growth in premium receipts and a \$100 million capital infusion in the fourth quarter of 2003.

The net realized and unrealized positions on weather and energy risk management derivative instruments resulted in a loss in the quarter ended March 31, 2004 as compared to gains in the same quarter in 2003. During the first quarter of 2004 the winter weather portfolio experienced losses due to higher than expected temperature volatility. During the first quarter of 2003, \$10.4 million in gains were recognized on derivative contracts related to natural gas exposures, however later in the year ended December 31, 2003 both the positions and activity related to natural gas derivatives were significantly reduced.

Equity in net income of financial affiliates decreased in the first quarter of 2004 as compared to the first quarter of 2003 due primarily to an equity loss in the Company's investment in Primus Guaranty, Ltd ("Primus"). Primus specializes in providing credit risk protection through credit derivatives. Primus had a negative mark-to-market adjustment in the quarter.

The increase in minority interest in 2004 and 2003 is due to an increase in the profitability of XL Financial Assurance Ltd., of which 15% is held by a minority shareholder.

The Company's credit derivative transactions relate primarily to financial guaranty coverage that is written in swap form and pertains to tranches of collateralized debt obligations and asset backed securities, particularly the higher rated tranches. The net realized and unrealized gains in the quarter ended March 31, 2004 related to the fair value adjustment for credit derivatives as well as the premiums earned associated with these transactions. These gains were mainly unrealized and related to the improvement of credit quality for certain credit pools. The Company continues to monitor its credit exposures and adjust the fair value of these derivatives as required.

#### **Financial Products and Services— Life and Annuity Operations**

The Company commenced writing life business in this segment in the fourth quarter of 2002. The Company writes municipal reinvestment contracts, funding agreements and institutional life products.

The Company commenced writing municipal reinvestment contracts in 2002 and funding agreements in 2003 whereby the Company receives deposits at contractual interest rates. The Company has investment risk related to its ability to generate sufficient investment income to enable the total invested assets to cover the payment of the estimated ultimate liability.

In December 2002, certain blocks of U.S. based term life mortality reinsurance business written were novated to the Company from an insurance affiliate.

The following table summarizes net income from life and annuity operations:

**(U.S. dollars in thousands)**

	(Unaudited) Three Months Ended March 31,		
	2004	2003	% Change
Gross premiums written	\$ 21,616	\$ 18,187	18.9%
Net premiums written	21,693	11,124	95.0%
Net premiums earned	21,693	9,534	127.5%
Fee income and other	69	21	NM
Claims and policy benefits – Life and annuity operations	17,887	9,086	96.9%
Acquisition costs	2,708	1,057	156.2%
Operating expenses	3,257	2,433	33.9%

Net investment income	18,291	5,911	209.4%
Interest expense	10,258	2,136	NM
<b>Net income from life and annuity operations</b>	<b>\$ 5,943</b>	<b>\$ 754</b>	<b>NM</b>

\* NM — Not Meaningful

Gross and net premiums written and earned relate to the blocks of U.S. based term life mortality reinsurance business. Claims and policy benefits from this book of business are in line with management's expectations.

Net premiums earned, claims and policy benefit reserves and acquisition costs are all related to this novated block of business. During the quarter ended September 30, 2003, the Company exercised its right and terminated a retrocession agreement of certain of these exposures which led to the significant increase in net premiums written compared to the quarter ended March 31, 2003.

Net investment income and interest expense relate to municipal reinvestment contracts and funding agreements transactions. The increase in investment income and the related interest expense was due to the initiation of the funding agreements in the second quarter of 2003 combined with increases in the average balances outstanding related to the book of municipal reinvestment contracts. The average balances outstanding for funding agreements and municipal reinvestment contracts have increased from nil and \$0.5 billion respectively as at March 31, 2003 to \$700 million and \$1.7 billion respectively as at March 31, 2004.

#### Investment Activities

The following table illustrates the change in net investment income from general operations, equity in net income of investment affiliates, net realized gains and losses on investments and net realized and unrealized gains and losses on investment derivatives from general operations for the quarters ended March 31, 2004 and 2003.

(U.S. dollars in thousands)

	(Unaudited) Three Months Ended March 31,		
	2004	2003	% Change
Net investment income — general operations	\$ 156,511	\$ 149,001	5.0%
Equity in net income of investment affiliates	70,376	26,798	162.6%
Net realized gains (losses) on investments	115,337	(4,663)	NM
Net realized and unrealized gains (losses) on investment derivative instruments – general operations	3,208	4,650	NM

\* NM — Not Meaningful

Net investment income related to general operations increased moderately in the first quarter of 2004 as compared to the first quarter of 2003 due primarily to a higher investment base. The growth in the investment base included net cash provided by operations, and the receipt of funds related to new debt and equity security units issued by the Company during the first quarter of 2004. The market yield to maturity on the fixed income portfolio was 3.6% at March 31, 2004 as compared to 4.1% at March 31, 2003.

Equity in net income of investment affiliates increased in the first quarter of 2004 compared to the first quarter of 2003 due to strong performance in both the alternative portfolios and financial results of the investment managers where the Company has a minority stake. The Company's forecasted returns from our investment affiliates are between 9% and 10% although this is not expected to earn evenly throughout the year.

At March 31, 2004 and 2003, approximately 80% and 60% respectively of the investment portfolio could not be meaningfully compared to applicable public market indices. This includes the deposit and regulatory holdings that are subject to investment restrictions and the Company's structured portfolio (i.e. assets supporting deposit liabilities and future policy benefit reserves) where, due to the unique nature of the underlying liabilities, customized benchmarks are used to measure performance. For those portions of the investment portfolio approximately 20% and 40%, respectively, could be meaningfully compared to public market indices. The following is a summary of the investment performance for the first quarters of 2004 and 2003:

(Unaudited) Three months ended March 31,	
2004	2003

<u>Asset/Liability Portfolios</u>	<u>(Note 1)</u>	
U.S. Investment Grade, Moderate Duration	n/a	1.6%
<i>Lehman Aggregate Bond Index</i>	n/a	1.4%
Relative Performance	n/a	0.2%
U.S. Investment Grade, Low Duration	n/a	1.2%
<i>Salomon 1-3 Year Treasury Index</i>	n/a	0.6%
Relative Performance	n/a	0.6%
Euro Aggregate, Unhedged	3.1%	1.6%
<i>Lehman Euro Aggregate Index</i>	2.9%	2.0%
Relative Performance	0.2%	(0.4)%
Pan European, Hedged	1.5%	3.8%
<i>Merrill U.K. / Merrill Pan Europe Composite</i>	1.5%	3.5%
Relative Performance	0.0%	0.3%
U.K. Sterling, Unhedged	n/a	1.8%
<i>Merrill U.K. Sterling Broad Index, 1-10 Years</i>	n/a	1.8%
Relative Performance	n/a	-
<u>Risk Asset Portfolios — Fixed Income</u>		
U.S. Moderate Grade	2.7%	5.0%
<i>Investment Grade / High Yield Composite</i>	3.2%	3.6%
Relative Performance	(0.5)%	1.4%

	<u>(Unaudited)</u> <u>Three months ended</u> <u>March 31,</u>	
	<u>2004</u>	<u>2003</u>
U.S. High Yield	0.6%	5.1%
<i>CS First Boston High Yield Index</i>	2.7%	6.9%
Relative Performance	(2.1)%	(1.8)%
<u>Risk Asset Portfolios — Equities</u>		
U.S. Large Cap Growth Equity	(0.3)%	(1.2)%
<i>Russell 1000 Growth Index</i>	0.7%	(1.1)%
Relative Performance	(1.0)%	(0.1)%
U.S. Large Cap Value Equity	4.8%	(3.8)%



<i>Russell 1000 Value Index</i>	2.9%	(5.0)%
Relative Performance	1.9%	1.2%
U.S. Small Cap Equity	5.9%	(2.9)%
<i>Russell 2000 Index</i>	6.2%	(4.5)%
Relative Performance	(0.3)%	1.6%
Non-U.S. Equity	6.1%	(7.4)%
<i>MSCI EAFE Index</i>	4.3%	(8.2)%
Relative Performance	1.8%	0.8%
<b><u>Risk Asset Portfolios — Alternative Investments</u></b>		
Alternative Investments (Note 2)	4.0%	1.7%
<i>Standard and Poor's 500 Index</i> (Note 2)	1.7%	(3.1)%
Relative Performance	2.3%	4.8%

Note 1 – All U.S. and Sterling fixed income portfolios within Asset/Liability investment portfolios are now managed relative to custom liability benchmarks. Comparisons to market indices are no longer relevant.

Note 2 – Effective June 30, 2003, alternative investments are priced one month in arrears; however, cash flows are reflected in the current reporting period. For comparative purposes, effective June 2003, the Standard & Poor's 500 Index returns are lagged one month.

Net realized gains on investments in the first quarter of 2004 included net realized gains of \$115.7 million from sales of investments and net realized losses of approximately \$0.4 million related to the write-down of certain of the Company's fixed income and equity investments where the Company determined that there was an other than temporary decline in the value of those investments.

Net realized losses on investments in the first quarter of 2003 included net realized gains of approximately \$70.4 million from sales of investments and \$75.1 million related to the write-down of certain of the Company's fixed income and equity investments where the Company determined that there was an other than temporary decline in the value of those investments.

The Company's process for identifying declines in the fair value of investments that are other than temporary involves consideration of several factors. These factors include: (i) the time period during which there has been a significant decline in value; (ii) an analysis of the liquidity, business prospects and overall financial condition of the issuer; (iii) the significance of the decline; (iv) an analysis of the collateral structure and other credit support, as applicable, of the securities in question; and (v) the Company's intent and ability to hold the investment for a sufficient period of time for the value to recover. Where the Company's analysis of the above factors results in the Company's conclusion that declines in fair values are other than temporary, the cost of the security is written down to fair value and the previously unrealized loss is therefore realized.

Net realized and unrealized gains on investment derivatives in the first quarter of 2004 resulted from the Company's investment strategy to economically hedge against interest and foreign exchange risk within the investment portfolio.

#### **Net Unrealized Gains and Losses on Investments**

At March 31, 2004, the Company had net unrealized gains on fixed income securities of \$659.5 million and net unrealized gains on equities of \$117.5 million. Of these amounts, gross unrealized losses on fixed income securities and equities were \$53.0 million and \$9.6 million respectively. The information presented below for the gross unrealized losses on the Company's investments at March 31, 2004 shows the potential effect upon future earnings and financial position should management later conclude that some of the current declines in the fair value of these investments are other than temporary declines.

At March 31, 2004, approximately 2,100 fixed income securities out of a total of approximately 14,300 securities were in an unrealized loss position. The largest single unrealized loss in the fixed income portfolio was \$4.1 million. Approximately 300 equity securities out of a total of approximately 1,800 securities were in an unrealized loss position at March 31, 2004 with the largest individual loss being \$1.0 million.

The following is an analysis of how long each of those securities with an unrealized loss at March 31, 2004 had been in a continual unrealized loss position:

**(U.S. dollars in thousands)**

Type of Securities	Length of time in a continual unrealized loss position	(Unaudited) Amount of unrealized loss at March 31, 2004
Fixed Income and Short-Term	Less than six months	\$ 19,770
	At least 6 months but less than 12 months	29,628
	At least 12 months but less than 2 years	3,065
	Over 2 years	493
	Total	<b>\$ 52,956</b>
Equities	Less than six months	\$ 6,819
	At least 6 months but less than 12 months	2,597
	At least 12 months but less than 2 years	100
	Over 2 years	129
	Total	<b>\$ 9,645</b>

31

At March 31, 2004 the following was the maturity profile of the fixed income securities that were in a gross unrealized loss position:

**(U.S. dollars in thousands)**

Maturity profile in years of fixed income securities in a continual unrealized loss position	(Unaudited) Amount of unrealized loss at March 31, 2004
Less than 1 year remaining	\$ 367
More than 1 and less than 5 years remaining	6,771
More than 5 and less than 10 years remaining	14,935
More than 10 and less than 20 years remaining	11,571
20 years or more remaining	11,802
Mortgage backed securities	7,510
Total	<b>\$ 52,956</b>

The Company operates a risk asset portfolio that includes high yield (below investment grade) fixed income securities. These represented approximately 4% of the total fixed income portfolio market value at March 31, 2004. These securities have a higher volatility to changes in fair values than investment grade securities. Of the total gross unrealized losses in the Company's fixed income portfolio at March 31, 2004, \$7.2 million related to securities that were below investment grade or not rated. The following is an analysis of how long each of these below investment grade and unrated securities had been in a continual unrealized loss position at the date indicated:

**(U.S. dollars in thousands)**

Length of time in a continual unrealized loss position	(Unaudited) Amount of unrealized loss at March 31, 2004
Less than six months	\$ 1,759
At least 6 months but less than 12 months	4,136
At least 12 months but less than 2 years	861
More than 2 years	410
Total	<b>\$ 7,166</b>

**Other Revenues and Expenses**

The following table sets forth other revenues and expenses for the three months ended March 31, 2004 and 2003:

**(U.S. dollars in thousands)**

	(Unaudited) Three Months Ended March 31		
	2004	2003	% Change
Equity in net income (loss) of insurance affiliates	1,015	(41,605)	NM
Amortization of intangible assets	3,257	375	NM
Corporate operating expenses	41,605	34,307	21.3%
Interest expense	29,661	44,004	(32.6)%
Minority interest	—	(208)	NM
Income tax expense	35,357	20,030	76.5%

\* NM — Not Meaningful

The equity earnings of insurance affiliates were significantly improved during the quarter ended March 31, 2004 when compared to the same period in the prior year, which included an other than temporary decline of \$40.9 million in the value of the Company's investment in Annuity and Life Re (Holdings) Ltd.

Corporate operating expenses in the first quarter ended March 31, 2004 increased compared to the three months ended March 31, 2003 due to the continued build out of the Company's global infrastructure in developing its network of shared service organizations to support operations in certain locations, costs related to compliance with the Sarbanes-Oxley Act and costs related to the Company's global branding campaign.

The decrease in interest expense primarily reflected a lower accretion charge on the deposit liabilities due to the commutation of certain finite reinsurance contracts. For more information on the Company's financing structure, see "Financial Condition and Liquidity."

The increase in the Company's income taxes arose principally from an improvement in the profitability of the Company's U.S. and European operations.

#### **Financial Condition, Liquidity and Capital Resources**

As a holding company, the Company's assets consist primarily of its investments in subsidiaries, and the Company's future cash flows depend on the availability of dividends or other statutorily permissible payments from its subsidiaries. The ability to pay such dividends is limited by the applicable laws and regulations of the various countries the Company operates in including, among others, Bermuda, the United States, Ireland, Switzerland and the United Kingdom, and those of the Society of Lloyd's and certain contractual provisions. No assurance can be given that the Company or its subsidiaries will be permitted to pay dividends in the future.

The Company and its subsidiaries provide no guarantees or other commitments (express or implied) of financial support to the Company's subsidiaries or affiliates, except for express written financial support provided by XL Insurance (Bermuda) Ltd. in connection with the Company's financial guaranty subsidiaries and where other express written guaranty or other financial support arrangements are in place.

The Company's ability to underwrite business is dependent upon the quality of its claims paying and financial strength ratings as evaluated by independent rating agencies. As a result, in the event that the Company is downgraded, its ability to write business would be adversely affected in financial guaranty and long-tailed insurance and reinsurance lines of business. In the normal course of business, the Company evaluates its capital needs to support the volume of business written in order to maintain its claims paying and financial strength ratings. In January 2004 several of the internationally recognized rating agencies amended their financial strength ratings of the Company's principal insurance and reinsurance subsidiaries and pools following the announcement by the Company of an increase in the prior period loss reserves in the fourth quarter of 2003. The Company regularly provides financial information to rating agencies to both maintain and enhance existing ratings.

The following are the current financial strength and claims paying ratings from internationally recognized rating agencies in relation to the Company's principal insurance and reinsurance subsidiaries and pools.

<b><u>Rating agency</u></b>	<b><u>Rating</u></b>	
Standard & Poor's	AA-	(Outlook Stable)
Fitch	AA	(Stable)
A.M. Best	A+	(Outlook Negative)
Moody's Investor Services	Aa2	(except members of the XL America Pool, XL Re Ltd. and XL Life Insurance and Annuity Company, which are rated Aa3.

The following are the financial strength ratings from internationally recognized rating agencies in relation to the Company's principal financial guaranty insurance and reinsurance subsidiaries:

<b><u>Rating agency</u></b>	<b><u>Rating</u></b>
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Standard & Poor's	AAA
Fitch	AAA
Moody's Investor Services	Aaa

In addition, XL Capital Ltd. currently has the following long term debt ratings: "a-" (Outlook Negative) from A.M. Best, "A" (Negative) from Standard and Poor's, "A2" (Stable) from Moody's and "A" (Stable) from Fitch.

### ***Financial Condition***

At March 31, 2004, total investments available for sale and cash, net of unsettled investment trades, were \$24.7 billion compared to \$23.1 billion at December 31, 2003. This increase in investment assets related primarily to proceeds of notes payable and the issuance of equity units of \$800.2 million, cash flow generated from operating activities for the quarter of \$525.9 million, and the receipt of deposit liabilities of \$225.1 million. Of the Company's total investments available for sale, including fixed maturities, short-term investments and equity securities, at March 31, 2004, approximately 99% was managed by several outside investment management firms. Approximately 96% of fixed maturity and short-term investments are investment grade, with 71% rated "Aa" or "AA" or better by a nationally recognized rating agency. Using the Standard & Poor's rating scale, the average quality of the fixed income portfolio was "AA".

As a significant portion of the Company's net premium written incepts in the first quarter of the year, certain assets and liabilities have increased at March 31, 2004 compared to December 31, 2003. This includes deferred acquisition costs, unearned premiums, premiums receivable and prepaid reinsurance premiums. For the three months ended March 31, 2004, currency translation adjustment losses were \$26.6 million. This is shown as part of accumulated other comprehensive income and primarily related to unrealized losses on foreign currency exchange rate movement in those operations where the functional currency is not the U.S. dollar.

The Company establishes reserves to provide for estimated claims, the general expenses of administering the claims adjustment process and for losses incurred but not reported. These reserves are calculated using actuarial and other reserving techniques to project the estimated ultimate net liability for losses and loss expenses. The Company's reserving practices and the establishment of any particular reserve reflect management's judgment concerning sound financial practice and do not represent any admission of liability with respect to any claims made against the Company. No assurance can be given that actual claims made and payments related thereto will not be in excess of the amounts reserved.

Included in unpaid loss and loss expenses recoverable at March 31, 2004 is an unsecured, net recoverable from the Winterthur Swiss Insurance Company (the "Seller") of \$750.1 million, related to the acquisition of Winterthur International. This amount is subject to ongoing adjustment, and the Seller is currently rated "A" by S&P. The sale and purchase agreement ("SPA") provides the Company with post-closing protection with respect to adverse development of loss and unearned premium reserves relating to the acquired Winterthur International business. This protection is based upon actual net loss experience and development over a three year post-closing seasoning period based on loss development experience, collectible reinsurance, reinsurance recoveries and certain other factors set forth in the SPA. The Company is currently preparing to submit its statement of the amount due from the Seller under the SPA. This preparation includes a review of the three year post closing seasoning period ended June 30, 2004. Completion of this review is expected to result in an increase in the net recoverable from the Seller that may be material. The amount of any adjustment is not yet determinable at this point. The SPA provides for independent actuarial determination should the Seller and the Company disagree on the final amounts due thereunder. The Company may recognize an impairment if the amount determined to be due to the Company is less than the carrying value of the SPA recovery balance deemed due from the Seller or to the extent that any amount proves to be uncollectible from the Seller for any reason.

Inflation can, among other things, potentially result in larger claims. The Company's underwriting philosophy is to adjust premiums in response to inflation.

### ***Liquidity and Capital Resources***

As at March 31, 2004, the Company had bank, letter of credit and loan facilities available from a variety of sources including commercial banks totaling \$7.1 billion, of which \$2.7 billion in debt was outstanding. In addition, \$2.8 billion of letters of credit were outstanding as of March 31, 2004, 8% of which were collateralized by the Company's investment portfolio, principally supporting U.S. non-admitted business and the Company's Lloyd's capital requirements.

In May 2001, the Company issued \$1.01 billion principal amount at maturity (subject to adjustment in the event there is an upward interest adjustment) of Zero Coupon Convertible Debentures ("CARZ") at \$593.57 per bond and, unless converted or repaid before their due date of May 2021, they will be repaid in May 2021 at \$1,000 per bond at a total cost of \$1.01 billion. The accretion rate is 2.625% per annum on a semi-annual basis or 2.6422% per annum on an annual basis. Although the CARZ are due to be repaid in 2021, there are several features that may result in the bonds being repaid or converted into the Company's Class A Ordinary Shares before the redemption date. The CARZ may be "put" at their accreted value or converted by the bondholders at various times prior to the 2021 redemption dates. The next "put" date is May 23, 2004. The Company may also choose to "call" the debt at its accreted value from that same date. To the extent that holders of the CARZ tender any Debentures for repurchase by the Company on May 23, 2004, the Company has elected to pay all of the purchase price for such Debentures in cash. The Company believes that it has the appropriate liquid resources in place to make such a payment should the holders elect to exercise this option.

In March, 2004 the Company issued 33 million 6.5% Equity Security Units ("Units") in a public offering. The Company received approximately \$800.2 million in proceeds from the sale of the Units after deducting underwriting discounts. The Company intends to use the net proceeds from the sale of the Units for general corporate purposes.

Each Unit has a stated amount of \$25 and consists of (a) a purchase contract pursuant to which the holder agreed to purchase, for \$25, a variable number of shares of the Company's Class A Ordinary Shares ("ordinary shares") on May 15, 2007 and (b) a one-fortieth, or 2.5%, ownership interest in a senior note issued by the Company due May 15, 2009 with a principal amount of \$1,000. The senior notes are pledged by the holders to secure their obligations under the purchase contract. The number of shares issued under the purchase contract is contingently adjustable based on, among other things, the share price of the Company on the stock purchase date and the dividend rate of the Company. The Company will make quarterly payments at the annual rate of 3.97% and 2.53% under the purchase contracts and senior notes, respectively. The

Company may defer the contract payments on the purchase contract, but not the senior notes, until the stock purchase date. In May 2007, the senior notes will be remarketed whereby the interest rate on the senior notes will be reset in order to generate sufficient remarketing proceeds to satisfy the Unit holder's obligation under the purchase contract. If the senior notes are not successfully remarketed, then the Company will exercise its rights as a secured party and may retain or dispose of the senior notes to satisfy in full the holder's obligation to purchase its ordinary shares under the purchase contracts.

The Company has entered into three new bilateral unsecured letter of credit facilities in 2004 to provide additional capacity to support the Company's U.S. non-admitted business. The new facilities total \$125.0 million of which \$50.0 million was utilized at March 31, 2004.

The following tables present the Company's indebtedness under outstanding securities and lenders' commitments as at March 31, 2004:

**(U.S. dollars in thousands)**  
**(Unaudited)**

Notes Payable And Debt	Commitment	In Use	Year Of Expiry	Payments Due By Period			
				Less Than 1 Year	1 To 3 Years	4 To 5 Years	After 5 Years
364-day revolver	\$ 675,000	\$ —	2004				
7.15% Senior Notes	99,988	99,988	2005		100,000		
6.58% Guaranteed Senior Notes	255,000	255,000	2011				255,000
6.50% Guaranteed Senior Notes (1)	597,521	597,521	2012				600,000
Zero Coupon Convertible Debentures ("CARZ") (1)	646,458	646,458	2021				1,010,833
Liquid Yield Option Notes ("LYONS") (1)	312,900	312,900	2021				514,622
2.53% Senior Notes (2)	825,000	825,000	2009			825,000	
<b>Total</b>	<b>\$ 3,411,956</b>	<b>\$ 2,736,867</b>		<b>\$ —</b>	<b>\$ 100,000</b>	<b>\$ 825,000</b>	<b>\$ 2,380,455</b>

(1) "Commitment" and "In Use" data represent March 31, 2004 accreted values. "Payments due by period" represents ultimate redemption values. The convertibles may be "put" or converted by the bondholders at various times prior to the 2021 redemption dates. The next "put" date is May 23, 2004 for the CARZ and September 7, 2004 for the LYONS. The Company may also choose to "call" the debt from May and September 2004 onwards for the CARZ and LYONS, respectively.

(2) The 2.53% Senior Notes are a component of the Units issued in March 2004. In addition to the Senior Notes coupon of 2.53%, contract adjustment payments of 3.97% per annum will be paid on forward purchase contracts for ordinary shares for a total distribution per annum on the Units of 6.50%. The forward purchase contracts mature on May 15, 2007, and the Senior Notes will mature on May 15, 2009.

The total pre-tax interest expense on the borrowings described above was \$20.6 million and \$22.0 million for the three months ended March 31, 2004 and 2003, respectively.

The following table presents, as at March 31, 2004, the Company's letter of credit facilities available, in use and when those facilities are due to expire:

**(U.S. dollars in thousands)**  
**(Unaudited)**

Other Commercial Commitments	Commitment	In Use	Year Of Expiry	Amount Of Commitment Expiration Per Period			
				Less Than 1 Year	1 To 3 Years	4 To 5 Years	After 5 Years
Letter of Credit Facilities	\$ 3,680,593	\$ 2,838,912	2004	\$ 3,680,593	\$ —	\$ —	\$ —

The Company has several letter of credit facilities provided on a syndicated and bilateral basis from commercial banks. These facilities are principally utilized to support non-admitted insurance and reinsurance operations in the United States and capital requirements at Lloyd's. All of the commercial facilities are scheduled for renewal during the remainder of 2004. In addition to letters of credit, the Company has established insurance trusts in the U.S. that provide cedents with statutory relief under state insurance regulations in the U.S. It is anticipated that the commercial facilities will be renewed on expiry but such renewals are subject to the availability of credit from banks utilized by the Company. In the event that such credit support is insufficient, the Company could be required to provide alternative security to cedents. This could take the form of additional insurance trusts supported by the Company's investment portfolio or funds withheld using the Company's cash resources. The value of letters of credit required is driven by, among other things, loss development of existing reserves, the payment pattern of such reserves, the expansion of business written by the Company and the loss experience of such business.

For information regarding cross-default and certain other provisions in the Company's debt and convertible securities documents, see Item 7 of the Company's Form 10-K for the year ended December 31, 2003.

The Company has had several share repurchase programs in the past as part of its capital management strategy. On January 9, 2000, the Board of Directors authorized a program for the repurchase of shares up to \$500.0 million. Under this plan, the Company has purchased 6.6 million shares at an aggregate cost of \$364.6 million or an average cost of \$55.24 per share. The Company has \$135.4 million remaining in its share repurchase authorization. During the three months ended March 31, 2004, no shares were repurchased in the open market. The Company has repurchased shares from employees and directors in relation to withholding tax on restricted stock.

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## CAUTIONARY NOTE REGARDING FORWARD-LOOKING STATEMENTS

The Private Securities Litigation Reform Act of 1995 ("PSLRA") provides a "safe harbor" for forward-looking statements. Any prospectus, prospectus supplement, the Company's Annual Report to ordinary shareholders, any proxy statement, any other Form 10-K, Form 10-Q or Form 8-K of the Company or any other written or oral statements made by or on behalf of the Company may include forward-looking statements which reflect the Company's current views with respect to future events and financial performance. Such statements include forward-looking statements both with respect to the Company in general, and to the insurance, reinsurance and financial products and services sectors in particular (both as to underwriting and investment matters). Statements which include the words "expect", "intend", "plan", "believe", "project", "anticipate", "will", and similar statements of a future or forward-looking nature identify forward-looking statements for purposes of the PSLRA or otherwise.

All forward-looking statements address matters that involve risks and uncertainties. Accordingly, there are or will be important factors that could cause actual results to differ materially from those indicated in such statements. The Company believes that these factors include, but are not limited to, the following: (i) the adequacy of rates and terms and conditions may not be as sustainable as the Company is currently projecting; (ii) the timely and full recoverability of reinsurance placed by the Company with third parties, or other amounts due to the Company, including, without limitation, amounts due to the Company from the Seller in connection with the Company's acquisition of the Winterthur International operations; (iii) the projected amount of ceded reinsurance recoverables and the ratings and creditworthiness of reinsurers may change; (iv) the timing of claims payments being faster or the receipt of reinsurance recoverables being slower than anticipated by the Company; (v) ineffectiveness or obsolescence of the Company's business strategy due to changes in current or future market conditions; (vi) increased competition on the basis of pricing, capacity, coverage terms or other factors; (vii) greater frequency or severity of claims and loss activity, including as a result of natural or man-made catastrophic events, than the Company's underwriting, reserving or investment practices anticipate based on historical experience or industry data; (viii) developments in the world's financial and capital markets which adversely affect the performance of the Company's investments and the Company's access to such markets; (ix) the potential impact on the Company from government-mandated insurance coverage for acts of terrorism; (x) the potential impact of variable interest entities or other off-balance sheet arrangements on the Company; (xi) developments in bankruptcy proceedings or other developments related to bankruptcies of companies insofar as they affect property and casualty insurance and reinsurance coverages or claims that the Company may have as a counterparty; (xii) availability of borrowings and letters of credit under the Company's credit facilities; (xiii) changes in regulation or tax laws applicable to the Company or its subsidiaries, brokers or customers; (xiv) acceptance of the Company's products and services, including new products and services; (xv) changes in the availability, cost or quality of reinsurance; (xvi) changes in the distribution or placement of risks due to increased consolidation of insurance and reinsurance brokers; (xvii) loss of key personnel; (xviii) the effects of mergers, acquisitions and divestitures; (xix) changes in rating agency policies or practices; (xx) changes in accounting policies or practices or the application thereof; (xxi) legislative or regulatory developments; (xxii) changes in general economic conditions, including inflation, foreign currency exchange rates and other factors; (xxiii) the effects of business disruption or economic contraction due to war, terrorism or other hostilities; and (xxiv) the other factors set forth in the Company's other documents on file with the SEC. The foregoing review of important factors should not be construed as exhaustive and should be read in conjunction with the other cautionary statements that are included herein or elsewhere. The Company undertakes no obligation to update publicly or revise any forward-looking statement, whether as a result of new information, future developments or otherwise.

## ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

Except as described below, there have been no material changes in the Company's market risk exposures, or how those exposures are managed, since December 31, 2003. The following discussion should be read in conjunction with "Quantitative and Qualitative Disclosures About Market Risk" presented under Item 7A of the Company's Form 10-K for the year ended December 31, 2003.

The Company enters into derivatives and other financial instruments primarily for risk management purposes. The Company's derivative transactions can expose the Company to credit default swap risk, weather and energy risk, investment market risk and foreign currency exchange rate risk. The Company attempts to manage these risks based on guidelines established by senior management. Derivative instruments are carried at fair value with resulting changes in fair value recognized in income in the period in which they occur.

Value-at-risk ("VaR") is one of the tools used by management to estimate potential losses in fair values using historical rates, market movements and credit spreads to estimate the volatility and correlation of these factors to calculate the potential loss that could occur over a defined period of time given a certain probability.

This risk management discussion and the estimated amounts generated from the sensitivity and VaR analyses presented in this document are forward-looking statements of market risk assuming certain adverse market conditions occur. Actual results in the future may differ materially from these estimated results due to, among other things, actual developments in the global financial markets. The results of analysis used by the Company to assess and mitigate risk should not be considered projections of future events or losses. See generally "Cautionary Note Regarding Forward-Looking Statements."

### Credit Default Swaps

The Company has written certain financial guaranty transactions in derivative or swap form. The Company does not actively trade these transactions and generally issues and holds these contracts to maturity. Changes in fair value can result from changes in market credit spreads, supply and demand for similar type instruments, changes in future loss and/or recovery estimates, interest rates and credit rating upgrades or

downgrades. The Company therefore is at risk for changes in fair value due to changes in any of the above factors.

### Weather and Energy Market Risk

The Company offers weather and energy risk management products in insurance or derivative form to end-users, while managing the risks in the over-the-counter and exchange traded derivatives markets in a weather and energy derivatives trading portfolio.

Fair values for the Company's natural gas derivative contracts are determined through the use of quoted market prices. As quoted market prices are not widely available in the weather derivative market, management uses available market data and internal pricing models based upon consistent statistical methodologies to estimate fair values. Estimating fair value of instruments which do not have quoted market prices requires management judgment in determining amounts which could reasonably be expected to be received from, or paid to, a third party in settlement of the contracts. The amounts could be materially different from the amounts that might be realized in an actual sale transaction. Fair values are subject to change in the near-term and reflect management's best estimate based on various factors including, but not limited to, realized and forecasted weather conditions, changes in commodity prices, changes in interest rates and other market factors.

The following table summarizes the movement in the fair value of weather and energy contracts outstanding during the three months ended March 31, 2004:

(U.S. dollars in thousands)

	(Unaudited) Three Months Ended March 31, 2004
Fair value of contracts outstanding, beginning of the year	\$ (11,490)
Option premiums received, net of premiums realized (1)	15,588
Reclassification of settled contracts to realized (2)	34,215
Other changes in fair value (3)	(25,944)
Fair value of contracts outstanding, end of period	\$ 12,369

- (1) The Company collected \$5.4 million of paid premiums and realized \$21.0 million of premiums on expired transactions for a net increase in the balance sheet derivative asset of \$15.6 million.
- (2) The Company paid \$34.2 million to settle derivative positions during the quarter resulting in a reclassification of this amount from unrealized to realized and a reduction in the derivative liability on the balance sheet.
- (3) This represents the effects of changes in commodity prices, the time value of options and other valuation adjustments of \$25.9 million on the Company's derivative positions, primarily attributable to hedges of the positions that realized \$21.0 million of premiums.

The change in the fair value of contracts outstanding at March 31, 2004 as compared to the beginning of the year is primarily due to the expiration of natural gas positions which were not replaced due to management's decision to reduce the size of its natural gas portfolio.

The following table summarizes the maturity of contracts outstanding as of March 31, 2004:

(U.S. dollars in thousands)  
(Unaudited)

Source Of Fair Value	Less Than 1 Year	1-3 Years	4-5 Years	Greater Than 5 Years	Total Fair Value
Prices actively quoted	\$ (6,781)	\$ —	\$ —	\$ —	\$ (6,781)
Prices based on models and other valuation methods	3,754	12,749	2,647		19,150
Total fair value of contracts outstanding	\$ (3,027)	\$ 12,749	\$ 2,647	\$ —	\$ 12,369

The Company manages its weather and energy portfolio through the employment of a variety of strategies. These include geographical and directional diversification of risk exposures and direct hedging within the capital and reinsurance markets. Risk management is undertaken on a product portfolio-wide basis, to maintain a portfolio that the Company believes is well diversified and which remains within the aggregate risk tolerance established by the Company's senior management.

The Company's aggregate average, low and high seasonal VaR amounts for its weather risk management portfolio, calculated at a 99% confidence level, during the period ended March 31, 2004 were \$168.5 million, \$154.1 million and \$187.0 million, respectively. The corresponding

levels for the weather risk management portfolio during the period ended March 31, 2003 were \$164.9 million, \$154.6 million and \$175.6 million, respectively. The Company calculates its aggregate VaR by summing the VaR amounts for each of its upcoming seasonal portfolios. The Company's aggregation methodology yields a conservative aggregate portfolio VaR, given that current weather events and patterns have an immaterial effect on expectations for future seasons and the Company could therefore greatly reduce or eliminate its VaR on future seasons by selling its positions prior to the beginning of a season. At present, the Company's VaR calculation does not exceed \$90.0 million prior to any season and \$75.0 million at the inception of any one season.

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For the natural gas portfolio, VaR is calculated using a one-day holding period. Management has established a daily VaR limit for this portfolio of \$0.3 million. The Company's average, low and high daily VaR amounts, calculated at a 99% confidence level, during the period ended March 31, 2004 were \$0.2 million, \$0.1 million and \$0.2 million, respectively. The corresponding amounts during the period ended March 31, 2003, under the previously existing daily limit of \$3.5 million, were \$2.3 million, \$2.0 and \$2.7 million, respectively.

For electricity generation outage insurance products, VaR is calculated using an annual holding period. Management has established an annual VaR limit of \$25 million for this book of business. The Company's average, low and high annual VaR amounts, calculated at a 99% confidence level, during the period ended March 31, 2004 were \$2.8 million, \$2.6 million, and \$2.9 million, respectively. The first transactions under this product line were executed at the end of the quarter ended March 31, 2003 and the annual VaR was \$1.3 million.

### **Investment Market Risk**

The Company's investment portfolio consists of exposures to fixed income securities, equities, alternative investments, derivatives, business and other investments and cash. These securities and investments are denominated in both U.S. dollar and foreign currencies.

Through the structure of the Company's investment portfolio, the Company's book value is directly affected by changes in the valuations of the securities and investments held in the investment portfolio. These valuation changes reflect changes in fixed income security prices (e.g. slope and curvature of the yield curves, volatility of interest rates, credit spreads and mortgage prepayment speeds), equity prices (e.g. changes in prices and volatilities of individual securities, equity baskets and equity indices) and foreign currency exchange rates (e.g. changes in spot prices, forward prices and volatilities of currency rates). Market risk therefore arises due to the uncertainty surrounding the future valuations of these different assets, the factors that impact their values and the impact that this could have on the Company's book value.

The Company generally seeks to manage the risks of the investment portfolio through a combination of asset class, country, industry and security level diversification and investment manager allocations. Further, individual security and issuer exposures are generally controlled and monitored at the investment portfolio level, via specific investment constraints outlined in investment guidelines and agreed with the appropriate external investment professionals. Additional constraints may be agreed with the external investment professionals that may address exposures to eligible securities, prohibited investments/transactions, credit quality and general concentration limits.

The Company's direct use of investment derivatives includes futures, forwards, swaps and option contracts that derive their value from underlying assets, indices, reference rates or a combination of these factors. When investment guidelines allow for the use of derivatives, these can generally only be used for the purposes of managing interest rate risk, foreign exchange risk and credit risk, provided the use of such instruments is incorporated in the overall portfolio duration, spread, convexity and other relevant portfolio metrics. The direct use of derivatives is not permitted to economically leverage the portfolio outside of the stated guidelines. Derivatives may also be used to add value to the investment portfolio where market inefficiencies are perceived to exist, to utilize cash holdings to purchase equity indexed derivatives and to adjust the duration of a portfolio of fixed income securities to match the duration of related deposit liabilities.

### **Investment Value-At-Risk**

In the third quarter of 2003, the Company introduced a new, more widely used risk management system to generate the investment VaR and to stress test the investment portfolio. Although the overall methodology is consistent between the two systems, there are certain differences between these systems relating to security pricing models, time series, time periods and proxies used for individual instruments. Accordingly, the VaR for the investment portfolio and the stress tests on the investment portfolio are not directly comparable to periods prior to the fourth quarter of 2003.

The VaR of the total investment portfolio at March 31, 2004, based on a 95% confidence level with a one month holding period, was approximately \$578.3 million. The VaR of all investment related derivatives as at March 31, 2004 was approximately \$11.4 million. The Company's investment portfolio VaR as at March 31, 2004 is not necessarily indicative of future VaR levels.

To complement the VaR analysis which is based on normal market environments, the Company considers the impact on the investment portfolio in several different historical stress periods to analyze the effect of unusual market conditions. The Company establishes certain historical stress test scenarios which are applied to the actual investment portfolio. As these stress tests and estimated gains and losses are based on historical events, they will not

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necessarily reflect future stress events or gains and losses from such events. The results of the stress test scenarios are reviewed on a regular basis to ensure they reflect current shareholders equity, market conditions and the Company's total risk profile. Given the investment portfolio allocations as at March 31, 2004, the Company would expect to lose approximately 5.6% of the portfolio if the most damaging event stress tested was repeated, all other things held equal. Given the investment portfolio allocations as at March 31, 2004, the Company would expect to gain approximately 18.3% on the portfolio if the most favorable event stress tested was repeated, all other things held equal. The Company assumes that no action is taken during the stress period to either liquidate or rebalance the portfolio and believes that this fairly reflects the potential decreased liquidity that is often associated with stressed market environments.

### **Fixed Income Portfolio**



The Company's fixed income portfolio is exposed to credit and interest rate risk through its portfolio of debt securities. The fixed income portfolio includes fixed maturities, short-term investments, cash and cash equivalents and net payable for investments purchased.

As at March 31, 2004, the value of the Company's fixed income portfolio, including cash and cash equivalents and net payable for investments purchased, was approximately \$24.0 billion as compared to approximately \$18.2 billion as at March 31, 2003. As at March 31, 2004, the fixed income portfolio consisted of approximately 88.4% of the total investment portfolio (including cash and cash equivalents, and net payable for investments purchased) as compared to approximately 87.3% as at March 31, 2003.

The table below shows the Company's fixed income portfolio by credit rating in percentage terms of the Company's total fixed income portfolio (including fixed maturities, short-term investments, cash and cash equivalents and net payable for investments purchased) as at March 31, 2004.

	<b>Total</b>
AAA	56.5%
AA	14.0%
A	15.2%
BBB	9.9%
BB & BELOW	4.0%
NR	0.4%
Total	100.0%

At March 31, 2004 the average credit quality of the Company's total fixed income portfolio was "AA".

As at March 31, 2004, the top 10 corporate holdings represented approximately 7.5% of the total fixed income portfolio and approximately 15% of all corporate holdings. The top 10 corporate holdings listed below utilizes a conservative approach to aggregation as it includes unsecured as well as securitized, credit enhanced and collateralized securities issued by parent companies and their affiliates.

<b>Top 10 Corporate Holdings (2)</b>	<b>Percentage of Total Fixed Income Portfolio (1)</b>
Citigroup Inc	1.15%
JPMorgan Chase & Co	1.10%
Bank of America Corporation	0.99%
General Electric Company	0.71%
Morgan Stanley	0.69%
General Motors Corporation	0.68%
DaimlerChrysler AG	0.58%
HSBC Holdings plc	0.53%
Bear, Stearns & Co. Inc.	0.52%
Bank One Corp	0.51%

39

- (1) Including fixed maturities, short-term investments, cash and cash equivalents and net payable for investments purchased.
- (2) Corporate holdings include parent and affiliated companies that issue fixed income securities. In some cases a portion of the market value may be invested in bonds that are securitized or have sufficient credit enhancement that provides a long-term credit rating that is higher than the rating of the unsecured debt of the parent company.

The Company's fixed income portfolio is exposed to interest rate risk. Interest rate risk is the price sensitivity of a fixed income security to changes in interest rates. The hypothetical case of an immediate 100 basis point adverse parallel shift in global bond curves as at March 31, 2004 would decrease the fair value of the Company's fixed income portfolio by approximately 4.6% or \$1.1 billion as compared to approximately 5.1% or \$0.8 billion as at March 31, 2003. Based on historical observations, it is unlikely that all global yield curves would shift in the same direction, by the same amount and at the same time.

### Equity Portfolio

As at March 31, 2004, the Company's equity portfolio was \$721.1 million as compared to \$530.3 million as at March 31, 2003. As at March 31, 2004, the Company's allocation to equity securities was approximately 2.7% of the total investment portfolio (including cash and cash equivalents, accrued investment income and net payable for investments purchased) as compared to approximately 2.5% as at March 31, 2003.

As at March 31, 2004, approximately 56% of the equity portfolio was invested in U.S. companies as compared to approximately 65% as at March 31, 2003. As at March 31, 2004, the top ten equity holdings represented approximately 8.7% of the Company's total equity portfolio as compared to approximately 6.4% as at March 31, 2003.

The Company's equity portfolio is exposed to price risk. Equity price risk is the potential loss arising from decreases in the market value of equities. An immediate hypothetical 10% change in the value of each equity position would affect the fair value of the portfolio by approximately \$72.1 million as at March 31, 2004 as compared to \$53.0 million as at March 31, 2003.

## Alternative Investment Portfolio

The Company's alternative investment portfolio had approximately 100 separate investment funds in different funds at March 31, 2004 with a total portfolio of \$1.6 billion representing approximately 5.6% of the total investment portfolio (including cash and cash equivalents, accrued investment income and net payable for investments purchased) as compared to March 31, 2003 where the Company had approximately 100 separate fund investments with a total exposure of \$1.3 billion representing approximately 6.3% of the total investment portfolio.

As at March 31, 2004, the alternative investment style allocation was 27% in arbitrage strategies, 39% in directional/tactical strategies, 25% in event driven strategies and 9% in multi-strategy strategies.

## Private Investment Portfolio

As at March 31, 2004, the Company's exposure to private investments was approximately \$205 million compared to \$234 million as at March 31, 2003. As at March 31, 2004, the Company's exposure to private investments consisted of approximately 0.8% of the total investment portfolio (including cash and cash equivalents, accrued investment income and net payable for investments purchased), as compared to 1.1% as at March 31, 2003.

## Bond and Stock Index Futures Exposure

As at March 31, 2004, bond and stock index futures outstanding were \$36.7 million with underlying investments having a market value of \$388.1 million. A 10% appreciation or depreciation of these derivative instruments would have resulted in realized gains and realized losses of \$3.7 million respectively. The Company reduces its exposure to these futures through offsetting transactions, including options and forwards.

40

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## Foreign Currency Exchange Risk

The Company uses foreign exchange contracts to manage its exposure to the effects of fluctuating foreign currencies on the value of certain of its foreign currency fixed maturities and equity investments. These contracts are not designated as specific hedges for financial reporting purposes and therefore, realized and unrealized gains and losses on these contracts are recorded in income in the period in which they occur. These contracts generally have maturities of three months or less. At March 31, 2004, forward foreign exchange contracts with notional principal amounts totaling \$236.4 million were outstanding. The fair value of these contracts as at March 31, 2004 was \$236.3 million with unrealized gains of \$0.2 million. For the quarter ended March 31, 2004, realized gains of \$6.2 million and unrealized losses of \$3.4 million were recorded in net realized and unrealized gains and losses on derivative instruments. Based on this value, a 10% appreciation or depreciation of the U.S. dollar as compared to the level of other currencies under contract at March 31, 2004 would have resulted in approximately \$33.7 million of unrealized gains and \$50.8 million in unrealized losses, respectively.

The Company attempts to manage the exchange volatility arising on certain costs denominated in foreign currencies. Throughout the year, forward contracts are entered into to acquire foreign currencies at an agreed rate in the future. At March 31, 2004, the Company had forward contracts outstanding for the purchase of \$25.3 million Euros and \$122.5 million GBP at fixed rates. The unrealized loss on these contracts at March 31, 2004 was \$1.9 million and \$3.9 million, respectively.

## Credit Risk

The Company is exposed to credit risk in the event of non-performance by the other parties to the forward contracts, however the Company does not anticipate non-performance. The difference between the notional principal amounts and the associated market value is the Company's maximum credit exposure.

## Embedded Derivatives

Certain features embedded in the CARZ and LYONs are considered derivatives and are subject to fair value. There is currently minimal fair value ascribed to these features as the contingent events related to these features are considered unlikely to occur.

## ITEM 4. CONTROLS AND PROCEDURES

The Company carried out an evaluation, under the supervision and with the participation of the Company's management, including the Chief Executive Officer and Chief Financial Officer, of the effectiveness of disclosure controls and procedures pursuant to Rules 13a-15 and 15d-15 promulgated under the Securities Exchange Act of 1934 as of the end of the period covered by this report. Based on that evaluation, the Chief Executive Officer and Chief Financial Officer concluded that the disclosure controls and procedures are effective to provide reasonable assurance that all material information relating to the Company required to be filed in this report has been made known to them in a timely fashion. There have been no changes in internal control over financial reporting that occurred during the most recent fiscal quarter that have materially affected, or are reasonably likely to materially affect, internal control over financial reporting.

The Company's management, including the Chief Executive Officer and Chief Financial Officer, does not expect that the Company's disclosure controls or its internal controls will prevent all errors and all fraud. Further, the design of a control system must reflect the fact that there are resource constraints, and the benefits of controls must be considered relative to their costs. As a result of the inherent limitations in all control systems, no evaluation of controls can provide absolute assurance that all control issues and instances of fraud, if any, within the Company have been detected. These inherent limitations include the realities that judgments in decision-making can be faulty, and that breakdowns can occur because of simple error or mistake. As a result of the inherent limitations in a cost-effective control system, misstatements due to error or fraud may occur and not be detected. Accordingly, the Company's disclosure controls and procedures are designed to provide reasonable, not absolute, assurance that the disclosure controls and procedures are met.

41

## PART II — OTHER INFORMATION

### ITEM 1. LEGAL PROCEEDINGS

On March 17, 2004, current and former directors and officers of the Company were named as defendants in a putative “shareholder derivative complaint” (Marilyn Clark, Derivatively on Behalf of XL Capital Ltd v. Brian O’Hara et al.) filed in Connecticut Superior Court by a California shareholder (the “Action”). The Company is named as a nominal defendant. The complaint alleges several causes of action including breach of fiduciary duty, abuse of control, gross mismanagement, waste of corporate assets and unjust enrichment during the time period “from November 2001 to the present” (the “Relevant Period”). The Action alleges that the Company continually maintained inadequate loss reserves for its NAC Re subsidiary (now known as XL Reinsurance America, Inc.) during the Relevant Period and that, as a consequence, the Company’s earnings and assets were materially overstated. While no relief is sought against the Company, the relief sought against certain of the defendants includes profits made on sales of the Company’s shares over a two year period. The time for the defendants to respond to the complaint has not occurred and there has been no discovery in the Action. The defendants intend to vigorously defend the claims asserted against them.

The Company is also subject to litigation and arbitration in the normal course of its business. These lawsuits and arbitrations principally involve claims on policies and are typical for the Company and for the property and casualty insurance and reinsurance industry in general. Such legal proceedings are considered in connection with the Company’s loss and loss expense reserves. Reserves in varying amounts may or may not be established in respect of particular claims proceedings based on many factors, including the legal merits thereof and other factors. In addition to claims litigation, the Company and its subsidiaries are subject to lawsuits in the normal course of business that do not arise from or directly relate to claims on insurance or reinsurance policies.

The Company believes that the ultimate outcomes of all outstanding litigation and arbitration will not have a material adverse effect on its consolidated financial condition, future operating results and/or liquidity, although an adverse resolution of a number of these items could have a material adverse effect on the Company’s results of operations in a particular fiscal quarter or year.

### ITEM 6. EXHIBITS AND REPORTS ON FORM 8-K

#### (a) Exhibits

- 4.1 First Supplemental Indenture, dated March 23, 2004, to the Indenture, dated January 23, 2003, between the Registrant and U.S. Bank National Association, as Trustee, incorporated by reference to the Company’s current report on Form 8-K filed on March 24, 2004.
- 4.2 Purchase Contract Agreement, dated March 23, 2004, between the Registrant and U.S. Bank National Association, as Purchase Contract Agent, incorporated by reference to the Company’s current report on Form 8-K filed on March 24, 2004.
- 4.3 Pledge Agreement, dated March 23, 2004, by and among the Registrant and U.S. Bank Trust National Association, as Collateral Agent, Custodial Agent and Securities Intermediary, and U.S. Bank National Association, as Purchase Contract Agent, incorporated by reference to the Company’s current report on Form 8-K filed on March 24, 2004.
- 4.4 Form of Normal Units Certificate (included in Exhibit 4.2 hereto), incorporated by reference to the Company’s current report on Form 8-K filed on March 24, 2004.
- 4.5 Form of Stripped Units Certificate (included in Exhibit 4.2 hereto), incorporated by reference to the Company’s current report on Form 8-K filed on March 24, 2004.
- 4.6 Form of Senior Note (included in Exhibit 4.1 hereto), incorporated by reference to the Company’s current report on Form 8-K filed on March 24, 2004.
- 10.1 Nicholas M. Brown Supplemental Retirement Benefit Agreement dated March 26, 2004.
- 10.2 Letter of Credit Facility and Reimbursement Agreement, dated as of December 29, 2003, by and between XL Insurance (Bermuda) Ltd, XL Capital Ltd, XL Re Ltd, and X.L. America, Inc. as the Guarantors, and Mellon Bank, N.A., as the Bank.
- 10.3 Offer Letter for a Committed Line of Credit, dated as of April 12, 2004 between Credit Lyonnais New York Branch as the Lender, and XL Capital Ltd, X.L. America, Inc., XL Insurance (Bermuda) Ltd and XL Re Ltd as the Account Parties.
- 31 Rule 13a-14(a)/15d-14(a) Certifications.
- 32 Section 1350 Certification.

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99.1 XL Capital Assurance Inc. condensed consolidated financial statements (unaudited) for the three month periods ended March 31, 2004 and 2003.

99.2 XL Financial Assurance Ltd. condensed consolidated financial statements (unaudited) for the three month periods ended March 31, 2004 and 2003.

#### (b) Reports on Form-8-K

Current Report on Form 8-K filed on March 24, 2004, under Item 5 and Item 7 thereof.

Current Report on Form 8-K filed on March 18, 2004, under Item 5 and Item 7 thereof.

Current Report on Form 8-K filed on March 16, 2004, under Item 5 and Item 7 thereof.

43

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### SIGNATURES

Pursuant to the requirements of the Securities and Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned hereunto duly authorized.

**XL CAPITAL LTD**  
(Registrant)

Dated: May 10, 2004

/s/ BRIAN M. O'HARA

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Brian M. O'Hara  
*President and Chief Executive Officer*

Dated: May 10, 2004

/s/ JERRY DE ST. PAER

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Jerry de St. Paer  
*Executive Vice President and Chief Financial Officer*

44

Nicholas M. Brown, Jr.  
297 Smith Ridge Rd.  
New Canaan, Connecticut 06840

Re: Supplemental Retirement Benefit Agreement

Dear Nick:

Reference is made to those certain Agreements made and entered into as of April 1, 2002 by and among XL Insurance Inc., XL America Inc. (the "Company"), XL Capital Ltd ("XL") and you relating to your employment (the "Employment Agreement") and your supplemental retirement benefits, retiree medical benefits, and post-termination vesting and exercise (the "Supplemental Retirement Agreement") (collectively, the "Agreements"). In relation to the Agreements, I wish to confirm the following:

1. Attached hereto as Exhibit A is a summary of your separation payments and benefits as described in your Employment Agreement.
2. The Company agrees that (a) for purposes of determining the starting date of your supplemental retirement benefits set forth in Section 1 of the Supplemental Retirement Agreement and the early retirement benefit reduction thereunder, the Company will treat you as though you had attained age 50 on the last day of your employment with the Company; (b) for purposes of Section 3 of the Supplemental Retirement Agreement, you will be treated as having terminated employment with the Company after attaining age 50; and (c) for purposes of Section 3 of the Supplemental Retirement Agreement as it relates to options to purchase equity securities of XL or other equity grants, your termination of employment with the Company will qualify as a retirement and you shall have such rights as provided to senior executives who qualify for retirement. Attached hereto as Exhibit B is a summary of your stock options and restricted stock as of April 1, 2004.
3. Except as set forth above, the Supplemental Retirement Agreement will continue in full force and effect in accordance with its terms and those provisions of the Employment Agreement intended to survive your separation from employment shall do so.

If you agree to the foregoing please execute a copy of this letter agreement and return it to Daniel J. Losito, Vice President & Associate General Counsel of XL America, Inc.

Sincerely,

XL AMERICA INC.

By /s/ Charles F. Barr

\_\_\_\_\_  
Title Senior Vice President & General Counsel

XL CAPITAL LTD

By /s/ Tony Beale

\_\_\_\_\_  
Title Senior Vice President

Agreed this 26th day of March, 2004

/s/ Nicholas M. Brown, Jr.

\_\_\_\_\_  
Nicholas M. Brown, Jr.

LETTER OF CREDIT FACILITY AND REIMBURSEMENT AGREEMENT, dated as of December 29, 2003, by and between XL INSURANCE (BERMUDA) LTD, a Bermuda limited liability company ("XL Insurance"), XL CAPITAL LTD, a corporation organized under the laws of the Cayman Islands ("XL Capital"), XL RE LTD, a Bermuda limited liability company ("XL Re") and X.L. AMERICA, INC., a corporation organized under the laws of Delaware ("X.L. America") (XL Capital is referred to hereinafter as the "Account Party" and XL Insurance, XL Capital, XL Re and X.L. America are referred to herein individually as a "Guarantor" and collectively as the "Guarantors"), and MELLON BANK, N.A., a national banking association, (the "Bank" or the "Issuing Bank").

#### PRELIMINARY STATEMENT

WHEREAS, the Bank has agreed to issue for the account of the Account Party a Letter of Credit upon all of the terms and conditions herein set forth;

NOW, THEREFORE, in consideration of their mutual agreements hereinafter set forth and intending to be legally bound hereby, the Account Party, the Guarantors and the Bank agree as follows.

#### ARTICLE I

##### DEFINITIONS: CONSTRUCTION

1.01. Certain Definitions. In addition to other words and terms defined elsewhere in this Agreement, as used herein the following words and terms shall have the following meanings, respectively, unless the context hereof otherwise clearly requires:

"Account Party" shall have the meaning assigned that term in the preamble hereof.

"Affiliate" shall mean an entity which is directly or indirectly controlled by the Account Party or which controls the Account Party or which is under common control with the Account Party.

"Agreement" shall mean this Letter of Credit Facility and Reimbursement Agreement as amended, modified or supplemented from time to time.

"Applicable Interest Rate" shall mean the Prime Rate.

"Bank" shall have the meaning assigned that term in the preamble hereof.

"Bermuda Companies Law" shall mean The Companies Act of 1981 of Bermuda, as amended, and the regulations promulgated thereunder.

"Bermuda Insurance Law" shall mean The Insurance Act of 1978 of Bermuda, as amended, and the regulations promulgated thereunder.

"Business Day" shall mean any day other than a Saturday, Sunday, public holiday under the laws of the Commonwealth of Pennsylvania, of Bermuda or of the Cayman Islands, or other day on which banking institutions are authorized or obligated to close in Pittsburgh, Pennsylvania, Bermuda or the Cayman Islands.

"Change in Control" shall mean the occurrence of any of the following events or conditions: (a) any Person or group of Persons (as used in Sections 13 and 14 of the Securities Exchange Act of 1934, as amended (the "Exchange Act"), and the rules and regulations thereunder) shall have become the beneficial owner (as defined in rules promulgated by the Securities and Exchange Commission) of more than 40% of the voting securities of XL Capital; (b) the sale, lease, exchange or other transfer (in one transaction or a series of related transactions) of all, or substantially all, of the assets of XL Capital; or (c) a majority of the members of XL Capital's Board of Directors are persons who are then serving on the Board of Directors without having been elected by the Board of Directors or having been nominated for election by its shareholders.

"Closing Date" shall mean December 29, 2003 or such later date prior to March 31, 2004, as may be specified by XL Capital by one day's written notice to the Bank.

"Consolidated Subsidiaries" of a Person shall mean those Subsidiaries of such Person the accounts of which are consolidated with the accounts of such Person in accordance with GAAP.

"Continuing Letter of Credit Agreement" shall mean the letter of credit agreement executed and delivered by the Account Party substantially in the form of Exhibit A hereto.

"Credit Parties" means the Account Party and the Guarantors and "Credit Party" means any of them.

"Dollar," "Dollars" and the symbol \$ shall mean lawful money of the United States of America.

"Dollar Equivalent" of an amount of a currency other than Dollars shall mean the amount of Dollars which such amount of such currency could purchase at 11:00 o'clock A.M., Pittsburgh time on the date of determination, based upon the quoted spot rates of the Issuing Bank at which its applicable branch or office offers to exchange Dollars for such currency in the foreign exchange market and "Dollar Equivalent" of an amount denominated in Dollars shall mean such amount of Dollars.

"Event of Default" shall mean any of the Events of Default described in Article VII hereof.

"Excluded Taxes" shall mean, with respect to the Bank or any other recipient of a payment from the Account Party hereunder or under any other Transaction Document, (a) Taxes imposed on (or measured by) its net income, net profits or overall gross receipts (including, without limitation, branch profits taxes) by any jurisdiction under the laws of which such recipient is organized or in which such recipient has an office or conducts business (other than a business that is deemed to arise solely by reason of both (A) the transactions contemplated by this Agreement and (B) the Account Party being organized, maintaining an office or conducting business in such jurisdiction), (b) any Tax that is not imposed solely as a result of a change in Law formally announced after the date hereof and (c) any Tax that is attributable to the recipient's failure to comply with Section 2.13(c).

"Facility Fee" shall have the meaning given that term in Section 2.01(d) hereof.

-2-

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"GAAP" shall have the meaning set forth in Section 1.03 hereof.

"Guaranteed Obligations" shall have the meaning assigned to that term in Section 10.01 hereof.

"Guarantors" and "Guarantor" shall have the meaning assigned those terms in the preamble hereof.

"Indemnified Taxes" shall mean all Taxes, other than Excluded Taxes, that are imposed on the Bank on or with respect to any payment made by the Account Party or any Guarantor hereunder or under any other Transaction Document.

"Insurance Subsidiary" means any, present or future, direct or indirect Subsidiary of the Account Party that offers insurance products.

"Law" shall mean any law (including common law), constitution, statute, treaty, regulation, rule, ordinance, order, injunction, writ, decree or award of any Official Body.

"Letter of Credit" shall mean the letter of credit issued by the Issuing Bank for the account of the Account Party pursuant to this Agreement.

"Letter of Credit Application" shall have the meaning given that term in Section 2.03 hereof.

"Letter of Credit Fee" shall have the meaning given that term in Section 2.01(d) hereof.

"Letter of Credit Reimbursement Obligation" means the obligation of the Account Party to reimburse the Issuing Bank for drawings on the Letter of Credit, together with interest thereon.

"Letter of Credit Undrawn Availability" at any time shall mean the maximum amount available to be drawn under the Letter of Credit at such time or thereafter, regardless of the existence or satisfaction of any conditions or limitations on drawing (including, without limitation, the amount of drafts presented but not yet paid).

"Letter of Credit Unreimbursed Draw" at any time shall mean the amount at such time of a payment made by the Issuing Bank under the Letter of Credit, to the extent not repaid by the applicable Account Party.

"Lien" shall mean any mortgage, deed of trust, pledge, lien, security interest, charge or other encumbrance or security arrangement of any nature whatsoever, including but not limited to any conditional sale or title retention arrangement, and any assignment, deposit arrangement or lease intended as, or having the effect of, security.

"Material Adverse Effect" shall mean the occurrence of an event (including any adverse determination in any litigation, arbitration, or governmental investigation or proceeding), which has or could reasonably be expected to have a materially adverse effect on: (a) the assets, business, financial condition or operations of a Credit Party and its Subsidiaries taken as a whole; or (b) the ability of a Credit Party to perform any of its payment or other material obligations under this Agreement; or (c) the legality, validity, binding effect or enforceability against a Credit Party of any Transaction Document that by its terms purports to bind such Credit Party.

"Obligations" shall mean, collectively, the Letter of Credit Reimbursement Obligations and the obligations of the Account Party to pay all fees, indemnities and all other liabilities arising pursuant to the terms of this Agreement or the other Transaction Documents.

-3-

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"Office," when used in connection with the Bank, shall mean its office located at One Mellon Bank Center, Pittsburgh, Pennsylvania 15258, or at such other office or offices of the Bank or branch, subsidiary or affiliate thereof as may be designated in writing from time to time by the Bank to the Account Party.

"Official Body" shall mean any government or political subdivision or any agency, authority, bureau, central bank, commission, department or instrumentality of either, or any court, tribunal, grand jury or arbitrator, in each case whether foreign or domestic.

"Other Taxes" shall mean any present or future stamp, documentary, recording or similar tax, levy, impost, duty, charge or withholding (including any interest or penalties attributable thereto) imposed on the execution, delivery or enforcement of this Agreement or the other Transaction Documents.

"Person" shall mean an individual, corporation, partnership, trust, unincorporated association, joint venture, joint-stock company, government (including political subdivisions), official body or agency, or any other entity.

"Potential Default" shall mean any event or condition referenced in Article VII hereof which with notice, passage of time or both would constitute an Event of Default.

"Prime Rate" shall mean the interest rate per annum announced from time to time by the Bank as its prime rate, such rate to change automatically effective as of the effectiveness of each announced change in such prime rate (it being understood that such Prime Rate may be greater or less than other interest rates charged by the Bank to other borrowers and is not solely based or dependent upon the interest rate which the Bank may charge any particular borrower or class of borrower).

"Regular Payment Date" shall mean the last day of each March, June, September and December after the date hereof, or, if such last day is not a Business Day, the next succeeding Business Day.

"SAP" shall mean, as to each Account Party and each Insurance Subsidiary, the statutory accounting practices prescribed or permitted by the relevant Official Body for such Account Party's or such Insurance Subsidiary's domicile for the preparation of Annual Statements and other Default reports by insurance corporations of the same type as such Account Party or such Insurance Subsidiary in effect on the date such statements or reports are to be prepared.

"Standard Notice" shall mean an irrevocable notice provided to the Bank at no later than 10:00 o'clock a.m., Pittsburgh time, on a Business Day. Standard Notice shall be in writing (including telex, facsimile or cable communication) or by telephone (to be subsequently confirmed in writing) in any such case, effective upon receipt by the Bank.

"Stated Amount" shall mean, with respect to a Letter of Credit, the maximum face or stated amount of such Letter of Credit, irrespective of whether such maximum amount is available for drawing at the time in question.

"Subsidiary" of a Person at any time shall mean any corporation of which a majority (by number of shares or number of votes) of any class of outstanding capital stock normally entitled to vote for the election of one or more directors (regardless of any contingency which does or may suspend or dilute the voting rights of such class) is at such time owned directly or indirectly by such Person or one or more Subsidiaries of such Person.

-4-

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"Tax" shall mean any present or future income, stamp or other tax, levy, impost, duty, deduction, charge or withholding imposed, levied, collected, withheld or assessed by any Official Body (including any interest or penalties attributable thereto).

"Transaction Document" or "Transaction Documents" shall mean this Agreement, the Letter of Credit and any other documents or instruments executed and delivered in connection herewith or therewith.

"XL Parties" shall mean the Credit Parties and "XL Party" shall mean a Credit Party.

1.02. Construction. Unless the context of this Agreement otherwise clearly requires, "or" has the inclusive meaning represented by the phrase "and/or." References in this Agreement to "determination" by the Bank include estimates by the Bank in good faith, without gross negligence and without manifest error (in the case of quantitative determinations) and beliefs held by the Bank in good faith and without gross negligence (in the case of qualitative determinations). The words "hereof," "herein," "hereunder" and similar terms in this Agreement refer to this Agreement as a whole and not to any particular provision of this Agreement. The section and other headings contained in this Agreement are for reference purposes only and shall not control or affect the construction of this Agreement or the interpretation hereof in any respect. Section, subsection and exhibit references are to this Agreement unless otherwise specified.

1.03. Accounting Principles. (a) As used herein, "GAAP" shall mean generally accepted accounting principles as such principles shall be in effect in the United States of America at the Relevant Date, subject to the other provisions of this Section 1.03. As used herein, "Relevant Date" shall mean the date a relevant computation or determination is to be made or the date of relevant financial statements, as the case may be.

(b) Except as otherwise provided in this Agreement, all computations and determinations as to accounting or financial matters shall be made, and all financial statements to be delivered pursuant to this Agreement shall be prepared, in accordance with GAAP or SAP, as the context requires (including principles of consolidation where appropriate), and all accounting or financial terms shall have the meanings ascribed to such terms by GAAP or SAP, as appropriate.

(c) If any change in GAAP or SAP after the date of this Agreement is or shall be required to be applied to transactions then or thereafter in existence, and a violation of one or more financial covenants of this Agreement shall have occurred (or in the opinion of the Bank would be likely to occur) which would not have occurred or be likely to occur if no change in accounting principles had taken place, the parties agree in such event to negotiate in good faith an amendment of this Agreement which shall approximate to the extent possible the economic effect of the original financial covenants after taking into account such change in GAAP or SAP, as appropriate.

(d) Without in any manner limiting the provisions of this Section 1.03, if any change in GAAP or SAP occurs after the date of this Agreement and such change in GAAP or SAP would have materially changed the Account Party's reported financial results or position from that reflected in such Account Party's financial statements most recently prepared prior to such change, the Account Party shall notify the Bank as soon as practicable.

## ARTICLE II

### THE LETTER OF CREDIT

#### 2.01. Letter of Credit

-5-

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(a) Letter of Credit Commitment. Subject to the terms and conditions and relying upon the representations and warranties herein set forth, the Issuing Bank agrees to issue a Letter of Credit for the account of the Account Party on the Closing Date in a stated amount not exceeding \$25,000,000.

(b) Terms of Letter of Credit. The Letter of Credit shall be denominated in Dollars and shall be payable only against sight drafts (and not time drafts). The Letter of Credit shall have an expiration date no later than 12 months after the date of issuance thereof; provided, however, that the Letter of Credit may have an "evergreen" provision satisfactory to the Bank. The Bank may, but shall have no obligation to, permit the expiration date of the Letter of Credit to be extended pursuant to any such "evergreen" provision. The following "evergreen" provision is satisfactory to the Bank: "This Letter of Credit will be deemed to be automatically extended without amendment for one year from the expiration date hereof, or any further expiration date, unless at least ninety (90) days prior to such expiration date the Bank shall notify the Beneficiary by registered or certified mail or by overnight courier (who obtains written confirmation of receipt) that this Letter of Credit will not be renewed for any such additional period, which the Bank reserves the right to do in its sole discretion. Contemporaneously with the issuance to the Beneficiary of such notice that the Bank will not renew the term of this Letter of Credit, which the Bank reserves the right to do in its sole discretion, the Bank shall provide the Account Party with a copy of such notice."

(c) Form of Letter of Credit. The Issuing Bank shall have no obligation to issue a letter of credit which is unsatisfactory in form, substance or beneficiary to the Issuing Bank in the exercise of its reasonable judgment consistent with its customary practice.

(d) Letter of Credit Fee and Facility Fee. The Account Party shall pay or cause to be paid to the Bank a fee (the "Letter of Credit Fee") for the Letter of Credit (based on a year of 360 days and actual days elapsed) for each day from and including the date of issuance thereof to and including the date of expiration or termination thereof, on the Letter of Credit Undrawn Availability on such day at a rate per annum equal to 0.365%. Such Letter of Credit Fee shall be due and payable for the preceding period for which such fee has not been paid on each of the following dates: (i) each Regular Payment Date, (ii) the date of each drawing on the Letter of Credit, and (iii) the date of expiration or termination of the Letter of Credit. The Account Party shall pay or cause to be paid to the Bank a fee (the



"Facility Fee") for the Bank's commitment hereunder (based on a year of 360 days and actual days elapsed) for each day from and including the date of the execution and delivery of this Agreement to and including the date of expiration or termination of the Letter of Credit, on \$25,000,000, at a rate per annum equal to 0.060%. Whether or not the Letter of Credit is ever issued and whether or not the Closing Date ever occurs, such Facility Fee shall be due and payable for the preceding period for which such fee has not been paid on each of the following dates: (i) each Regular Payment Date and (ii) the date of expiration or termination of the Letter of Credit (or, if the Letter of Credit is never issued, the first anniversary of the date of execution and delivery of this Agreement).

(e) Purpose of Letter of Credit. The Account Party agrees that the Letter of Credit shall be used by the Account Party in the ordinary course of business of such Account Party. For the avoidance of doubt, the parties agree that the Account Party may apply for a Letter of Credit hereunder to support the obligations of any Affiliate of XL Capital, it being understood that the Account Party shall nonetheless remain the account party and as such be liable with respect to such Letter of Credit.

(f) Administration Fees. The Account Party shall pay to the Bank such other administration, maintenance, amendment, drawing and negotiation fees as are customarily charged by the Bank to its customers generally at the time in question or are otherwise agreed between the Issuing Bank and the Account Party.

2.02. Signing Fee. Upon the execution and delivery of this Agreement, the Account Party will pay to the Bank a signing fee equal \$12,500.00. Such signing fee shall be nonrefundable, whether or not the Letter of Credit is ever issued and whether or not the closing occurs by the Closing Date.

-6-

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2.03. Letter of Credit Application. At least three Business Days prior to the Closing Date, the Account Party shall deliver to the Bank a completed application, in the form annexed hereto as Exhibit B, or in such other form as is from time to time be required by the Bank in accordance with its customary practice with respect to its customers generally (a "Letter of Credit Application"), together with such other certificates, documents and other papers as are specified in such application.

2.04. [Intentionally omitted]

2.05. Letter of Credit Drawings and Reimbursements. The Account Party hereby agrees to reimburse the Bank, by making payment in accordance with Section 2.11(a) hereof on the date of each payment made by the Bank under the Letter of Credit (or, if later, the date which is one Business Day after notice of such payment or of the drawing giving rise to such payment is given to XL Capital), without, protest or demand, all of which are hereby waived, and an action therefor shall immediately accrue. The Account Party agrees that it will make such payment to the Bank in the Dollars in the amount of the payment by the Bank under such Letter of Credit. To the extent such payment is not timely made, the Account Party hereby agrees to pay to the Bank, on demand, interest on any Letter of Credit Unreimbursed Draws for each day from and including the date of such payment by the Issuing Bank until paid (before and after judgment) in accordance with Section 2.11(a) hereof, at the rate per annum set forth in Section 2.11(b) hereof.

2.06 [Intentionally omitted]

2.07. Obligations Absolute. The payment obligations of the Account Party under Section 2.05 shall be unconditional and irrevocable and shall be paid strictly in accordance with the terms of this Agreement under all circumstances, including, without limitation, the following circumstances:

(a) any lack of validity or enforceability of this Agreement, any Letter of Credit or any Transaction Document against the Account Party;

(b) the existence of any claim, set-off, defense or other right which the Account Party, any Guarantor or any other Person may have at any time against any beneficiary or transferee of any Letter of Credit (or any Persons for whom any such beneficiary or transferee may be acting), the Issuing Bank, any Bank, or any other Person, whether in connection with this Agreement, the transactions contemplated hereby or any unrelated transaction;

(c) any draft, certificate, statement or other document presented under the Letter of Credit proving to be forged, fraudulent, invalid or insufficient in any respect or any statement therein being untrue or inaccurate in any respect;

(d) payment by the Bank under the Letter of Credit against presentation of a draft or certificate which does not comply with the terms of the Letter of Credit, or payment by the Bank under the Letter of Credit in any other circumstances in which conditions to payment are not met, except any such wrongful payment resulting solely from the gross negligence or willful misconduct of the Issuing Bank; or

(e) any other event, condition or circumstance whatever, whether or not similar to any of the foregoing, except if the same results solely from the gross negligence or willful misconduct of the Bank.

The Account Party bears the risk of, and neither the Bank nor any of its directors, officers, employees or agents shall be liable or responsible for any of, the foregoing matters, the use which may be made of the Letter of Credit, or acts or omissions of the beneficiary or any transferee in connection therewith, except for such person's gross negligence or willful misconduct.

-7-

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2.08. Further Assurances. The Account Party and each Guarantor hereby agrees, from time to time, to do and perform any and all acts and to execute any and all further instruments reasonably requested by the Bank more fully to effect the purposes of this Agreement and the issuance of the Letter of Credit hereunder.

2.09. Letter of Credit Applications. The representations, warranties and covenants by the Account Party under, and the rights and remedies of the Bank under, the Continuing Letter of Credit Agreement and any Letter of Credit Application relating to the Letter of Credit are in addition to, and not in limitation or derogation of, representations, warranties and covenants by the Account Party under, and rights and remedies of the Bank under, this Agreement, the Transaction Documents, and applicable Law. In the event of any inconsistency between the terms of this Agreement and either any Letter of Credit Application or the Continuing Letter of Credit Agreement, this Agreement shall prevail.

2.10. Certain Provisions Relating to the Bank

(a) General. The Bank shall have no duties or responsibilities except those expressly set forth in this Agreement and the other Transaction Documents, and no implied duties or responsibilities on the part of the Bank shall be read into this Agreement or any Transaction Document or shall otherwise exist. The Bank shall not be liable for any action taken or omitted to be taken by it under or in connection with this Agreement or any other Transaction Document, unless caused by its

own gross negligence or willful misconduct.

(b) Administration. The Bank may rely upon any notice or other communication of any nature (written or oral, including but not limited to telephone conversations, whether or not such notice or other communication is made in a manner permitted or required by this Agreement or any Transaction Document) purportedly made by or on behalf of the proper party or parties, and the Bank shall not have any duty to verify the identity or authority of any Person giving such notice or other communication. The Bank may consult with legal counsel (including, without limitation, in-house counsel for the Issuing Bank or in-house or other counsel for the Account Party), independent public accountants and any other experts selected by it from time to time, and the Bank shall not be liable for any action taken or omitted to be taken in good faith in accordance with the advice of such counsel, accountants or experts.

#### 2.11. Payments Generally; Interest and Interest on Overdue Amounts.

(a) Payments Generally. All payments to be made by the Account Party in respect of fees, indemnity, expenses or other amounts due from such Account Party hereunder or under any Transaction Document shall be payable in Dollars at 12:00 o'clock Noon, Pittsburgh time, on the day when due without presentment, demand, protest or notice of any kind, all of which are hereby expressly waived, and an action therefor shall immediately accrue, without setoff, counterclaim, withholding or other deduction of any kind or nature. Such payments shall be made to the Bank at its Office in Dollars in funds immediately available at such Office. Any payment or prepayment received by the Bank after 12:00 o'clock Noon, Pittsburgh time, on any day shall be deemed to have been received on the next succeeding Business Day.

(b) Interest and Interest on Overdue Amounts. Interest on Letter of Credit Reimbursement Obligations shall accrue at a rate per annum (based on a year of 360 days and actual days elapsed) which for each day shall be equal to the then-current Applicable Interest Rate beginning on the day that the related Letter of Credit payment is made and shall be due and payable on the day that the Letter of Credit Reimbursement Obligation is due and payable in accordance with Section 2.05 hereof. To the extent permitted by law, after there shall have become due (by acceleration or otherwise) fees, indemnity, expenses or any other amounts due from the Account Party hereunder or under any other Transaction Document, such amounts shall bear interest for each day until paid (before and after

-8-

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judgment), payable on demand, at a rate per annum (in each case based on a year of 360 days and actual days elapsed) which for each day shall be equal to 2% above the then-current Applicable Interest Rate. To the extent permitted by law, interest accrued on any amount which has become due hereunder or under any Transaction Document shall compound on a day-by-day basis, and hence shall be added daily to the overdue amount to which such interest relates.

2.12. Additional Compensation in Certain Circumstances. If the introduction of or any change in, or any change in the interpretation or application of, any Law, regulation or guideline by any Official Body charged with the interpretation or administration thereof or compliance with any request or directive of any applicable Official Body (whether or not having the force of law):

(i) imposes, modifies or deems applicable any reserve, special deposit or similar requirement against credits or commitments to extend credit extended by, assets (funded or contingent) of, deposits with or for the account of, other acquisitions of funds by, the Bank,

(ii) imposes, modifies or deems applicable any capital adequacy or similar requirement (A) against assets (funded or contingent) of, or credits or commitments to extend credit extended by, the Bank or (B) otherwise applicable to the obligations of the Bank under this Agreement, or

(iii) imposes upon the Bank any other condition or expense with respect to this Agreement or the issuance of the Letter of Credit (other than with respect to Taxes, which shall be governed exclusively by Section 2.13 hereof),

and the result of any of the foregoing is to increase the cost to, reduce the income receivable by, or impose any expense (including loss of margin) upon the Bank or, in the case of clause (iii) hereof, any Person controlling the Bank, with respect to this Agreement or the issuance of the Letter of Credit (or, in the case of any capital adequacy or similar requirement, to have the effect of reducing the rate of return on the Bank's or such controlling Person's capital, taking into consideration the Bank's or such controlling Person's policies with respect to capital adequacy so long as such policies are reasonable in light of prevailing market practice at the time) by an amount which the Bank deems to be material, the Bank may from time to time notify the Account Party of the amount determined in good faith (using any averaging and attribution methods) by the Bank (which determination shall be conclusive) to be necessary to compensate the Bank for such increase, reduction or imposition. Such amount shall be due and payable by the Account Party to the Bank five Business Days after such notice is given, together with an amount equal to interest on such amount from the date two Business Days after the date demanded until such due date at the Prime Rate. A certificate by the Bank as to the amount due and payable under this Section 2.12 from time to time and the method of calculating such amount shall be conclusive. The Bank agrees that it will use good faith efforts to notify the Account Party of the occurrence of any event that would give rise to a payment under this Section 2.12; provided, however that, so long as such notice is given within a reasonable period after the occurrence of such event, any failure of the Bank to give any such notice shall have no effect on the Account Party's obligations hereunder.

#### 2.13. Taxes.

(a) Payments Net of Taxes. All payments made to the Bank by each Credit Party under this Agreement or any other Transaction Document shall be made free and clear of, and without reduction or withholding for or on account of, any Indemnified Taxes, unless such Credit Party is required to withhold or deduct Indemnified Taxes. If any Indemnified Taxes are required to be withheld or deducted from any amounts payable to the Bank under this Agreement or any other Transaction Document, the applicable Credit Party shall pay the relevant amount of such Indemnified Taxes and the amounts so payable to the Bank shall be increased to the extent necessary to yield to the Bank (after payment of all Indemnified Taxes) amounts that would have been payable hereunder or under the other

-9-

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Transaction Documents had no such withholding or deduction been required. Whenever any Indemnified Taxes are paid by a Credit Party with respect to payments made in connection with this Agreement or any other Transaction Document, as promptly as possible thereafter, such Credit Party shall send to the Bank a certified copy of an original official receipt received by such Credit Party showing payment thereof. If the Bank determines in its sole discretion in good faith that it has received a refund in respect of any Indemnified Taxes or Other Taxes as to which it has been indemnified by any Credit Party, or with respect to which any Credit Party has paid additional amounts pursuant to this Section 2.13, the Bank shall promptly after the date of such receipt pay over the amount of such refund to such Credit Party (but only to the extent of indemnity payments made, or additional amounts paid, by such Credit Party under this Section 2.13 with respect to the Indemnified Taxes giving rise to such refund and only to the extent that the Bank has determined that the amount of any such refund is directly attributable to payments made under this Agreement or another Transaction Document), net of all reasonable expenses of the Bank (including additional Taxes attributable to such refund, as determined by the Bank) and without interest (other than interest, if any, paid by the relevant Official Body with respect to such refund). Each

Credit Party shall, upon demand, repay to the Bank any amount paid over to such Credit Party by the Bank (plus penalties, interest or other charges) in the event the Bank is required to repay any portion of such refund to such Official Body. Nothing in this Section 2.13(a) shall entitle any Credit Party to have access to the records of the Bank, including, without limitation, tax returns.

(b) Indemnity. The Account Party hereby indemnifies the Bank for the full amount of all Indemnified Taxes and Other Taxes whether or not such Indemnified Taxes or Other Taxes were correctly or legally asserted (and including reasonable expenses related thereto). Such indemnification shall be made within 10 days from the date the Bank makes written demand therefor.

(c) Exemptions. The Bank shall from time to time, at the written request of any Credit Party, provide to such Credit Party such form, certification or similar documentation, if any (each duly completed, accurate and signed) as is currently required by any jurisdiction, in order to obtain an exemption from, or reduced rate of, deduction, payment or withholding of Indemnified Taxes or Other Taxes to which the Bank is entitled pursuant to an applicable tax treaty or other applicable law; provided that, in the case of any Taxes imposed by a jurisdiction other than the United States, such Credit Party shall have furnished to the Bank in a reasonably timely manner copies of such documentation and notice of such requirements together with applicable instructions.

(d) Assignees. An assignee of the Bank or subsequent assignee shall not be entitled to any greater gross-up or indemnification payments under this Section 2.13 than such assignee's assignor would have been entitled to absent such assignment (determined taking into account the provisions of this Section 2.13) except to the extent that the entitlement to greater payments resulted solely from a change in Law formally announced after the date on which such assignee became an assignee hereunder.

### ARTICLE III

#### REPRESENTATIONS AND WARRANTIES.

3.01. Incorporation of Representations and Warranties by Reference. Each XL Party represents and warrants each of the representations and warranties contained in Sections 4.01 through 4.03 and 4.05 through 4.16 of the June 2003 364-day Credit Agreement (as defined below). For purposes of this Section 3.01, the aforesaid Sections 4.01 through 4.03 and 4.05 through 4.16 of the June 2003 364-day Credit Agreement, together with the other sections of the June 2003 364-day Credit Agreement to which reference is made therein, and related definitions, schedules and ancillary provisions, are hereby incorporated herein by reference, *mutatis mutandis*, and will be deemed to continue in effect for the benefit of the Issuing Bank and the Bank, as if the Bank was a

-10-

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"Lender" under the June 2003 364-day Credit Agreement, whether or not the June 2003 364-day Credit Agreement remains in effect among the parties thereto. As used in this Agreement, the term "June 2003 364-day Credit Agreement" shall mean the 364-Day Credit Agreement dated as of June 25, 2003, by and between XL Capital Ltd, X.L. America, Inc, XL Insurance (Bermuda) Ltd, XL Europe Ltd and XL Re Ltd, the Lenders party thereto, and JPMorgan Chase Bank, as Administrative Agent, without regard to any amendment thereto after such date other than any such amendment to which the Bank shall have consented in writing with reference to this Agreement. For avoidance of doubt, all references in the aforesaid Section 4.01 through 4.03 and 4.05 through 4.16 to "Account Party" shall be deemed to be references to Credit Party and all references therein to "Transactions" shall be deemed to be references to the execution, delivery and performance of this Agreement and the other Transaction Documents to which any Credit Party is intended to be a party and the issuance of Letters of Credit.

3.02. Financial Condition; No Material Adverse Change. (a) XL Capital has heretofore furnished to the Bank the consolidated balance sheet and statements of income, stockholders' equity and cash flows of XL Capital Ltd and its consolidated Subsidiaries as of and for the year ended December 31, 2003, reported on by PricewaterhouseCoopers LLP, independent public accountants (as provided in XL Capital's Report on Form 10-K filed with the SEC for the fiscal year ended December 31, 2003). Such financial statements present fairly, in all material respects, the financial position and results of operations and cash flows of XL Capital and its consolidated Subsidiaries as of and for the period ended December 31, 2003, in accordance with GAAP.

(b) Since December 31, 2003, there has been no material adverse change in the assets, business, financial condition or operations of XL Capital and its consolidated Subsidiaries, taken as a whole, or as otherwise having a Material Adverse Effect.

### ARTICLE IV

#### CONDITIONS

4.01. Closing Date Conditions. The obligation of the Bank to issue the Letter of Credit hereunder on the Closing Date shall be subject to the following conditions:

(a) Proceedings and Incumbency. There shall have been delivered to the Bank a certificate with respect to each Credit Party in form and substance satisfactory to the Bank dated the Closing Date and signed on behalf of each Credit Party by the Secretary or an Assistant Secretary of such Credit Party certifying as to: (a) true copies of all corporate action taken by such Credit Party relative to this Agreement and the other Transaction Documents applicable to it including but not limited to that described in Section 4.02 of the June 2003 364-day Credit Agreement as incorporated herein by reference and (b) the names, true signatures and incumbency of the officer or officers of such Credit Party authorized to execute and deliver this Agreement and the other Transaction Documents applicable to it. The Bank may conclusively rely on such certificates unless and until a later certificate revising the prior certificate has been furnished to the Bank.

(b) Organizational Documents. There shall have been delivered to the Bank (i) certified copies of the articles of incorporation or memorandum of association and by-laws or other equivalent organizational documents for each Credit Party and (ii) a certificate of good standing for each Credit Party or other equivalent documentation, certified by the appropriate Official Body of its place of organization.

-11-

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(c) Opinions of Counsel. There shall have been delivered to the Bank written opinions addressed to the Bank, dated the Closing Date, of Messrs. Cahill Gordon & Reindel, Messrs. Conyers, Dill & Pearman, Hunter & Hunter and Paul S. Giordano, Esq., respectively, the Account Party's and Guarantors' counsel, and opinions of counsel qualified to practice in each jurisdiction, if any, other than Bermuda and the United States, under the laws of which the Account Party is organized substantially to such effects to the extent that the laws of such jurisdiction are relevant, all in form (which are expected to be substantially similar to the form of opinions previously delivered to the Bank in connection with prior transactions with the Guarantors) and substance reasonably satisfactory to the Bank.

(d) Details, Proceedings and Documents. All legal details and proceedings in connection with the transactions contemplated by this Agreement shall be

reasonably satisfactory to the Bank, and the Bank shall have received all such counterpart originals or certified or other copies of this Agreement and the other the Transaction Documents and such other documents and proceedings in connection with such transactions, in form and substance satisfactory to it, as the Bank have reasonably requested.

(e) Fees and Expenses. The Account Party shall have paid all fees and other compensation to be paid by it hereunder on or prior to the Closing Date.

(f) Representation and Warranties. The representation and warranties contained in Article III hereof shall be true on and as of the Closing Date with the same effect as though made on and as of the Closing Date.

(g) Letter of Credit Agreement. The Continuing Letter of Credit Agreement shall have been delivered to the Bank, duly executed by the Account Party.

## ARTICLE V

### AFFIRMATIVE COVENANTS

Each Credit Party, as applicable, hereby covenants to the Bank as follows:

5.01. Incorporation of Affirmative Covenants by Reference. Each XL Party shall observe, perform and fulfill, for the benefit of the Issuing Bank or the Bank, each of the covenants, agreements and obligations contained in Article VI of the June 2003 364-day Credit Agreement. For purposes of this Section 5.01, the aforesaid Article VI of the June 2003 364-day Credit Agreement, together with the other sections of the June 2003 364-day Credit Agreement to which reference is made therein, and related definitions, schedules and ancillary provisions, are hereby incorporated herein by reference, *mutatis mutandis*, and will be deemed to continue in effect for the benefit of the Bank, as if the Bank was a "Lender" under the June 2003 364-day Credit Agreement, whether or not the June 2003 364-day Credit Agreement remains in effect among the parties thereto.

## ARTICLE VI

### NEGATIVE COVENANTS

Each Credit Party, as applicable, hereby covenants to the Bank as follows:

6.01. Incorporation of Negative Covenants by Reference. Each XL Party shall observe, perform and fulfill, for the benefit of the Issuing Bank or the Bank, each of the covenants, agreements and obligations contained in Article VII of the June 2003 364-day Credit Agreement.

-12-

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For purposes of this Section 6.01, the aforesaid Article VII of the June 2003 364-day Credit Agreement, together with the other sections of the June 2003 364-day Credit Agreement to which reference is made therein, and related definitions, schedules and ancillary provisions, are hereby incorporated herein by reference, *mutatis mutandis*, and will be deemed to continue in effect for the benefit of the Bank, as if the Bank was a "Lender" under the June 2003 364-day Credit Agreement, whether or not the June 2003 364-day Credit Agreement remains in effect among the parties thereto.

## ARTICLE VII

### EVENTS OF DEFAULT

7.01. Events of Default. An Event of Default shall mean the occurrence or existence of one or more of the following events or conditions (for any reason, whether voluntary, involuntary or effected or required by Law):

(a) The Account Party shall default in the payment when due of any reimbursement obligation with respect to any Letter of Credit;

(b) The Account Party shall default in the payment when due of any Letter of Credit Fee, Facility Fee or any other fee or amount payable hereunder which default shall continue for a period of three days from the due date thereof;

(c) Any Credit Party shall default in the observance, performance or fulfillment of any covenant contained in Article VI hereof;

(d) Any Credit Party shall default in the observance, performance or fulfillment of any other covenant, condition or provision hereof and such default shall not be remedied for a period of twenty days after written notice thereof to such Credit Party from the Bank;

(e) Any Credit Party or any Subsidiary of any Credit Party shall default (i) in any payment of principal of or interest on any other obligation for borrowed money in principal amount of \$50,000,000 or more, or any payment of any principal amount of \$50,000,000 or more under Hedging Agreements (as defined in the June 2003 364-day Credit Agreement), in each case beyond any period of grace provided with respect thereto, or (ii) in the performance of any other agreement, term or condition contained in any such agreement (other than Hedging Agreements) under which any such obligation in principal amount of \$50,000,000 or more is created, if the effect of such default is to cause or permit the holder or holders of such obligation (or trustee on behalf of such holder or holders) to cause such obligation to become due prior to its stated maturity or to terminate its commitment under such agreement, provided that this clause (e) shall not apply to secured indebtedness that becomes due as a result of the voluntary sale or transfer of the property or assets securing such indebtedness;

(f) One or more judgments for the payment of money in an aggregate amount in excess of \$100,000,000 shall be rendered against any Credit Party or any of its Subsidiaries or any combination thereof and the same shall not have been vacated, discharged, stayed (whether by appeal or otherwise) or bonded pending appeal within 45 days from the entry thereof;

(g) Any representation or warranty herein made by any Credit Party, or any certificate or financial statement furnished pursuant to the provisions hereof, shall prove to have been false or misleading in any material respect as of the time made (or deemed made) or furnished;

-13-

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(h) XL Capital shall cease to own, beneficially and of record, directly or indirectly, all of the outstanding voting shares of capital stock of XL Insurance, XL Re or X.L. America;

(i) This Section 7.01(i) is intentionally left blank;

(j) A Change in Control shall occur;

(k) The guarantee contained in Article X hereof shall terminate or cease, in whole or material part, to be a legally valid and binding obligation of XL Insurance, XL Capital or XL Re or any Credit Party or any Person acting for or on behalf of any of such parties contests such validity or binding nature of such guarantee itself or the transactions contemplated by this Agreement, or any other Person shall assert any of the foregoing;

(l) A decree or order by a court having jurisdiction in the premises shall have been entered adjudging any Credit Party a bankrupt or insolvent, or approving as properly filed a petition seeking reorganization of such Credit Party under the Bermuda Companies Law, or any other similar applicable Law, and such decree or order shall have continued undischarged or unstayed for a period of sixty days; or a decree or order of a court having jurisdiction in the premises for the appointment of a receiver or liquidator or trustee or assignee in bankruptcy or insolvency of such Credit Party or a substantial part of its property, or for the winding up or liquidation of its affairs, shall have been entered, and such decree or order shall have remained in force undischarged and unstayed for a period of sixty days; or

(m) Any Credit Party shall institute proceedings to be adjudicated a voluntary bankrupt, or shall consent to the filing of a bankruptcy proceeding against it, or shall file a petition or answer or consent seeking reorganization under the Bermuda Companies Law, or the companies laws of the Cayman Islands, British West Indies or any other similar applicable Law, or shall consent to the filing of any such petition, or shall consent to the appointment of a receiver or liquidator or examiner or trustee or assignee in bankruptcy or insolvency of it or of a substantial part of its property, or shall make an assignment for the benefit of creditors, or shall admit in writing its inability to pay its debts generally as they become due, or corporate action shall be taken by such Credit Party in furtherance of any of the aforesaid purposes;

then the Bank shall be under no further obligation to issue the Letter of Credit hereunder if the same has not theretofore been issued and the Bank may send notice to the Account Party demanding the deposit of cash collateral in an aggregate amount equal to the sum of the Letter of Credit Undrawn Availability and all Letter of Credit Unreimbursed Draws, whereupon the Account Party shall immediately deposit into an account established and maintained on the books and records of the Bank, which account may be a "securities account" (within the meaning of the Uniform Commercial Code as in effect in the Commonwealth of Pennsylvania), in the name of the Bank, such aggregate amount plus any accrued and unpaid interest thereon; provided that the obligation to deposit such cash collateral shall become effective immediately, and such deposit shall become immediately due and payable, without demand or notice of any kind, upon the occurrence of any Event of Default with respect to the Account Party described in paragraph (l) or (m) of this Article. Such deposit shall be held by the Bank as collateral for the obligations of the Account Party under this Agreement and for this purpose the Account Party hereby grants a security interest to the Bank in such collateral account and in any financial assets (as defined in the Uniform Commercial Code) or other property held therein. Upon satisfaction in full in cash of all obligations of the Credit Parties to the Bank under this Agreement and the Letter of Credit, any amount remaining on deposit pursuant to this Section 7.01 shall be returned to the Account Party.

## ARTICLE VIII

[Intentionally omitted]

-14-

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## ARTICLE IX

### MISCELLANEOUS

9.01. No Implied Waiver etc. No delay or failure of the Bank in exercising any right, power or privilege hereunder shall affect such right, power or privilege; nor shall any single or partial exercise thereof or any abandonment or discontinuance of steps to enforce such a right, power or privilege preclude any further exercise thereof or of any other right, power or privilege. The rights and remedies hereunder of the Bank are cumulative and not exclusive of any rights or remedies which, it or they would otherwise have. Any amendment, waiver, permit, consent or approval of any kind or character on the part of the Bank of any breach or default under this Agreement or any such waiver of any provision or condition of this Agreement must be in writing and shall be effective only to the extent in such writing specifically set forth.

9.02. Set-Off. In case any one or more of the Events of Default described in Article VII hereof shall occur, the Bank shall have the right, in addition to all other rights and remedies available to it, to set-off against the unpaid balance of its interests in any Letter of Credit Reimbursement Obligations any debt owing by the Bank to the applicable Credit Party, including without limitation any funds in any deposit account maintained by such Credit Party with the Bank, and the Bank shall have and there is hereby created in favor of the Bank a security interest in all deposit accounts maintained by such Credit Party with the Bank, subject to Liens permitted under Section 6.01. Nothing in this Agreement shall be deemed any waiver or prohibition of any right of banker's lien or set-off under applicable Law.

9.03. Survival of Provisions. Each of the representations, warranties, covenants and agreements of the Credit Parties contained herein or made in writing in connection herewith shall survive the execution and delivery of this Agreement, and the issuance of the Letter of Credit hereunder.

9.04. Expenses and Fees; Indemnity.

(a) Each Account Party agrees to pay or cause to be paid and to save the Bank harmless against liability for the payment of all reasonable out-of-pocket costs and expenses (including but not limited to reasonable fees and expenses of counsel, including local counsel, auditors, and all other professional, accounting, evaluation and consulting costs) incurred by the Bank from time to time arising from or relating to (i) the negotiation, preparation, execution, delivery, administration and performance of this Agreement and the other Transaction Documents, (ii) any requested amendments, modifications, supplements, waivers or consents (whether or not ultimately entered into or granted) to this Agreement or any Transaction Document, and (iii) the enforcement or preservation of rights under this Agreement or any Transaction Document (including but not limited to any such costs or expenses arising from or relating to (A) collection or enforcement of any other amount owing hereunder or thereunder by the Bank and (B) any litigation, proceeding, dispute, work-out, restructuring or rescheduling related in any way to this Agreement or the Transaction Documents.

(b) The Account Party hereby agrees to reimburse and indemnify the Bank from and against any and all losses, liabilities, claims, damages, expenses, obligations, penalties, actions, judgments, suits, costs or disbursements of any kind or nature whatsoever (including, without limitation, the fees and disbursements of counsel for the Bank in connection with any investigative, administrative or judicial proceeding commenced, whether or not the Bank shall be designated a party thereto) that may at any time be imposed on, asserted against or incurred by the Bank as a result of, or arising out of, or in any way related to or by reason of, this Agreement or any other Transaction Document, any transaction from time to time contemplated hereby or thereby, or any

-15-

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transaction to which the Letter of Credit directly or indirectly relates (and without in any way limiting the generality of the foregoing, including any violation or breach of any Law by any Credit Party or any exercise by the Bank of any of its rights or remedies under this Agreement or any other Transaction Document; any breach of any representation or warranty, covenant or agreement of any Credit Party); but excluding any such losses, liabilities, claims, damages, expenses, obligations, penalties, actions, judgments, suits, costs or disbursements to the extent resulting from the gross negligence or willful misconduct of the Bank, as finally determined by a court of competent jurisdiction. If and to the extent that the foregoing obligations of the Account Party under this Section 9.04, or any other indemnification obligation of the Account Party hereunder or under any other Transaction Document, are unenforceable for any reason, the Account Party hereby agrees to make the maximum contribution to the payment and satisfaction of such obligations which is permissible under applicable Law.

9.05. Severability. In the event any one or more of the provisions contained in this Agreement or in any other Transaction Document should be held invalid, illegal or unenforceable in any respect, the validity, legality and enforceability of the remaining provisions contained herein and therein shall not in any way be affected or impaired thereby. The parties shall endeavor in good-faith negotiations to replace the invalid, illegal or unenforceable provisions with valid provisions the economic effect of which comes as close as possible to that of the invalid, illegal or unenforceable provisions.

9.06. Holidays. Unless otherwise specified herein, whenever any payment or action to be made or taken hereunder shall be stated to be due on a Saturday, Sunday or public holiday under the laws of the Commonwealth of Pennsylvania or Bermuda, such payment or action shall be made or taken on the next succeeding Business Day and such extension of time shall in such case be included in computing interest, if any, in connection with such payment or action.

9.07. Notices, etc. Any notice or other communication in connection with this Agreement shall be deemed to have been given or made when received by the party to whom directed. All such notices and other communications shall be in writing unless otherwise provided herein and shall be directed, if to a Bank, at such Bank's address on the signature pages hereof, if to the Bank at One Mellon Center, Room 4401, Pittsburgh, Pennsylvania 15258, Attention: Karla Maloof, fax no. (412) 234-8087, with a copy to Trade Banking Operations, Mellon Client Service Center, 500 Ross Street, Room 0860, Pittsburgh, PA 15262, fax no. (412) 234-2733; and if to any Credit Party, to XL Capital Ltd, XL House, One Bermudiana Road, Hamilton HM11 Bermuda, Attn: Roddy Gray, fax no. (441) 296-6399, with a copy to Paul Giordano, General Counsel, XL Capital Ltd, fax no. (441) 295-4867, or in accordance with the latest unrevoked written direction from any party to the other parties hereto. For the purposes of both receiving information from the Bank or providing information to the Bank, XL Capital shall act as the agent for each other Credit Party.

9.08. FORUM SELECTION AND CONSENT TO JURISDICTION. ANY LITIGATION BASED HEREON, OR ARISING OUT OF, UNDER, OR IN CONNECTION WITH, THIS AGREEMENT OR ANY OTHER TRANSACTION DOCUMENT, OR ANY COURSE OF CONDUCT, COURSE OF DEALING, OR ANY OTHER MATTER RELATED THERETO MAY BE BROUGHT AND MAINTAINED IN THE COURTS OF COMMONWEALTH OF PENNSYLVANIA OR IN THE UNITED STATES DISTRICT COURT FOR THE WESTERN DISTRICT OF PENNSYLVANIA. EACH CREDIT PARTY HEREBY EXPRESSLY AND IRREVOCABLY SUBMITS TO THE JURISDICTION OF THE COURTS OF THE COMMONWEALTH OF PENNSYLVANIA AND THE UNITED STATES DISTRICT COURT FOR THE WESTERN DISTRICT OF PENNSYLVANIA FOR THE PURPOSE OF ANY SUCH LITIGATION AS SET FORTH ABOVE AND IRREVOCABLY AGREES TO BE BOUND BY ANY JUDGMENT RENDERED THEREBY IN CONNECTION WITH SUCH LITIGATION, SUBJECT TO ANY GENERAL RIGHT OF APPEAL. EACH CREDIT PARTY FURTHER

-16-

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IRREVOCABLY CONSENTS TO THE SERVICE OF PROCESS BY REGISTERED MAIL, POSTAGE PREPAID, TO THE ADDRESS PROVIDED IN THIS AGREEMENT.

9.09. WAIVER OF JURY TRIAL. TO THE EXTENT LITIGATION HEREUNDER IS BROUGHT BEFORE A COURT IN THE UNITED STATES, THE PARTIES HEREBY KNOWINGLY, VOLUNTARILY AND INTENTIONALLY WAIVE ANY RIGHTS THEY MAY HAVE TO A TRIAL BY JURY. EACH PARTY ACKNOWLEDGES AND AGREES THAT IT HAS RECEIVED FULL AND SUFFICIENT CONSIDERATION FOR THIS PROVISION (AND EACH OTHER PROVISIONS OF EACH OTHER DOCUMENT RELATED HERETO TO WHICH IT IS A PARTY) AND THAT THIS PROVISION IS A MATERIAL INDUCEMENT FOR THE BANK ENTERING INTO THIS AGREEMENT AND RELATED AGREEMENTS.

9.10. Governing Law. This Agreement and any other documents delivered in connection herewith and the rights and obligations of the parties hereto and thereto shall for all purposes be governed by and construed and enforced in accordance with the substantive law of the State of New York without giving effect to conflict of laws principles.

9.11. Validity and Enforceability. If any stamp tax, levy, duty or fee is imposed or payable in respect to this Agreement or the transaction contemplated hereby or is necessary or advisable to ensure the legality, validity or enforceability of the documents in this transaction, the Account Party shall promptly pay such stamp tax, levy, duty or fee. No government approval or consent is necessary for the execution, delivery and performance of the transactions contemplated under this Agreement.

9.12. Counterparts. This Agreement may be executed in any number of counterparts and by the different parties hereto on separate counterparts, each of which, when so executed and delivered, shall be an original, but all such counterparts shall together constitute one (1) and the same instrument.

9.13. Successors and Assigns; Participations; Assignments.

(a) Successors and Assigns. The provisions of this Agreement shall be binding upon and inure to the benefit of the Account Party, the Guarantors, the Bank and their respective successors and assigns, except that no Credit Party may assign or otherwise transfer any of its rights or duties under this Agreement without the prior written consent of the Bank, and any purported assignment without such consent shall be void.

9.14. Amendments and Waivers. Neither this Agreement nor any Transaction Document may be amended, modified or supplemented except in accordance with the provisions of this Section. The Bank and the Credit Parties may from time to time amend, modify or supplement the provisions of this Agreement or any other Transaction Document for the purpose of amending, adding to, or waiving any provisions or changing in any manner the rights and duties of any Credit Party or the

Bank. Any such amendment, modification or supplement made by the Credit Parties and the Bank in accordance with the provisions of this Section shall be binding upon the Credit Parties and the Bank. Any Event of Default or Potential Default waived or consented to in any such amendment, modification or supplement shall be deemed to be cured and not continuing to the extent and for the period set forth in such waiver or consent, but no such waiver or consent shall extend to any other or subsequent Event of Default or Potential Default or impair any right consequent thereto.

9.15. Judgment Currency. In the event of a judgment or order being rendered by any court or tribunal for the payment of any amounts owing to the Bank under this Agreement or any other Transaction Document or for the payment of damages in respect of any breach of this Agreement or any other Transaction Document or under or in respect of a judgment or order of another court or tribunal for the payment of such amounts or damages, such judgment or order being expressed in a

-17-

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currency (the "Judgment Currency") other than Dollars the party against whom the judgment or order is made shall indemnify and hold the Bank harmless against any deficiency in terms of Dollars in the amounts received by the Bank arising or resulting from any variations as between (i) the exchange rate at which Dollars are converted into the Judgment Currency for the purposes of such judgment or order and (ii) the exchange rate at which the Bank is able to purchase Dollars with the amount of the Judgment Currency actually received by the Bank on the date of such receipt. The indemnity in this section shall constitute a separate and independent obligation from the other obligations of the Account Party hereunder and shall apply irrespective of any indulgence granted by the Bank.

9.16. Records. The amount of the outstanding Letter of Credit, the amount of any Letter of Credit Unreimbursed Draw and the accrued and unpaid Letter of Credit Fees and Facility Fees shall at all times be ascertained from the records of the Bank, which shall be conclusive absent manifest error.

9.17 Confidentiality. The Bank agrees to keep confidential any information relating to the Credit Parties received by it pursuant to or in connection with this Agreement which is (a) information which the Bank reasonably expects that the applicable Credit Party would want to keep confidential or (b) information which is clearly marked "CONFIDENTIAL"; provided, however, that this Section 9.17 shall not be construed to prevent the Bank from disclosing such information (i) to any affiliate that shall agree in writing for the benefit of the Credit Parties to be bound by this obligation of confidentiality, (ii) upon the order of any court or administrative agency of competent jurisdiction, (iii) upon the request or demand of any regulatory agency or authority having jurisdiction over the Bank which request or demand has the force of Law or is made by a bank regulatory agency, (iv) that has been publicly disclosed, other than from a breach of this provision by the Bank, (v) that has been obtained from any person that is neither a party to this Agreement nor an affiliate of any such party, but only to the extent that the Bank does not know or have reason to know that such disclosure violates a confidentiality agreement between such person and the applicable Credit Party (vi) in connection with the exercise of any right or remedy hereunder or under any other Transaction Document, (vii) as expressly contemplated by this Agreement or any other Transaction Document or (viii) to any prospective purchaser of all or any part of the interest of the Bank which shall agree in writing for the benefit of the Credit Parties to be bound by the obligation of confidentiality in this Agreement or the other Transaction Documents if such prospective purchaser is a financial institution or has been consented to by the Account Party, which consent will not be withheld if such purchaser is not a competitor of any Guarantor or an affiliate of a competitor of any Guarantor.

## ARTICLE X

### GUARANTEE

10.01. The Guarantee. Each of the Guarantors hereby irrevocably, unconditionally and absolutely guarantees to the Bank, and becomes surety for, the prompt payment of the Obligations of the Account Party (the "Guaranteed Obligations") in full when due (whether at stated maturity, by acceleration, or otherwise) strictly in accordance with the terms thereof. Each Guarantor hereby further agrees, as a primary obligor, that if any of the Guaranteed Obligations are not paid in full when due (whether at stated maturity, by acceleration, or otherwise and whether or not such payments would not be permitted under any applicable bankruptcy or similar law), the Guarantor will promptly pay the same, without any demand or notice whatsoever (except as expressly provided herein), and that in the case of any extension of time of payment or renewal of any of the Guaranteed Obligations, the same will be promptly paid in full when due (whether at extended maturity, by acceleration or otherwise) in accordance with the terms of such extension or renewal.

Notwithstanding any provision to the contrary contained herein or in any other of the Transaction Documents, to the extent the obligations of any Guarantor shall be adjudicated to be invalid or

-18-

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unenforceable for any reason (including, without limitation, because of any applicable law, including the insolvency laws, relating to fraudulent conveyances or transfers) then the obligations of such Guarantor hereunder automatically shall be limited to the maximum amount that is permissible under applicable law.

10.02. Obligations Unconditional. The obligations of each Guarantor under this Article are irrevocable, absolute and unconditional (to the fullest extent permitted by applicable law), irrespective of the value, genuineness, validity, regularity or enforceability of any of the Transaction Documents, or any other agreement or instrument referred to therein, or any substitution, release or exchange of any other guarantee of or security for any of the Guaranteed Obligations, and, to the fullest extent permitted by applicable law, irrespective of any other circumstance whatsoever which might otherwise constitute a legal or equitable discharge or defense of a surety or guarantor, it being the intent of this Article that the obligations of each Guarantor hereunder shall be absolute and unconditional under any and all circumstances. Each Guarantor agrees that such Guarantor shall have no right of subrogation, indemnity, reimbursement or contribution against the Account Party, for amounts paid under this Article X until such time as the Bank has been paid in full, no Letter of Credit is outstanding, and no Person or Official Body shall have any right to request any return or reimbursement of funds from the Bank in connection with monies received under the Transaction Documents. Without limiting the generality of the foregoing, it is agreed that, to the fullest extent permitted by applicable law, the occurrence of any one or more of the following shall not alter or impair the liability of any Guarantor hereunder which shall remain irrevocable, absolute and unconditional as described above:

(i) at any time or from time to time, without notice to the Guarantors, the time for any performance of or compliance with any of the Guaranteed Obligations shall be extended, or such performance or compliance shall be waived;

(ii) any of the acts mentioned in any of the provisions of any of the Transaction Documents, or any other agreement or instrument referred to in the Transaction Documents shall be done or omitted;

(iii) the maturity of any of the Guaranteed Obligations shall be accelerated, or any of the Guaranteed Obligations shall be modified, supplemented or amended in any respect, or any right under any of the Transaction Documents, or any other agreement or instrument referred to in the Transaction Documents shall be waived or any other guarantee of any of the Guaranteed Obligations or any security therefor shall be released or exchanged in whole or in part or otherwise dealt with;

(iv) any Lien granted to, or in favor of, the Bank as security for any of the Guaranteed Obligations shall be void or voidable, or shall fail to attach or be perfected or the Bank shall fail to realize on any collateral security; or

(v) any of the Guaranteed Obligations shall be determined to be void or voidable (including, without limitation, for the benefit of any creditor of any Guarantor) or shall be subordinated to the claims of any Person (including, without limitation, any creditor of any Guarantor).

With respect to its obligations hereunder, each Guarantor hereby expressly waives diligence, presentment, demand of payment, protest and all notices whatsoever (except notices expressly required hereunder), and any requirement that the Bank exhaust any right, power or remedy or proceed against any Person under any of the Transaction Documents, or any other agreement or instrument referred to in the Transaction Documents, or against any other Person under any other guarantee of, or security for, any of the Guaranteed Obligations. This is a guarantee of payment and not merely of collection.

-19-

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10.03. Reinstatement. The obligations of the Guarantors under this Article shall be automatically reinstated if and to the extent that for any reason any payment by or on behalf of any Person in respect of the Guaranteed Obligations is rescinded or must be otherwise restored by any holder of any of the Guaranteed Obligations, whether as a result of any proceedings in bankruptcy, receivership, or reorganization or otherwise, and each Guarantor agrees that it will indemnify the Bank on demand for all reasonable out-of-pocket costs and expenses (including, without limitation, reasonable fees and expenses of counsel) incurred by the Bank in connection with such rescission or restoration, including any such reasonable costs and expenses incurred in defending against any claim alleging that such payment constituted a preference, fraudulent transfer or similar payment under any bankruptcy, insolvency, receivership, reorganization or similar law.

10.04. Remedies. Each Guarantor agrees that, to the fullest extent permitted by applicable law, as between such Guarantor, on the one hand, and the Bank, on the other hand, the Guaranteed Obligations may be declared to be forthwith due and payable as provided in Section 7.01 hereof (and shall be deemed to have become automatically due and payable in the circumstances provided in said Section 7.01) for purposes of Section 10.01 hereof notwithstanding any stay, injunction or other prohibition preventing such declaration (or preventing the Guaranteed Obligations from becoming automatically due and payable) as to any other Person and that, in the event of such declaration (or Guaranteed Obligations being deemed to have become automatically due and payable), the Guaranteed Obligations (whether or not due and payable by any other Person) shall forthwith become due and payable by such Guarantor for purposes of said Section 10.01.

10.05. Continuing Guarantee. The guarantee in this Article is a continuing guarantee, and shall apply to all of the Guaranteed Obligations whenever arising.

10.06. No Restrictions. Except for restrictions under the Transaction Documents, no Guarantor shall be or become subject to any restriction of any nature (whether arising by operation of Law, by agreement, by its articles of incorporation, by-laws or other constituent documents of such Guarantor, or otherwise) on the right of such Guarantor from time to time to (x) pay any indebtedness, obligations or liabilities from time to time owed to the Account Party, (y) make loans or advances to the Account Party, or (z) transfer any of its properties or assets to the Account Party.

-20-

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IN WITNESS WHEREOF, the parties hereto, by their respective officers thereunto duly authorized, have executed this Agreement as of the day and year first above written.

**XL INSURANCE (BERMUDA) LTD, as a Guarantor**

By: /s/ Christopher A. Coelho

\_\_\_\_\_  
Name: Christopher A. Coelho

\_\_\_\_\_  
Title: Senior Vice President & Chief Financial Officer

**XL RE LTD, as a Guarantor**

By: /s/ Paul S. Giordano

\_\_\_\_\_  
Name: Paul S. Giordano

\_\_\_\_\_  
Title: EVP, General Counsel & Secretary

**XL CAPITAL LTD, as the Account Party and a Guarantor**

By: /s/ Paul S. Giordano

\_\_\_\_\_  
Name: Paul S. Giordano

\_\_\_\_\_  
Title: EVP, General Counsel & Secretary



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**X.L. AMERICA, INC., as a Guarantor**

By: /s/ Charles F. Barr

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Name: Charles F. Barr

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Title: Secretary

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-21-

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**MELLON BANK, N.A.,**

By: /s/ Karla K. Maloof

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Name: Karla K. Maloof

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Title: First Vice President

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Notice Address:

One Mellon Center, Room 4401  
Pittsburgh, PA 15258  
Attention: Karla Maloof,  
Telephone: (412) 236-4147  
Facsimile: (412) 234-8087

with a copy to:  
Manager, Trade Banking Operations  
Mellon Client Service Center  
500 Ross Street, Room 0860  
Pittsburgh, PA 15262  
Telephone: (412) 234-66408  
Facsimile: (412) 234 2733

-22-

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## EXECUTION COPY

XL Capital Ltd  
 XL Insurance (Bermuda) Ltd  
 XL Re Ltd  
 XL House  
 One Bermudiana Road  
 Hamilton HM 11 Bermuda

X.L. America, Inc.  
 Seaview House  
 70 Seaview Avenue  
 Stamford, Connecticut 06902

Re: Offer, dated as of April 12, 2004 for a U.S. \$50,000,000 Committed Line of Credit

Ladies and Gentlemen:

**1. Introduction:**

Credit Lyonnais New York Branch ("Lender") is pleased to offer XL Capital Ltd, a company incorporated under the laws of the Cayman Islands, ("XL Capital"), X.L. America, Inc., a Delaware corporation ("XL America"), XL Insurance (Bermuda) Ltd, a Bermuda limited liability company ("XL Insurance") and XL Re Ltd, a Bermuda limited liability company ("XL Re", together with XL Capital, XL America and XL Insurance, each an "Account Party" and, together, the "Account Parties"), a committed line of credit for the issuance of standby letters of credit (each, a "Letter of Credit" and, collectively, the "Letters of Credit") on and subject to the terms and conditions hereof and of the other Credit Documents (as defined in Section 2); provided, however, that the sum of the aggregate amount of Letters of Credit outstanding at any time shall not exceed U.S. \$50,000,000 (the "Commitment").

Upon execution hereof by the Account Parties and the satisfaction of the conditions to effectiveness set forth herein, this Agreement shall become effective and shall remain in effect until the earlier of July 31, 2004 and the date of termination hereof by Lender pursuant to the terms hereof (such earlier date, the "Expiration Date"). Any obligations of Account Parties incurred pursuant to this Agreement and any Application in respect of any issued and outstanding Letter of Credit shall survive the termination or expiration hereof.

**NOTWITHSTANDING ANYTHING HEREIN CONTAINED TO THE CONTRARY, IT IS HEREBY AGREED THAT SO LONG AS ANY LETTER OF CREDIT ISSUED PURSUANT TO THE TERMS HEREOF OR ANY APPLICATION REMAINS OUTSTANDING, THE EVENTS OF DEFAULT SPECIFIED HEREIN SHALL REMAIN EFFECTIVE AND SHALL SURVIVE THE TERMINATION OF THIS AGREEMENT, AND THE LENDER SHALL BE ENTITLED TO EXERCISE ANY AND ALL REMEDIES IN RESPECT THEREOF.**

**2. Definitions:**

As used herein and in the other Credit Documents, the following terms have the following meanings:

"Account Party" and "Account Parties": as defined in Section 1 hereof.

"Agreement": this Offer, as amended, supplemented, extended or otherwise modified from time to time.

"Application": an application, in the form attached hereto as Exhibit A, requesting Lender to issue a Letter of Credit.

"Base Rate": as determined by Lender on a daily basis, the higher of (a) the rate per annum established by Lender from time to time as the reference rate for short-term commercial loans in U.S. dollars to domestic corporate borrowers (which Account Parties acknowledge is not necessarily Lender's lowest rate) and (b) the overnight cost of funds of Lender as determined solely by Lender plus 1/4 of 1% per annum.

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"Business Day": any day, other than a Saturday or Sunday or legal holiday under the laws of the State of New York, Bermuda or the Cayman Islands, on which commercial banks generally are open for business in New York, New York, Bermuda and the Cayman Islands.

"Change in Law": (a) the adoption of any law, rule or regulation, (b) any change in any law, rule or regulation or in the interpretation or application thereof by any Government Authority or (c) any request, guideline or directive (whether or not having the force of law) of any Governmental Authority made or issued.

"Change of Control": XL Capital shall cease to own, directly or indirectly, 100% of the economic and voting interests in each of XL America, XL Insurance and XL Re, free and clear of any Lien.

"Collateral Account": as defined in Section 10.

"Contingent Obligation": as to any Person, any guarantee of payment by such Person of any Indebtedness or other obligation of any other Person, or any agreement to provide financial assurance with respect to the financial condition, or the payment of the obligations of, such other Person which has the effect of assuring or holding harmless any third Person against loss with respect to one or more obligations of such third Person; provided, however, that the term Contingent Obligation shall not include endorsements of instruments for deposit or collection in the ordinary course of business.

"Covered Taxes": all Taxes, other than Excluded Taxes, that are imposed on the Lender with respect to any payment made by any Account Party hereunder.

"Credit Documents": this Agreement and any Application.

**"Default"**: any Event of Default or any condition or event which, after the giving of notice, the lapse of time, or both, or any other condition, would, unless cured or waived, become an Event of Default.

**"Event of Default"**: as defined in Section 10.

**"Excluded Taxes"**: with respect to the Lender or any other recipient of a payment from any Account Party hereunder, (i) Taxes imposed on (or measured by) net income, net profits or overall gross receipts (including, without limitation, branch profits taxes) by any jurisdiction under the laws of which such recipient is organized, in which such recipient has an office or with respect to which such recipient has any other connection (other than a connection deemed to arise solely by reason of the recipient's being a party to this Agreement or receiving a payment under this Agreement, or the recipient's enforcement of its rights or exercise of its remedies under this Agreement), (ii) any Tax that is not imposed solely as a result of a Change in Law formally announced after the date hereof and (iii) any Tax that is attributable to the recipient's failure to comply with Section 6(iii).

**"Existing Credit Agreement"**: that certain 364-Day Credit Agreement dated as of June 25, 2003, as the same may be amended, modified or supplemented from time to time, among, *inter alia*, the Account Parties, XL Europe Ltd, the Lenders party thereto and JPMorgan Chase Bank, as Administrative Agent.

**"Expiration Date"**: as defined in Section 1.

**"GAAP"**: generally accepted accounting principles in the United States of America consistent with those utilized in preparing the audited financial statements referred to in Section 9; provided that, if XL Capital notifies the Lender that the Account Parties request an amendment to any provision hereof to eliminate the effect of any change occurring after the date hereof in GAAP or SAP, as the case may be, or in the application thereof on the operation of such provision (or if the Lender notifies the Account Parties that it requests an amendment to any provision hereof for such purpose), regardless of whether any such notice is given before or after such change in GAAP or SAP, as the case may be, or in the application thereof, then such provision shall be interpreted on the basis of GAAP or SAP, as the case may be, as in effect and applied immediately before such change shall have become effective until such notice shall have been withdrawn or such provision amended herewith.

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**"Indemnified Liabilities"**: as defined in Section 13.

**"L/C Obligations"**: at any time, an amount equal to the sum of (a) the aggregate then undrawn and unexpired amount of the then outstanding Letters of Credit and (b) the aggregate amount of drawings under Letters of Credit for which Lender has not then been reimbursed.

**"Lender"**: as defined in Section 1.

**"Material Adverse Effect"**: a material adverse effect on (a) the business, operations or condition (financial or otherwise) of any Account Party and its Subsidiaries taken as a whole or (b) the ability of such Account Party to perform its payment or other material obligations under any Credit Document.

**"Maturity Date"**: in respect of any Letter of Credit, July 31, 2005 or such earlier date as the L/C Obligations shall mature, whether by reason of acceleration or otherwise.

**"Person"**: an individual, partnership, corporation, limited liability company, business trust, joint stock company, trust, unincorporated association, joint venture, Governmental Authority or other entity of whatever nature.

**"Reimbursement Amounts"**: as defined in Section 5.

**"Requirement of Law"**: as to any Person, the Certificate of Incorporation and By-Laws or other organizational or governing documents of such Person, and any law, treaty, rule, restriction or regulation or determination of an arbitrator or a court or other Governmental Authority (including, without limitation, any federal, state or local environmental and employee benefit laws and regulations), in each case applicable to or binding upon such Person or any of its property or to which such Person or any of its property is subject.

**"S&P"**: Standard & Poor's Ratings Services, a division of The McGraw-Hill Companies, Inc., (or any successor entity thereto).

**"SAP"**: as to each Account Party and each Subsidiary that offers insurance products, the statutory accounting practices prescribed or permitted by the relevant Governmental Authority for such Account Party's or such Subsidiary's domicile for the preparation of its financial statements and other reports by insurance corporations of the same type as such Account Party or such Subsidiary in effect on the date such statements or reports are to be prepared; provided that, if XL Capital notifies the Lender that the Account Parties request an amendment to any provision hereof to eliminate the effect of any change occurring after the date hereof in GAAP or SAP, as the case may be, or in the application thereof on the operation of such provision (or if the Lender notifies the Account Parties that it requests an amendment to any provision hereof for such purpose), regardless of whether any such notice is given before or after such change in GAAP or SAP, as the case may be, or in the application thereof, then such provision shall be interpreted on the basis of GAAP or SAP, as the case may be, as in effect and applied immediately before such change shall have become effective until such notice shall have been withdrawn or such provision amended herewith.

**"Subsidiary"**: as to any Person (the "Parent"), a corporation, partnership or other entity of which shares of stock or other ownership interests having ordinary voting power (other than stock or such other ownership interests having such power only by reason of the happening of a contingency) to elect the board of directors of such corporation, partnership or other entity are at the time owned, directly or indirectly, by the parent or one or more subsidiaries of the parent. Unless otherwise qualified, all references to a "Subsidiary" or to "Subsidiaries" in this Agreement shall refer to a Subsidiary or Subsidiaries of Account Party.

**"Taxes"**: all present and future taxes, levies, deductions, imposts, charges or withholdings, imposed by any Governmental Authority.

**"Usage Fee"**: as defined in Section 4.

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**"Used Amount"**: the aggregate face amount of all Letters of Credit issued pursuant to the terms hereof, whether drawn or undrawn.

Capitalized terms used herein and not otherwise defined shall have the meaning ascribed thereto in the Existing Credit Agreement, including, without limitation, for purposes of calculating, and measuring compliance with, the covenants under Section 9(vi) hereof.

### **3. Issuance:**

Promptly upon the written request by Account Party for a utilization hereunder (which request must be received by Lender prior to 10:00 A.M. (New York time) on the Business Day immediately preceding the proposed date of such utilization (which must be a Business Day prior to the Expiration Date), Lender shall, subject to the terms and conditions hereof, honor such request. In lieu of delivering such written notice, such Account Party may give Lender telephonic notice of any proposed utilization by the time required herein if it confirms such notice by delivery to Lender of written notice promptly (but in no event later than the date on which such utilization is requested to be made).

### **4. Terms of Letters of Credit:**

Each Letter of Credit (a) shall be governed by the provisions hereof and of the relevant Application and (b) shall expire on a Business Day no later than one year after the date of its issuance; provided, however, that no Letter of Credit shall expire later than the Maturity Date. Account Parties shall pay to Lender (i) a facility fee equal to 0.06% per annum, calculated on the entire Commitment and (ii) a usage fee (the "Usage Fee") equal to the product of (x) the Used Amount and (y) 0.365% per annum, in each case, payable quarterly, in arrears, beginning with the first such quarter following the effective date of this Agreement. In addition, Account Parties shall pay to Lender a non-refundable (a) issuance fee with respect to each Letter of Credit in the amount of \$200, payable in advance on the date of issuance of such Letter of Credit and (b) amendment fee with respect to each amendment to any Letter of Credit in the amount of \$100, payable in advance on the date of such amendment. In the event of an inconsistency between this Agreement and the Application, this Agreement shall control. In furtherance of the foregoing, it is understood and agreed that notwithstanding anything to the contrary contained in the first sentence of paragraph 7 of each Application, the Credit (as therein defined) shall be governed by the U.C.P. (as therein defined).

### **5. Overdue Amounts:**

Amounts due in respect of drawings under Letters of Credit ("Reimbursement Amounts"), interest (to the extent permitted by law) and other amounts due hereunder or under any other Credit Document that are not paid on the date when due shall bear interest (before as well as after judgment) payable on demand at 2% over the Base Rate from and including the date when such payment was due to, but excluding, the date of receipt of payment.

### **6. Calculations; Payments:**

(i) All calculations of interest hereunder shall be made on the basis of a 360-day year for the actual number of days elapsed. All payments of Reimbursement Amounts, interest or other amounts due under the Credit Documents shall be made without set-off, counterclaim or any other deduction no later than 11:00 A.M. (New York time) two (2) Business Days after notice from the Lender that such Reimbursement Amounts are due in immediately available funds at the offices of Lender for its account. If any such payment falls due on a day which is not a Business Day, the date of payment shall be the next succeeding Business Day.

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(ii) Any and all payments to the Lender by Account Parties under the Credit Documents shall be made free and clear of any Covered Taxes unless an Account party is required to deduct Covered Taxes. If an Account Party shall be required by law to deduct any Covered Taxes from or in respect of any sum payable under the Credit Documents to the Lender, (a) such Account Party shall forthwith pay to the Lender such additional amounts as may be necessary so that after making all required deductions for Covered Taxes the Lender receives an amount equal to the sum it would have received had no such deductions been made and (b) such Account Party shall make such deductions and shall pay the full amount deducted to the relevant taxing authority in accordance with applicable law. Account Parties shall, upon request, provide appropriate documentation, including receipts, evidencing payment by Account Parties of any such Covered Taxes. If the Lender determines in good faith that it has received a refund in respect of any Covered Taxes or with respect to which any Account Party has paid additional amounts pursuant to this Section 6, the Lender shall promptly after the date of such receipt pay over the amount of such refund to such Account Party (but only to the extent of additional amounts paid by the Account Party under this Section 6 with respect to the Covered Taxes giving rise to such refund), net of all reasonable expenses of the Lender (including additional Taxes attributable to such refund, as determined in good faith by the Lender) and without interest (other than interest, if any, paid by the relevant taxing authority with respect to such refund). Any Account Party shall, upon demand, repay to the Lender any amount paid over to such Account Party by the Lender in the event the Lender is required to repay any portion of such refund to such taxing authority. Nothing in this Section 6 shall entitle any Account Party to have access to the records of the Lender, including, without limitation, tax returns.

(iii) To the extent it is legally entitled to do so, the Lender shall from time to time, at the written request of any Account Party, provide to such Account Party such form, certification or similar documentation, if any (each duly completed, accurate and signed) as is required by any jurisdiction, in order to obtain an exemption from, or reduced rate of, deduction, or withholding of Covered Taxes to which the Lender is entitled pursuant to an applicable tax treaty or other applicable law.

(iv) An assignee of the Lender or subsequent assignee shall not be entitled to any greater additional amounts under this Section 6 than such assignee's assignor would have been entitled to absent such assignment (determined taking into account the provisions of this Section 6) except to the extent that the entitlement to greater additional amounts resulted solely from a Change in Law formally announced after the date on which such assignee became an assignee hereunder.

The obligations of Account Parties under this Section 6 shall survive the termination of this Agreement, the repayment of all Reimbursement Amounts and all other amounts payable hereunder and under the other Credit Documents.

### **7. Increased Costs:**

In the event of the introduction of, or any change in, any applicable law, rule, regulation or official directive (whether or not having the force of law), or in the interpretation or application thereof by any Governmental Authority after the date hereof which results in an increase in the cost to Lender of making or maintaining, or which reduces the rate of return on capital of Lender as a consequence of its obligations with respect to, Letters of Credit by reason of reserve, capital adequacy or similar requirements, or which results in a reduction of amounts otherwise receivable by Lender from Account Parties of Reimbursement Amounts, interest or other fees and charges hereunder and thereunder by reason of any tax (other than tax on the overall net income of Lender), levy, impost, fee, charge, withholding or similar requirements of any kind, Account Parties will pay to Lender

upon demand an amount equal to such actual increased cost or reduction; provided that this Section 7 shall not apply to Taxes, which shall be governed exclusively by Section 6 hereof. If an Account Party becomes liable for the payment of any additional amounts by reason of the immediately preceding sentence, it may avoid further liability for such additional amounts by seeking and obtaining replacements of such Letters of Credit from other financial institutions satisfactory to Lender which fully cancel all obligations of Lender under such Letters of Credit (which shall thereupon be promptly returned to Lender) and the relevant Application and paying to Lender in full on the date of replacement all Reimbursement Amounts, interest, fees and other amounts or charges due relating to such obligations. The obligations of Account Parties under this Section 7 shall survive the termination of this Agreement, the repayment of all Reimbursement Amounts and all other amounts payable hereunder and under the other Credit Documents.

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## **8. Representations and Warranties:**

Each Account Party represents and warrants as of the date hereof and as of the date that each Letter of Credit is issued that:

(i) (a) it is a corporation duly organized and validly existing under the laws of its jurisdiction of organization, (b) it is in good standing therein, (c) it is duly qualified to transact business in all jurisdictions where such qualification is necessary or required, (d) no consent or authorization of, approval by, notice to, filing with or other act by or in respect of, any Governmental Authority or any other Person is required in connection with the execution, delivery, performance, validity or enforceability of any of the Credit Documents and (e) it has the corporate power and authority to execute and deliver the Credit Documents and all documents, instruments and agreements related thereto and perform the transactions and agreements contemplated thereby;

(ii) the execution, delivery and performance of the Credit Documents have been duly authorized by all necessary corporate action;

(iii) this Agreement and any Application have been duly executed and delivered by it, and constitute the legal, valid and binding obligations of such Account Party enforceable in accordance with their respective terms except as enforceability may be limited by applicable bankruptcy, insolvency, reorganization, moratorium or similar laws of general applicability affecting the enforcement of creditors' rights generally and by general equitable principles (whether enforcement is sought by proceedings in equity or at law);

(iv) it is not in default under any agreement to which it is a party or by which its assets or properties are bound and the execution and delivery of, and the performance by it under, the Credit Documents do not and will not contravene any Requirement of Law, nor result in a breach or default under any agreement to which it is a party or by which its assets or properties are bound;

(v) there are no actions, suits or proceedings of any kind pending or, to the knowledge of such Account Party, threatened against such Account Party or its assets or properties which, in any one case or in the aggregate, could reasonably be expected to have a Material Adverse Effect;

(vi) XL Capital has heretofore furnished to Lender (a) its audited consolidated balance sheet for it and its consolidated Subsidiaries (other than XL America) and the related statements of income, stockholders' equity and cash flows for the fiscal year ended December 31, 2003, reported on by PricewaterhouseCoopers LLP, independent public accountants (as provided in XL Capital's Report on Form 10-K filed with the SEC) for such fiscal year). Such financial statements present fairly, in all material respects, the consolidated financial position of XL Capital and its Subsidiaries as of such dates and its consolidated results of operations and cash flows for such periods in accordance with GAAP.

(vii) it is in compliance with all Requirements of Law except where such non-compliance could not reasonably be expected to have a Material Adverse Effect;

(viii) it has filed or caused to be filed all tax returns which are required to be filed by it, and has paid or has made provision for the payment of all taxes shown to be due and payable on such returns or on any assessments received by it, other than any taxes or assessments it is contesting in good faith by appropriate proceedings and with respect to which it shall have set aside adequate reserves on its books or except to the extent that the failure to file any tax returns or pay or provide for any Taxes could not reasonably be expected to result in a Material Adverse Effect;

(ix) the Letters of Credit shall be used for reinsurance purposes only, and no part of the proceeds of any Letter of Credit will be used for "purchasing" or "carrying" any "margin stock" within the respective meanings of such quoted terms under Regulations T, U and X of the Board of Governors of the Federal Reserve System of the United States or for any purpose which violates, or which would cause Lender to violate, the provisions of any such regulations; and

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(x) it is not subject to regulation under the Public Utility Holding Company Act of 1935 or the Investment Company Act of 1940, each as amended, or to any Federal or state statutes or regulations limiting its ability to incur the indebtedness contemplated under, or otherwise affecting the validity or enforceability of, the Credit Documents.

## **9. Covenants:**

Until the later of (a) the Expiration Date and (b) the date on which all obligations of Account Parties in respect of the Credit Documents are indefeasibly paid in cash in full and all Letters of Credit have expired or been released by the beneficiaries thereof and tendered to Lender for cancellation, Account Parties agree and covenant with Lender as follows:

(i) (A) within 135 days after the end of each fiscal year of each Account Party, except for XL America, and within 100 days after the end of each fiscal year in the case of XL America, such Account Party shall provide Lender with its annual, audited consolidated financial statements (it being understood that delivery to Lender of XL Capital's Report on Form 10-K filed with the SEC shall satisfy the financial statement delivery requirements of this clause 9(i) (A)); (B) within 60 days after the end of each of the first three fiscal quarters of each of its fiscal years each Account Party shall provide Lender with its quarterly unaudited consolidated financial statements (it being understood that delivery to Lender of XL Capital's Report on 10-Q filed with the SEC shall satisfy the financial statement delivery requirement of this clause 9(i)(B)) and (C) each Account Party shall provide Lender with written notice of any Default or Event of Default.

(ii) The Account Parties shall comply with all Requirements of Law; provided that no Account Party shall be deemed in violation of this clause 9(ii) as a result of the failure to comply with any Requirement of Law which would not (A) result in fines, penalties, injunctive relief or

other civil or criminal liabilities which, in the aggregate, would have a Material Adverse Effect or (B) otherwise affect the ability of such Account Party to perform its obligations under this Agreement;

(iii) The Account Parties shall (A) continue to engage in business of the same general type as now conducted by them (or now proposes to conduct), (B) preserve, renew and keep in full force and effect their respective corporate existences, (C) take all reasonable action to maintain all rights, privileges and franchises necessary or desirable in the normal conduct of their respective businesses and (D) comply with their respective material contractual obligations;

(iv) XL Capital shall maintain at all times a claims-paying rating of at least "A" from A.M. Best & Co. (or any successor entity thereto) and XL Insurance and XL Re shall maintain at all times a rating of at least "A" from S&P;

(v) No Account Party shall, or permit any of its Subsidiaries to, at any time create, incur, assume or permit to exist any Indebtedness, except as otherwise permitted under Section 7.07 of the Existing Credit Agreement, or convey, sell, lease, transfer or otherwise dispose of, or create, assume or suffer to exist any Lien on, all or any material portion of its assets (in each case, whether in one transaction or in a series of transactions), except as otherwise permitted under Sections 7.02 and 7.03 of the Existing Credit Agreement;

(vi) No Account Party shall consolidate with, or merge into, any other Person (unless such Account Party is the surviving corporation and no Default or Event of Default shall have occurred and be continuing or result therefrom);

(vii) XL Capital will not permit (A) its ratio of (x) Total Funded Debt to (y) the sum of Total Funded Debt plus Consolidated Net Worth to be greater than 0.35:1.00 at any time and (B) its Consolidated Net Worth to be less than \$5,000,000,000 at any time; and

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(viii) each Account Party's obligations hereunder shall rank pari passu with all other unsecured and unsubordinated indebtedness of such Account Party, including, without limitation, its obligations under the Existing Credit Agreement save (i) those whose claims are preferred solely by any bankruptcy, insolvency, liquidation or other similar laws of general application; and (ii) with respect to XL Re only, those claims required to be preferred by and under the Bermuda Insurance Act 1978.

#### **10. Events of Default:**

The occurrence of any one or more of the following events shall constitute an "Event of Default" under the Credit Documents:

(i) if any Account Party shall (a) fail to reimburse any Reimbursement Amount when due and payable or (b) fail to pay interest, any fee or any other amounts due under the Credit Documents within 3 days of the date on which such payment of interest or other amount was due and payable;

(ii) if any Account Party or any of its Subsidiaries shall default (i) in any payment of principal of or interest on any other obligation for borrowed money in principal amount of \$50,000,000 or more, or any payment of any principal amount of \$50,000,000 or more under Hedging Agreements, in each case beyond any period of grace provided with respect thereto, or (ii) in the performance of any other agreement, term or condition contained in any such agreement (other than Hedging Agreements) under which any such obligation in principal amount of \$50,000,000 or more is created, if the effect of such default is to cause or permit the holder or holders of such obligation (or trustee on behalf of such holder or holders) to cause such obligation to become due prior to its stated maturity or to terminate its commitment under such agreement, provided that this clause (ii) shall not apply to secured Indebtedness that becomes due as a result of the voluntary sale or transfer of the property or assets securing such Indebtedness;

(iii) if any Account Party shall:

(a) commence a voluntary case or other proceeding seeking liquidation, reorganization or other relief with respect to itself or its debts under any bankruptcy, insolvency or other similar law now or hereafter in effect or seeking the appointment of a trustee, receiver, liquidator, custodian or other similar official of it or any material part of its property, or shall consent to any such relief or to the appointment of or taking possession by any such official in an involuntary case or other proceeding commenced against it, or shall make a general assignment for the benefit of creditors, or shall fail generally to pay its debts as they become due, or shall take any action to authorize any of the foregoing; or

(b) suffer the commencement of an involuntary case or other proceeding seeking liquidation, reorganization or other relief with respect to itself or its debts under any bankruptcy, insolvency or other similar law now or hereafter in effect or seeking the appointment of a trustee, receiver, liquidator, custodian or other similar official of it or any material part of its property, and such involuntary case or other proceeding shall not be controverted by appropriate proceedings within 30 days of the commencement thereof or shall remain undismissed or undischarged for a period of 60 days; or suffer the entry of an order for relief or be adjudicated a bankrupt or insolvent under the bankruptcy, insolvency or similar laws of any competent jurisdiction;

(iv) if any representation, warranty or statement made by any Account Party in any Credit Document or in any certificate or financial statement furnished pursuant to, or in connection with, any Credit Document shall prove to have been incorrect, misleading or incomplete in any material respect when made or deemed made;

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(v) if any Account Party shall fail to perform or observe any term, covenant or agreement on its part to be performed or observed pursuant to Section 9(iii) through (vi) inclusive, or shall fail to perform or observe any other term, covenant or agreement on its part to be performed under any Credit Document (other than those covered by subsection 10(i)), and such failure shall continue unremedied for a period of 20 or more days after notice thereof from Lender to such Account Party;

(vi) if one or more judgments or decrees shall be entered against any Account Party or any of its Subsidiaries involving in the aggregate for all such Persons a liability (not paid or fully covered by insurance) of \$100,000,000 or more and all such judgments and decrees shall not have been vacated, discharged, stayed or bonded pending appeal within 60 days from the entry thereof;

(vii) if there shall occur any of the events of default set forth in any Application, including the provisions of paragraph 5 thereof,

provided, however, that to the extent any such event of default is inconsistent with the Events of Default under this Agreement, this Agreement shall control; or

(viii) if a Change of Control shall occur.

Upon the occurrence of any Event of Default (other than any Event of Default specified in subsection 10(iii) in respect of any Account Party), Lender may, by written notice to such Account Party, declare this Agreement canceled and/or declare all amounts outstanding under this Agreement and the Applications (including, without limitation, all amounts of L/C Obligations, whether or not the beneficiaries of the then outstanding Letters of Credit shall have presented the documents required thereunder) to be immediately due and payable in full, whereupon this Agreement shall be canceled and/or such amounts shall become immediately due and payable; provided, however, that upon the occurrence of any Event of Default specified in subsection 10(iii) in respect of such Account Party, this Agreement automatically shall be canceled and all such amounts outstanding automatically shall become immediately due and payable in full, in each case without notice, presentment, demand, protest or other action of any kind, all of which are hereby expressly waived by such Account Party.

With respect to all Letters of Credit with respect to which presentment for honor shall not have occurred at the time of an acceleration pursuant to the immediately preceding paragraph, such Account Party shall at such time deposit in a cash collateral account (the "Collateral Account") maintained by such Account Party with Lender an amount equal to the aggregate then undrawn and unexpired amount of such Letters of Credit. The Collateral Account (and any and all funds and investments held therein) shall be held in the name of, and subject to the sole dominion and control of, Lender, as cash collateral for the reimbursement obligations of such Account Party in the event of any drawing under a Letter of Credit. Any and all amounts held in the Collateral Account shall be applied by Lender to satisfy such Account Party's L/C Obligations for which Lender has not been reimbursed and to pay for drawings under Letters of Credit, and any unused portion of such amounts after all Letters of Credit shall have expired or been fully drawn upon and all L/C Obligations shall have been satisfied, shall be applied to repay other obligations of such Account Party under this Agreement and the other Credit Documents. Except as expressly provided in this Section, notice, presentment, demand, protest and any other action of any kind are hereby expressly waived by Account Parties.

Each Account Party hereby grants to Lender a security interest in, and right of set-off against, any and all funds and investments held in the Collateral Account from time to time and any instrument evidencing the foregoing to secure the obligations of such Account Party hereunder in respect of Letters of Credit, any and all reimbursement obligations arising in connection therewith and other obligations under this Agreement and the other Credit Documents.

Lender shall have the rights, powers and remedies of a secured party under the Uniform Commercial Code as in effect from time to time in the State of New York with respect to the funds and investments held in the Collateral Account from time to time. Account Parties shall take such actions from time to time as Lender may reasonably request to perfect and preserve the security interests provided for in this Agreement.

Lender shall release all funds and investments held in the Collateral Account to, or upon the order of, Account Parties (or as a court of competent jurisdiction may otherwise direct) upon the later to occur of the date that (i) this Agreement and the other Credit Documents terminate and (ii) all obligations of Account Parties under all Letters of

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Credit and all L/C Obligations are satisfied and indefeasibly paid in full and such Letters of Credit have been cancelled or expired and all amounts drawn thereunder have been reimbursed in full.

The rights and remedies of Lender under this Agreement are in addition to, and not in substitution of, the rights and remedies Lender is entitled to exercise at law, in equity and under the other Credit Documents.

#### **11. Effectiveness of Agreement; Conditions Precedent:**

The effectiveness of this Agreement is subject to receipt by Lender of a non-refundable fee, which fee shall be deemed fully earned when paid, in an amount equal to the Commitment multiplied by 0.05% per annum, and of each of the following, in form and substance satisfactory to it:

(i) a copy of the articles of incorporation or comparable organizational document of each Account Party, duly certified by the Secretary of State or comparable office of its jurisdiction of organization as of a recent date (if applicable);

(ii) a copy of the by-laws or comparable organizational document of each Account Party, duly certified by such Account Party's Secretary or Assistant Secretary as in full force and effect;

(iii) a copy of each Account Party's resolutions certified by the Secretary or Assistant Secretary of such Account Party authorizing such Account Party to enter into the transactions contemplated by the Credit Documents to which such Account Party is a party, including, without limitation, directing Lender to issue Letters of Credit for its account in the aggregate amount contemplated hereunder, and evidencing the authority of the officer(s) named therein to sign the Credit Documents and such other documents on behalf of such Account Party as Lender shall require;

(iv) a certificate of incumbency and specimen signatures of the authorized signers of the Credit Documents issued by the Secretary or Assistant Secretary of each Account Party;

(v) a legal opinion of counsel to Account Parties as to such matters as the Lender may reasonably request;

(vi) a letter from the process agent specified in Section 20 agreeing to act as agent for each of XL Capital, XL Insurance and XL Re for the purposes specified therein for the period through and including the Maturity Date; and

(vii) such other documents, instruments or agreements as Lender shall reasonably request.

Each utilization by an Account Party hereunder shall constitute a representation and warranty that (a) each of the representations and warranties made by such Account Party contained herein or in any other Credit Document shall be true and correct on and as of the date of such utilization as if made on and as of such date and (b) no Default or Event of Default exists (either immediately before or immediately after giving effect to such utilization).

An additional condition precedent to the issuance of each Letter of Credit is the receipt by Lender of a duly executed Application in respect of such

Letter of Credit.

**12. Authorization to Debit; Right of Set-Off:**

In the event any Account Party shall default in the payment of any amount due hereunder or under the other Credit Documents, Lender shall have the right to set off and apply any deposit, general or special, time or demand, provisional or final, at any time held or owing by any branch or office of Credit Lyonnais S.A. (or any successor entity thereto) to, or for the credit of, such Account Party.

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**13. Indemnity:**

Account Party agrees: (a) to pay or reimburse Lender for all reasonable costs and expenses incurred in connection with the enforcement or preservation of any rights under any Credit Document and any other document prepared in connection therewith (including, without limitation, reasonable fees and disbursements of counsel to Lender), (b) to pay, indemnify and hold Lender harmless from any and all liabilities with respect to, or resulting from any delay in paying, stamp, documentary and other similar taxes, if any, which may be payable or determined to be payable in connection with the execution and delivery of, or consummation or administration of, any of the transactions contemplated by, or any amendment, supplement or modification of, or any waiver or consent under or in respect of, any Credit Document and any other related document, (c) to pay, indemnify and hold Lender harmless from and against any and all other liabilities, obligations, losses, damages, penalties, actions (whether sounding in contract, in tort or on any other ground), judgments, suits, costs, expenses or disbursements of any kind or nature whatsoever with respect to the execution, delivery, enforcement, performance or administration of, or in any other way arising out of or relating to, any Credit Document or any other documents contemplated by or referred to therein or any action taken or omitted to be taken by Lender with respect to any of the foregoing (all the foregoing, collectively, the "Indemnified Liabilities"); provided, however, that Account Parties shall have no obligation hereunder to Lender with respect to Indemnified Liabilities arising solely from the gross negligence or willful misconduct of Lender. Without prejudice to the survival of any other provision hereof, the obligations of Account Parties under this Section 13 shall survive the termination of this Agreement, the repayment of all Reimbursement Amounts and all other amounts payable hereunder and under the other Credit Documents.

**14. Governing Law:**

THIS AGREEMENT SHALL BE GOVERNED BY, AND CONSTRUED IN ACCORDANCE WITH, THE LAWS OF THE STATE OF NEW YORK WITHOUT REGARD TO THE PRINCIPLES OF CONFLICTS OF LAWS THEREOF.

**15. No Waiver; Severability; Integration; Counterparts:**

The failure or delay by Lender to exercise any right, power or remedy under this Agreement or any other Credit Document or with respect to the indebtedness evidenced hereby or thereby shall not operate as a waiver thereof, nor shall the exercise of any single or partial right, power or remedy preclude any other or further exercise of the same or any other right, power or remedy. Any provision of this Agreement which is prohibited or unenforceable in any jurisdiction shall, as to such jurisdiction, be ineffective to the extent of such prohibition or unenforceability without invalidating the remaining provisions hereof, and any such prohibition or unenforceability in any jurisdiction shall not invalidate or render unenforceable such provision in any other jurisdiction. The Credit Documents constitute the entire agreement and understanding between the parties hereto and supersede any and all prior agreements and understandings, oral or written, relating to the subject matter hereof. This Agreement may be executed in counterparts (and by different parties hereto on different counterparts), each of which shall constitute an original, but all of which when taken together shall constitute a single contract.

**16. Jurisdiction; Venue; Waiver of Jury Trial:**

Each of the parties hereto hereby irrevocably and unconditionally submits, for itself and its property, to the nonexclusive jurisdiction of any New York State or federal court of the United States of America sitting in New York City, whether trial or appellate, in any action or proceeding arising out of, or relating to, this Agreement or any of the other Credit Documents, or for recognition or enforcement of any judgment in respect thereof, and each of the parties hereto hereby irrevocably and unconditionally agrees that all claims in respect of any such action or proceeding may be heard and determined in any such New York State court or, to the extent permitted by law, in such federal court and consents that any such action or proceeding may be brought in such courts and waives to the fullest extent permitted by law any objection that it may now or hereafter have to the venue of any such action or proceeding in any such court or that such action or proceeding was brought in an inconvenient court and agrees not to plead or claim the same. Each of the parties hereto agrees that a final judgment in any such action or proceeding shall be conclusive and may be enforced in other jurisdictions by suit on the judgment or in any other manner provided by law. Nothing in this Agreement shall affect any right that any party may otherwise have to bring any action or proceeding relating to the Credit Documents in the courts of any jurisdiction.

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**EACH OF THE PARTIES HERETO HEREBY IRREVOCABLY WAIVES ALL RIGHT TO TRIAL BY JURY IN ANY ACTION, PROCEEDING OR COUNTERCLAIM ARISING OUT OF, OR RELATING TO, ANY CREDIT DOCUMENT OR THE ACTIONS OF LENDER IN THE NEGOTIATION, ADMINISTRATION, PERFORMANCE OR ENFORCEMENT THEREOF.**

**17. Successors and Assigns:**

This Agreement shall be binding upon and inure to the benefit of Account Parties, Lender and their respective successors and assigns, including, without limitation, any such successor or assign of Credit Lyonnais New York Branch as a result of the sale, merger, partial merger, asset contribution or other consolidation of the corporate and investment banking business of Credit Lyonnais with or into Credit Agricole Indosuez pursuant to which Credit Agricole Indosuez will succeed to the rights and obligations of Credit Lyonnais hereunder and Credit Lyonnais will be released from the liabilities which are so assumed by Credit Agricole Indosuez, except that no Account Party may assign, transfer or delegate any of its rights or obligations under this Agreement without the prior written consent of Lender.

**18. Assignments; Pledges to Federal Reserve Bank:**

Lender may, at any time and from time to time, assign to any branch, lending office or affiliate of Credit Lyonnais S.A. all or any part of its rights and obligations under the Credit Documents by notification thereof to the applicable Account Party.

Nothing herein shall prohibit Lender from pledging or assigning this Agreement to any Federal Reserve Bank in accordance with applicable law or to



one or more NAIC Approved Lenders.

**19. Notices:**

Any notice or other communication in connection with this Agreement shall be deemed to have been given or made when received by the party to whom directed. All such notices and other communications shall be in writing unless otherwise provided herein and shall be directed, if to the Lender, at 1301 Avenue of the Americas, New York, New York 10019, Attn: Peter Rasmussen, facsimile number: (212) 261-3438; and if to any Account Party, to XL Capital Ltd, XL House, One Bermudiana Road, Hamilton HM11 Bermuda, Attn: Roderick Gray, facsimile number: (441) 296-6399, with a copy to Paul Giordano, General Counsel, facsimile number: (441) 295-4867, or in accordance with the latest unrevoked written direction from any party to the other parties hereto. For the purposes of both receiving information from the Lender or providing information to the Lender, XL Capital shall act as the agent for each other Account Party.

**20. Service of Process:**

XL Capital, XL Insurance and XL Re shall appoint CT Corporation System, 111 Eighth Avenue, New York, New York 10011 (or any successor entity thereto) as process agent to receive service of process in any suit, action or proceeding relating to the Credit Documents. If for any reason such process agent is unable to act as such, the relevant Account Party will promptly notify the Lender and within thirty (30) days appoint a substitute process agent acceptable to the Lender. Nothing in this Agreement or any other Credit Document will affect the right of the Lender to serve process in any other manner permitted by law.

**21. Confidentiality:**

The Lender agrees to keep confidential any information relating to the Account Parties received by it pursuant to or in connection with this Agreement which is information received from an Account Party relating to an Account Party or its business, other than any such information that is available to Lender on a nonconfidential basis prior to disclosure by such Account Party; provided that, in the case of information received from an Account Party after the date hereof, such information is clearly identified at the time of delivery as confidential; provided, however, that this Section 21 shall not be construed to prevent the Lender from disclosing such information (i) to any of its employees, officers, directors, accountants, counsel or other agents or representatives (collectively, its "Representatives"); provided that Lender shall be liable for any breach of the terms of this Section 21 by such Representatives, (ii) upon the

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order of any court or administrative agency of competent jurisdiction, or as otherwise required by law or regulation, (iii) upon the request or demand of any regulatory agency or authority (including any Governmental Authority) having jurisdiction over the Lender which request or demand has the force of Law or is made by a bank regulatory agency, (iv) that has been publicly disclosed, other than from a breach of this provision by the Lender, (v) that has been obtained from any person that is not a party to this Agreement, but only to the extent that the Lender does not know or have reason to know that such disclosure violates a confidentiality agreement between such person and the applicable Account Party, (vi) in connection with the exercise of any right or remedy under any Credit Document, (vii) as expressly contemplated by the Credit Documents or (viii) to any prospective purchaser of all or any part of the interest of the Lender which shall agree in writing for the benefit of the Account Parties to be bound by the obligation of confidentiality in the Credit Documents if such prospective purchaser is a financial institution or has been consented to by the relevant Account Party, which consent shall not be unreasonably withheld.

**22. Joint and Several Obligation:**

Each of XL Capital, XL Insurance, XL America and XL Re shall be jointly and severally liable for any obligation undertaken by any one of them under this Agreement and the other Credit Documents, and confirms and agrees for the benefit of Lender that Lender may seek to enforce such obligations against any one or all of them as Lender deems appropriate in its sole discretion.

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If the foregoing is acceptable, kindly acknowledge your agreement with the terms and conditions hereof by having one original copy of this Agreement signed by duly authorized officer(s) of Account Party (pursuant to its resolutions) and returned to Lender as soon as possible.

Yours truly,

**CREDIT LYONNAIS  
NEW YORK BRANCH**

By: /s/ Peter Rasmussen

\_\_\_\_\_  
Name: Peter Rasmussen

\_\_\_\_\_  
Title: First Vice President

Acknowledged and Agreed:

XL CAPITAL LTD

By: /s/ Michael A. Siese

\_\_\_\_\_  
Name: Michael A. Siese

\_\_\_\_\_  
Title: SVP & Controller

XL AMERICA, INC.

By: /s/ Charles Barr

\_\_\_\_\_  
Name: Charles F. Barr

\_\_\_\_\_  
Title: Secretary

XL INSURANCE (BERMUDA) LTD

By: /s/ Christopher Coelho

\_\_\_\_\_  
Name: Christopher Coelho

\_\_\_\_\_  
Title: SVP & CFO

XL RE LTD

By: /s/ Greg Hendrick

\_\_\_\_\_  
Name: Greg Hendrick

\_\_\_\_\_  
Title: President & CUO

**CERTIFICATION  
OF CHIEF EXECUTIVE OFFICER**

**XL CAPITAL LTD**

**Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002  
(Chapter 63, Title 18 U.S.C. §§ 1350(a) and (b))**

I, Brian M. O'Hara, certify that:

1. I have reviewed this Quarterly Report on Form 10-Q of XL Capital Ltd;
2. Based on my knowledge, this report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this report;
3. Based on my knowledge, the financial statements, and other financial information included in this report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this report;
4. The registrant's other certifying officers and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) for the registrant and have:
  - a) Designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this report is being prepared;
  - b) Evaluated the effectiveness of the registrant's disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluation; and
  - c) Disclosed in this report any change in the registrant's internal control over financial reporting that occurred during the registrant's most recent fiscal quarter (the registrant's fourth fiscal quarter in the case of an annual report) that has materially affected, or is reasonably likely to materially affect, the registrant's internal control over financial reporting; and
5. The registrant's other certifying officers and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the registrant's auditors and the audit committee of the registrant's board of directors (or persons performing the equivalent functions):
  - a) All significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the registrant's ability to record, process, summarize and report financial information; and
  - b) Any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal control over financial reporting.

Dated: May 10, 2004

/s/ BRIAN M. O'HARA

\_\_\_\_\_  
Brian M. O'Hara  
*President and Chief Executive Officer*

**CERTIFICATION OF CHIEF FINANCIAL OFFICER**

**XL CAPITAL LTD**

**Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002  
(Chapter 63, Title 18 U.S.C. §§ 1350(a) and (b))**

I, Jerry de St. Paer, certify that:

1. I have reviewed this Quarterly Report on Form 10-Q of XL Capital Ltd;
2. Based on my knowledge, this report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this report;
3. Based on my knowledge, the financial statements, and other financial information included in this report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this report;
4. The registrant's other certifying officers and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) for the registrant and have:
  - a) Designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this report is being prepared;
  - b) Evaluated the effectiveness of the registrant's disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluation; and

- c) Disclosed in this report any change in the registrant's internal control over financial reporting that occurred during the registrant's most recent fiscal quarter (the registrant's fourth fiscal quarter in the case of an annual report) that has materially affected, or is reasonably likely to materially affect, the registrant's internal control over financial reporting; and
- 5. The registrant's other certifying officers and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the registrant's auditors and the audit committee of the registrant's board of directors (or persons performing the equivalent functions):
  - a) All significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the registrant's ability to record, process, summarize and report financial information; and
  - b) Any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal control over financial reporting.

Dated: May 10, 2004

/s/ JERRY DE ST. PAER

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Jerry de St. Paer  
*Executive Vice President and Chief Financial  
Officer*

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**CERTIFICATION ACCOMPANYING FORM 10-Q REPORT  
of  
XL CAPITAL LTD**

**Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002  
(Chapter 63, Title 18 U.S.C. §§ 1350(a) and (b))**

Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002 (Chapter 63, Title 18 U.S.C. §§ 1350(a) and (b)), each of the undersigned hereby certifies that the Quarterly Report on Form 10-Q for the period ended March 31, 2004 of XL Capital Ltd (the "Company") fully complies with the requirements of Section 13(a) or Section 15(d) of the Securities Exchange Act of 1934 and that the information contained in such Report fairly presents, in all material respects, the financial condition and results of operations of the Company.

Dated: May 10,  
2004

/s/ BRIAN M. O'HARA  
Brian M. O'Hara  
*President and Chief Executive Officer*  
XL Capital Ltd

Dated: May 10,  
2004

/s/ JERRY DE ST. PAER  
Jerry de St. Paer  
*Executive Vice President and Chief Financial Officer*  
XL Capital Ltd

A signed original of this written statement required by Section 906, or other document authenticating, acknowledging, or otherwise adopting the signature that appears in typed form within the electronic version of this written statement required by Section 906, has been provided to XL Capital Ltd and will be retained by XL Capital Ltd and furnished to the Securities and Exchange Commission or its staff upon request.

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**XL CAPITAL ASSURANCE INC.  
AND SUBSIDIARY**  
CONDENSED CONSOLIDATED FINANCIAL STATEMENTS  
(UNAUDITED)  
FOR THE THREE MONTH PERIODS ENDED MARCH 31, 2004 AND 2003

**XL Capital Assurance Inc. and Subsidiary**  
**Condensed Consolidated Balance Sheets**  
(UNAUDITED)  
(U.S. Dollars in thousands, except share and per share amounts)

	As At March 31, 2004	As At December 31, 2003
	<u>          </u>	<u>          </u>
<b>Assets</b>		
Investments:		
Fixed maturities available for sale, at fair value (amortized cost: 2004 - \$249,097; 2003 - \$237,589)	\$ 255,094	\$ 239,629
Short-term investments, at fair value (amortized cost: 2004 - \$2,478; 2003 - \$8,812)	2,478	8,814
	<u>          </u>	<u>          </u>
<b>Total investments</b>	257,572	248,443
Cash and cash equivalents	48,284	76,854
Accrued investment income	1,675	2,324
Prepaid reinsurance premium	298,366	291,530
Premiums receivable	4,138	2,712
Reinsurance balances recoverable on unpaid losses	24,783	22,998
Intangible assets - acquired licenses	11,529	11,529
Deferred Federal income tax assets	12,236	13,560
Other assets	11,586	12,703
	<u>          </u>	<u>          </u>
<b>Total assets</b>	\$ 670,169	\$ 682,653
	<u>          </u>	<u>          </u>
<b>Liabilities and Shareholder's Equity</b>		
Liabilities:		
Unpaid losses and loss adjustment expenses	\$ 27,358	\$ 25,009
Deferred premium revenue	331,873	318,547
Deferred ceding commissions, net	32,498	33,738
Reinsurance premiums payable	15,547	33,422
Accounts payable and accrued expenses	14,335	19,482
Current Federal income tax payable	6,803	6,754
Intercompany payable to affiliates	1,800	8,473
	<u>          </u>	<u>          </u>

<b>Total liabilities</b>	430,214	445,425
	<hr/>	<hr/>
Shareholder's Equity:		
Common stock (par value \$7,500 per share at March 31, 2004 and December 31, 2003; authorized shares - 8,000 at March 31, 2004 and December 31, 2003; issued and outstanding shares - 2,000 at March 31, 2004 and December 31, 2003)	15,000	15,000
Additional paid-in capital	239,173	239,173
Accumulated other comprehensive income (Net of deferred Federal income tax liability of: 2004 - \$2,039; 2003 - \$715)	3,958	1,327
Accumulated deficit	(18,176)	(18,272)
	<hr/>	<hr/>
<b>Total shareholder's equity</b>	239,955	237,228
	<hr/>	<hr/>
<b>Total liabilities and shareholder's equity</b>	\$ 670,169	\$ 682,653
	<hr/>	<hr/>

See accompanying notes to condensed consolidated financial statements.

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**XL Capital Assurance Inc. and Subsidiary**  
**Condensed Consolidated Statements of Operations and Comprehensive Income**  
**(UNAUDITED)**  
**(U.S. Dollars in thousands)**

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	<b>Three months ended</b>	
	<b>March 31,</b>	
	<b>2004</b>	<b>2003</b>
	<hr/>	<hr/>
<b>Revenues</b>		
Gross premiums written	\$ 36,947	\$ 33,240
Ceded premiums written	(27,093)	(30,834)
	<hr/>	<hr/>
Net premiums written	9,854	2,406
Change in deferred premium revenue	(6,491)	(1,282)
	<hr/>	<hr/>
Net premiums earned (Net of ceded earned premium for the three months of \$20,257 in 2004 and \$14,013 in 2003)	3,363	1,124
Net investment income	2,495	1,374
Net realized gains (losses) on investments	473	(62)
Net realized and unrealized gains on credit derivatives	618	260
	<hr/>	<hr/>
Total revenues	6,949	2,696
	<hr/>	<hr/>
<b>Expenses</b>		
Net losses and loss adjustment expenses (net of ceded losses and loss adjustment expenses for the three months of \$1,785 in 2004 and \$4,181 in 2003)	564	359
Net operating expenses	6,239	6,347
	<hr/>	<hr/>
Total expenses	6,803	6,706

Income (loss) before Federal income tax expense (benefit)	146	(4,010)
Current Federal income tax expense	50	—
Deferred Federal income tax benefit	—	(1,610)
Total Federal income tax expense (benefit)	50	(1,610)
<b>Net income (loss)</b>	<b>96</b>	<b>(2,400)</b>
<b>Comprehensive Income (Loss)</b>		
Other comprehensive income (loss)	2,631	(60)
<b>Comprehensive income (loss)</b>	<b>\$ 2,727</b>	<b>\$ (2,460)</b>

See accompanying notes to condensed consolidated financial statements.

**XL Capital Assurance Inc. and Subsidiary**  
**Condensed Consolidated Statements of Changes in Shareholder's Equity**  
**(UNAUDITED)**  
**(U.S. Dollars in thousands, except share amounts)**

	<b>Three months ended March 31, 2004</b>	<b>Year Ended December 31, 2003</b>
<b>Common Shares</b>		
Number of shares, beginning of year	2,000	2,000
Number of shares, end of period	2,000	2,000
<b>Common Stock</b>		
Balance - beginning of year	\$ 15,000	\$ 15,000
Balance- end of period	15,000	15,000
<b>Additional Paid-In Capital</b>		
Balance - beginning of year	239,173	139,154
Capital contribution	—	100,019
Balance- end of period	239,173	239,173
<b>Accumulated Other Comprehensive Income</b>		
Balance - beginning of year	1,327	2,812
Net change in unrealized appreciation of investments, net of deferred Federal tax expense (benefit) of \$ 1,324 in 2004 and \$(847) in 2003	2,631	(1,485)
Balance- end of period	3,958	1,327
<b>Accumulated deficit</b>		
Balance - beginning of year	(18,272)	(14,504)
Net income (loss)	96	(3,768)



Balance- end of period		(18,176)		(18,272)
<b>Total shareholder's equity</b>	\$	239,955	\$	237,228

See accompanying notes to condensed consolidated financial statements.

**XL Capital Assurance Inc. and Subsidiary**  
**Condensed Consolidated Statements of Cash Flows**  
**(UNAUDITED)**  
**(U.S. Dollars in thousands)**

	Three months ended	
	March 31,	
	2004	2003
<b>Cash flows from operating activities:</b>		
Net Income (loss)	\$ 96	\$ (2,400)
Adjustments to reconcile net income (loss) to net cash used in operating activities		
Net realized (gains) losses on sale of investments	(473)	62
Net realized and unrealized (gains) losses on credit derivatives excluding cash received and paid	(224)	64
Amortization of premium on bonds	380	201
Increase (decrease) in unpaid losses and loss adjustment expenses, net	564	(318)
Increase in deferred premium revenue, net	6,491	1,282
(Decrease) Increase in deferred ceding commissions, net	(1,240)	814
Decrease in reinsurance premiums payable	(17,875)	(868)
Increase in premiums receivable	(1,426)	(1,378)
Decrease in accrued investment income	649	171
Increase in current Federal income tax payable	49	—
Deferred Federal income tax assets	—	(1,610)
Decrease in accounts payable and accrued expenses	(5,892)	(1,758)
(Decrease) increase in intercompany payable to affiliates	(6,673)	685
Other	2,085	2
	<u>(23,585)</u>	<u>(2,651)</u>
Total adjustments		
Net cash used in operating activities	<u>(23,489)</u>	<u>(5,051)</u>
<b>Cash flows from investing activities:</b>		
Proceeds from sale of fixed maturities and short-term investments	64,659	20,143
Proceeds from maturity of fixed maturities and short-term investments	—	20,154
Purchase of fixed maturities and short-term investments	(69,740)	(38,886)
	<u>(5,081)</u>	<u>1,411</u>
Net cash (used in) provided by investing activities		
Decrease in cash and cash equivalents	(28,570)	(3,640)
Cash and cash equivalents- beginning of year	76,854	44,714
	<u>\$ 48,284</u>	<u>\$ 41,074</u>
Cash and cash equivalents- end of period		

Taxes paid

\$ — \$ —

See accompanying notes to condensed consolidated financial statements.

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**XL Capital Assurance Inc. and Subsidiary**  
**Notes to Condensed Consolidated Financial Statements**  
**(UNAUDITED)**

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**1. Organization and Ownership**

XL Capital Assurance Inc. and subsidiary (the “Company”) is a wholly-owned subsidiary of XL Reinsurance America Inc. (“XL RE AM”), which is an indirect wholly-owned subsidiary of X.L. America, Inc. (“XLA”). XLA is an indirect wholly-owned subsidiary of XL Insurance (Bermuda) Ltd. (“XL Insurance”). XL Insurance is an indirect wholly-owned subsidiary of XL Capital Ltd. (“XL Capital”), a holding company incorporated in the Cayman Islands. XLA is XL Capital’s U.S. holding company.

The Company is an insurance company domiciled in the State of New York. The Company is engaged in the business of providing credit enhancement by writing financial guaranty insurance policies on asset-backed structured finance, essential infrastructure project finance, future flow, public finance transactions, and credit default swap obligations. The Company issued its first insurance contract in December 2000.

The Company was formed on September 13, 1999 and became licensed as a financial guaranty insurer in New York upon its merger with an affiliate, X.L. Risk Solutions, Inc. on September 30, 1999.

On February 22, 2001 XL RE AM acquired all the outstanding shares of The London Assurance of America, Inc. (“LAA”). LAA was incorporated in New York on July 25, 1991. Prior to its purchase by XL RE AM, LAA was a New York-domiciled property and casualty insurance company that was licensed in 44 states and the District of Columbia. The business previously underwritten through LAA, together with all the liabilities of LAA, was reinsured effective July 1, 2000 to an affiliate of LAA under a reinsurance assignment and assumption agreement. XL RE AM caused the Company to merge with and into LAA on the day of the acquisition (with LAA as the surviving entity) and for LAA to simultaneously change its name to XL Capital Assurance Inc.

On May 15, 2002, the Company capitalized XL Capital Assurance (U.K.) Limited, (“XLCA-UK”), an insurance company organized under the laws of England. XLCA-UK is a direct wholly owned subsidiary of the Company.

In addition to its New York headquarters and London subsidiary (which has a Madrid branch), the Company maintains branch offices domestically in California and abroad in Singapore.

**2. Basis of Presentation and Consolidation**

The accompanying condensed consolidated financial statements include the accounts of the Company and its subsidiary and are unaudited. The results include the consolidation of XLCA-UK, accounted for as a subsidiary with effect from April 24, 2002. In the opinion of management, all adjustments, which include only normal recurring adjustments, necessary for a fair statement of the financial position, results of operations and cash flows at March 31, 2004 and for all periods presented, have been made and all significant intercompany accounts and transactions have been eliminated.

Certain information and footnote disclosures normally included in consolidated financial statements prepared in accordance with accounting principles generally accepted in the United States of America have been condensed or omitted. These statements should be read in conjunction with the Company’s December 31, 2003 consolidated financial statements and notes thereto. The accompanying condensed consolidated balance sheet as of December 31, 2003 was derived from audited financial statements, but does not include all disclosures required by accounting principles generally accepted in the United States of America. The results of operations for the periods ended March 31, 2004 and 2003 are not necessarily

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**XL Capital Assurance Inc. and Subsidiary**  
**Notes to Condensed Consolidated Financial Statements**  
**(UNAUDITED)**

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indicative of the operating results for the full year. Certain prior period balances have been reclassified to conform with current period’s presentation.

The preparation of condensed consolidated financial statements requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the condensed consolidated financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates. Any such adjustments are reflected in income in the period in which the adjustments are made. The Company’s principal estimates and assumptions used to determine the condensed consolidated financial statements are the calculation of loss reserves and the fair value of credit default swap instruments.

**3. Credit Default Swaps**

Credit default swaps are recorded at fair value which is determined using a model developed by the Company and is dependent upon a number of factors including changes in interest rates, credit spreads, changes in credit quality, expected recovery rates and other market factors. The change resulting from movements in these factors is unrealized as the credit default swaps are not traded to realize this value and is included in “net realized and unrealized gains on credit derivatives”. Other elements of the change in fair value are based upon pricing established at the inception of the contract. Credit default swaps are considered by the Company to be, in substance, financial guaranty contracts as the Company has the intent to hold them to maturity.

The credit default swap portfolio consists of structured pools of corporate obligations that were awarded investment grade ratings at the respective deals’ inception. At March 31, 2004, approximately 82% of the portfolio was rated AAA with the remaining 18% allocated to other investment grade ratings. The weighted average

term of the contracts in force was approximately 4.69 years, and the credit default swaps represented approximately 12% of the Company's credit enhancement par exposure at March 31, 2004.

The components of the Company's net credit default swap asset and liability as at March 31, 2004 and December 31, 2003 were as follows:

(U.S. Dollars in thousands):	March 31, 2004	December 31, 2003
<b>Assets</b>		
Gross credit derivative unrealized gains	\$ 6,520	\$ 4,945
Reinsurance	5,809	4,424
	<hr/>	<hr/>
Net assets	\$ 711	\$ 521
	<hr/>	<hr/>
<b>Liabilities</b>		
Gross credit derivative unrealized losses	\$ 4,079	\$ 4,718
Reinsurance	3,625	4,230
	<hr/>	<hr/>
Net liabilities	\$ 454	\$ 488
	<hr/>	<hr/>

The components of the Company's net realized and unrealized gains on credit derivatives for each of the three month periods ended March 31, 2004 and 2003 are as follows:

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**XL Capital Assurance Inc. and Subsidiary**  
**Notes to Condensed Consolidated Financial Statements**  
**(UNAUDITED)**

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(U.S. Dollars in thousands):	March 31, 2004	March 31, 2003
Net premiums earned	\$ 394	\$ 213
Loss reserves and other adjustments	—	111
Net fair value adjustment	224	(64)
	<hr/>	<hr/>
Net realized and unrealized gains on credit derivatives	\$ 618	\$ 260
	<hr/>	<hr/>

**4. Deferred Acquisition Costs**

Certain costs incurred, primarily relating to and varying with the production of new business, have been deferred. These costs include direct and indirect expenses related to underwriting, marketing and policy issuance, rating agency fees and premium taxes, reduced by ceding commission income on premiums ceded to reinsurers. The Company considers the present value of future premiums under installment contracts written and the current value of deferred premium revenue when determining the recoverability of deferred acquisition costs ("DAC"). Deferred acquisition costs and deferred ceding commissions ("DCC") are amortized on a straight-line basis over the average maturity of the Company's portfolio of insured transactions. In the first quarter of 2004, the amortization period changed from five years to ten years to be consistent with the average maturity of the Company's portfolio of insured transactions. If an insured issue is retired or defeased prior to the end of the expected period of coverage, the remaining deferred acquisition cost is recognized.

**5. Recent Accounting Pronouncements**

In January 2003, the Financial Accounting Standards Board ("FASB") issued FASB Interpretation No. 46, "Consolidation of Variable Interest Entities" ("FIN 46"). The objective of FIN 46 is to improve financial reporting by companies involved with variable interest entities. This new model for consolidation applies to an entity in which either (1) the powers or rights of the equity holders do not give them sufficient decision making ability; (2) the equity investment at risk is insufficient to finance that entity's activities without receiving additional subordinated financial support from other parties; or (3) the equity investment at risk does not absorb the expected losses or residual returns of the entity. FIN 46 requires a variable interest entity to be consolidated by the company that is subject to a majority of the risk of loss from the variable interest entity's activities or that is entitled to receive a majority of the entity's residual returns or both. In December 2003, FASB issued a revision to FIN 46 ("FIN 46-R") which clarified several provisions of FIN 46, superceded the related FASB Staff Positions (FSPs), and amended the effective date and transition of the pronouncement, except for certain types of entities. The Company must apply the provisions of FIN 46-R to those variable interest entities that are not considered to be special purpose entities no later than March 31, 2004 and was required to apply the provisions of FIN 46 or FIN 46-R to those entities that are considered to be special-purpose entities as at December 31, 2003. The adoption of this standard did not have a material effect on the Company's financial condition and results of operation.

**6. Variable Interest Entities**

The Company participates in transactions which utilize variable interest entities in the ordinary course of business. The Company provides financial guaranty insurance of structured transactions backed by pools of assets of specified types, municipal obligations supported by the issuers' ability to collect tax or fee revenue for specified services or projects, and other structured risk obligations including essential infrastructure projects and obligations backed by receivables from future

sales of commodities and other specified services. The obligations related to these transactions are often securitized through off-balance sheet variable interest entities. In synthetic transactions, the Company guarantees payment obligations of

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**XL Capital Assurance Inc. and Subsidiary**  
**Notes to Condensed Consolidated Financial Statements**  
**(UNAUDITED)**

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counterparties, including variable interest entities, through credit default swaps referencing asset portfolios.

The Company only provides financial guaranty insurance of these variable interest entities for fixed premiums at market rates but does not hold any equity positions or subordinated debt in these off-balance sheet arrangements. Accordingly, these variable interest entities are not consolidated.

**7. Tax Sharing Agreement**

The Company's U.S. Federal income tax return is consolidated with XLA and its subsidiaries. XLA maintains a tax sharing agreement with its subsidiaries, whereby the consolidated U.S. Federal income tax liability is allocated among affiliates in the ratio that each affiliate's separate return liability bears to the sum of the separate return liabilities of all affiliates that are members of the consolidated group. In addition, a complementary method is used which results in reimbursement by profitable affiliates to loss affiliates for tax benefits generated by loss affiliates. As at March 31, 2004 and December 31, 2003, the Company had deferred Federal income tax assets of \$12,236,000 and \$13,560,000, respectively. Management has concluded that the net deferred federal income tax assets are more likely than not to be realized, therefore, no valuation allowance has been provided.

**8. Treaties and Agreements with Affiliates**

On October 6, 1999, the Company entered into a Facultative Quota Share Reinsurance Treaty (the "Treaty") with XL Financial Assurance Ltd. ("XLFA"), a Bermuda financial guaranty insurer, which is 86.8% owned by XL Insurance. The remaining 13.2% is owned by Financial Security Assurance Holdings Ltd., an unrelated company. The Treaty was amended and restated on June 22, 2001. Under the terms of the treaty, XLFA agrees to reinsure up to 90% of the Company's acceptable risks. The Company is allowed up to a 30% ceding commission on premiums written ceded under the terms of the Treaty.

XL Insurance entered into a reinsurance agreement dated October 6, 1999 with the Company, that unconditionally and irrevocably guarantees the full and complete performance of all obligations of XLFA to the Company under the above described Facultative Quota Share Reinsurance Treaty. In connection with the amendment and restatement of the Treaty, XL Insurance entered into another reinsurance agreement guarantee on June 22, 2001.

The Company entered into a Facultative Master Certificate (the "XL Re Treaty") with XL RE AM, a New York insurance corporation with administrative offices in Stamford, Connecticut and the direct parent of the Company. The XL Re Treaty is effective as of November 1, 2002. Under the terms of the XL Re Treaty, XL RE AM agrees automatically to reinsure risk assumed by the Company under financial guaranty insurance policies up to the amount necessary for the Company to comply with single risk limitations set forth in Section 6904(d) of the New York Insurance Laws. The reinsurance provided by XL RE AM may be on an excess of loss or quota share basis. The Company is allowed a 30% ceding commission on premiums written ceded under the terms of the XL Re Treaty.

The Company entered into a Surplus Maintenance Agreement dated February 20, 2001 pursuant to which XL RE AM has agreed to maintain the Company's statutory capital and surplus of at least \$75,000,000. On April 12, 2004, the New York Insurance Department approved a three- year extension of this agreement to February 20, 2007.

Effective December 31, 2003, in a one-time transaction, the Company commuted reinsurance business back from XL RE AM whereby the Company assumed business originally ceded to XL RE AM.

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**XL FINANCIAL ASSURANCE LTD.**

(Incorporated in Bermuda)

**CONDENSED FINANCIAL STATEMENTS**

(UNAUDITED)

**FOR THE THREE MONTH PERIODS ENDED  
MARCH 31, 2004 AND 2003****XL FINANCIAL ASSURANCE LTD.****CONDENSED BALANCE SHEETS****AS AT MARCH 31, 2004 AND DECEMBER 31, 2003**

(UNAUDITED)

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

	<u>2004</u>	<u>2003</u>
<b>Assets:</b>		
Investments :		
Fixed maturities, at fair value		
(amortized cost: 2004 - \$592,345; 2003 - \$542,600)	\$ 597,597	\$ 543,748
Short-term investments, at fair value		
(amortized cost: 2004 - \$75,480; 2003 - \$40,286)	75,521	40,312
	<u>673,118</u>	<u>584,060</u>
Cash and cash equivalents	4,944	26,346
Accrued investment income	4,091	7,420
Deferred acquisition costs	57,526	51,477
Prepaid reinsurance premiums	98,262	98,048
Reinsurance balances receivable	22,519	33,446
Unpaid losses and loss expenses recoverable	8,298	7,745
Amounts due from parent and affiliates	26,963	18,342
Derivative assets	7,462	4,826
Other assets	71	52
	<u>\$ 903,254</u>	<u>\$ 831,762</u>
<b>Total assets</b>		
<b>Liabilities, Redeemable Preferred Shares and Shareholders' Equity</b>		
<b>Liabilities:</b>		
Unpaid losses and loss expenses	\$ 37,743	\$ 35,899
Deferred premium revenue	369,322	348,719
Reinsurance premiums payable	3,379	6,275
Net payable for investments purchased	20,095	13
Accounts payable and accrued liabilities	1,314	1,249
Derivative liabilities	3,625	7,018
Dividend payable on preferred shares	2,431	1,950
	<u>\$ 437,909</u>	<u>\$ 401,123</u>
<b>Total liabilities</b>		
<b>Redeemable Preferred Shares:</b>		
Redeemable preferred shares (par value of \$120 per share; 10,000 shares authorized; 363 issued and outstanding as at March 31, 2004 and December 31, 2003, respectively)	\$ 44	\$ 44

Additional paid-in capital	38,956	38,956
	<u>39,000</u>	<u>39,000</u>
<b>Total redeemable preferred shares</b>		
	<u>39,000</u>	<u>39,000</u>
<b>Shareholders' Equity:</b>		
Common shares (par value of \$120 per share; 10,000 shares authorized; 2,057 issued and outstanding as at March 31, 2004 and December 31, 2003, respectively)	247	247
Additional paid-in capital	220,653	220,653
Accumulated other comprehensive income	5,293	1,174
Retained earnings	200,152	169,565
	<u>426,345</u>	<u>391,639</u>
<b>Total shareholders' equity</b>	<u>\$ 426,345</u>	<u>\$ 391,639</u>
<b>Total liabilities, redeemable preferred shares and shareholders' equity</b>	<u>\$ 903,254</u>	<u>\$ 831,762</u>

See accompanying notes to Condensed Financial Statements

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**XL FINANCIAL ASSURANCE LTD.**  
**CONDENSED STATEMENTS OF INCOME AND COMPREHENSIVE INCOME**  
**FOR THE THREE MONTHS ENDED MARCH 31, 2004 AND 2003**  
(UNAUDITED)  
(U.S. dollars in thousands, except per share amounts)

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	<u>2004</u>	<u>2003</u>
<b>REVENUES :</b>		
Net premiums earned	\$ 19,680	\$ 13,188
Net investment income	5,140	4,070
Net realized gains on investments	4,880	703
Net realized and unrealized gains on derivative instruments	10,905	7,934
	<u>40,605</u>	<u>25,895</u>
<b>Total revenues</b>	<u>\$ 40,605</u>	<u>\$ 25,895</u>
<b>EXPENSES :</b>		
Losses and loss expenses	\$ 1,291	\$ 5,861
Acquisition costs	6,193	5,467
Operating expenses	2,054	765
	<u>9,538</u>	<u>12,093</u>
<b>Total expenses</b>	<u>\$ 9,538</u>	<u>\$ 12,093</u>
<b>NET INCOME</b>	<u>\$ 31,067</u>	<u>\$ 13,802</u>
<b>COMPREHENSIVE INCOME</b>		
Net income	\$ 31,067	\$ 13,802
Unrealized appreciation of investments	8,999	377
Less: reclassification for gains realized in income	4,880	703
	<u>4,119</u>	<u>(326)</u>
<b>Other comprehensive gain (loss)</b>	<u>\$ 4,119</u>	<u>\$ (326)</u>

**COMPREHENSIVE INCOME**

\$	35,186	\$	13,476
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See accompanying notes to Condensed Financial Statements

**XL FINANCIAL ASSURANCE LTD.****CONDENSED STATEMENTS OF CHANGES IN SHAREHOLDERS' EQUITY  
FOR THE THREE MONTH PERIOD ENDED MARCH 31, 2004 AND FOR THE YEAR  
ENDED DECEMBER 31, 2003**

(UNAUDITED)

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

	<b>2004</b>	<b>2003</b>
<b>Common Shares – Authorized</b>		
Number of shares, beginning of year and period	2,057	2,057
Number of shares, end of year and period	2,057	2,057
<b>Common Shares – Issued</b>		
Balance - beginning of year and period	\$ 247	\$ 247
Balance - end of year and period	\$ 247	\$ 247
<b>Additional Paid-in Capital</b>		
Balance - beginning of year and period	\$ 220,653	\$ 220,653
Balance - end of year and period	\$ 220,653	\$ 220,653
<b>Accumulated Other Comprehensive Income</b>		
Balance - beginning of year and period	\$ 1,174	\$ 6,095
Other comprehensive income (loss)	4,119	(4,921)
Balance - end of year and period	\$ 5,293	\$ 1,174
<b>Retained Earnings</b>		
Balance - beginning of year and period	\$ 169,565	\$ 100,046
Net income	31,067	76,161
Dividends on preferred shares	(480)	(6,642)

Balance - end of year and period	\$ 200,152	\$ 169,565
<b>Total Shareholders' Equity</b>	<b>\$ 426,345</b>	<b>\$ 391,639</b>

See accompanying notes to Condensed Financial Statements

**XL FINANCIAL ASSURANCE LTD.**  
**CONDENSED STATEMENTS OF CASH FLOWS**  
**FOR THE THREE MONTH PERIODS ENDED MARCH 31, 2004 AND 2003**  
(UNAUDITED)  
(U.S. dollars in thousands, except per share amounts)

	<u>2004</u>	<u>2003</u>
<b>Cash flows provided by operating activities:</b>		
Net income for the period	\$ 31,067	\$ 13,802
Adjustments to reconcile net income to net cash provided by operating activities:		
Realized gains on investments	(4,880)	(703)
Amortization of discount on fixed maturities	1,815	(223)
Net realized gains on investment derivatives	(19)	(1,244)
Net realized and unrealized losses (gains) on credit derivatives excluding cash received and paid	(6,029)	732
Accrued investment income	3,329	163
Reinsurance premiums receivable	10,927	(3,369)
Deferred acquisition costs	(6,049)	(3,011)
Prepaid reinsurance premiums	(214)	(1,196)
Unpaid losses and loss expenses recoverable	(553)	(1,743)
Amounts due from parent and affiliates	(8,621)	1,437
Accounts payable and accrued liabilities	65	(853)
Reinsurance premiums payable	(2,896)	(16,049)
Deferred premium revenue	20,603	18,504
Unpaid losses and loss expenses	1,844	7,602
Other assets and liabilities	(19)	(19)
Total adjustments	9,303	28
Net cash provided by operating activities	40,370	13,830
<b>Cash flows used in investing activities:</b>		
Proceeds from sale of fixed maturities and short-term investments	1,375,699	59,768
Proceeds from redemption of fixed maturities and short-term investments	81,950	1,342,574
Purchase of fixed maturities and short-term investments	(1,519,421)	(1,480,645)
Net cash used in investing activities	(61,772)	(78,303)
<b>Decrease in Cash and Cash Equivalents</b>	<b>(21,402)</b>	<b>(64,473)</b>
<b>Cash and Cash Equivalents – Beginning of period</b>	<b>26,346</b>	<b>125,073</b>
<b>Cash and Cash Equivalents – End of period</b>	<b>\$ 4,944</b>	<b>\$ 60,600</b>

See accompanying notes to Condensed Financial Statements



# **XL FINANCIAL ASSURANCE LTD.**

**NOTES TO CONDENSED FINANCIAL STATEMENTS  
FOR THREE MONTH PERIODS ENDED MARCH 31, 2004 AND 2003  
(UNAUDITED)  
(U.S. dollars in thousands, except per share amounts)**

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## **1. Organization and Business**

XL Financial Assurance Ltd. (the "Company") was incorporated with limited liability under the Bermuda Companies Act 1981 on October 14, 1998 and is registered as a Class 3 insurer under The Insurance Act 1978, amendments thereto and related regulations ("The Act"). At March 31, 2004 and December 31, 2003, the Company was approximately 85% owned by XL Insurance (Bermuda) Ltd (a wholly-owned subsidiary of XL Capital Ltd); 6% by Financial Security Assurance Inc. (a wholly-owned subsidiary of Financial Security Assurance Holdings Ltd.) and 9% by Financial Security Assurance International Ltd. (owned 20% by XL Insurance (Bermuda) Ltd and 80% by Financial Security Assurance Inc.). The Company is an integral part of a joint venture agreement between XL Capital Ltd and Financial Security Assurance Holdings Ltd.

The Company is primarily engaged in the business of providing reinsurance of financial guaranties on asset-backed and municipal obligations underwritten by XL Insurance (Bermuda) Ltd, Financial Security Assurance Inc. and XL Capital Assurance Inc. (a wholly-owned subsidiary of XL Capital Ltd) and other monoline and multiline insurance companies. This may be in the form of traditional financial guaranty insurance or via a credit derivative execution. The Company's underwriting policy is to provide reinsurance of asset-backed and municipal obligations that would be of a lower investment-grade quality without the benefit of the Company's reinsurance. The asset-backed obligations reinsured by the Company are generally issued in structured transactions and are backed by pools of assets such as residential mortgage loans, consumer or trade receivables, securities or other assets having ascertainable cash flows or market value. The municipal obligations reinsured by the Company consist primarily of general obligation bonds that are supported by the issuers' taxing power and of special revenue bonds and other special obligations of states and local governments that are supported by the issuers' ability to impose and collect fees and charges for public services or specific projects. The Company's reinsurance guarantees payments when due of scheduled payments on an insured obligation. In the case of a payment default on an insured obligation, the Company is generally required to pay the principal, interest or other such amounts due in accordance with the obligations' original payment schedule or, at its option, to pay such amounts on an accelerated basis. The Company conducts surveillance on its exposures to try and ensure early identification of any loss events. In addition, in the normal course of business, the Company seeks to reduce the loss that may arise from such events by reinsuring certain levels of risks in various areas of exposure with other insurance enterprises or reinsurers.

On October 6, 1999, the Company entered into a Facultative Quota Share Reinsurance Treaty ("Treaty") with XL Capital Assurance Inc. ("XLCA"). The Treaty was amended and restated on June 22, 2001. Under the terms of this Treaty, the Company agrees to reinsure up to 90% of XLCA's compliant risks. The Company is subject to ceding commissions of up to 30% on business assumed under the terms of this Treaty.

On December 6, 2000, the Company entered into an excess of loss agreement, which reinsures 100% of net incurred losses in excess of \$250 million up to a limit of liability of \$100 million. On June 30, 2003, the Company terminated the agreement. On October 3, 2001, the Company entered into an excess of loss reinsurance agreement with XL Insurance (Bermuda) Ltd, which indemnifies the Company up to an aggregate limit of liability of \$500 million in excess of defined obligor losses.

## **2. Significant Accounting Policies**

### **Basis of Preparation**

The accompanying condensed financial statements have been prepared by the Company and are unaudited. In the opinion of management, all adjustments, which include only normal recurring adjustments necessary to present fairly the financial position, results of operations and cash flows at March 31, 2004 and for all periods presented, have been made.

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# **XL FINANCIAL ASSURANCE LTD.**

**NOTES TO CONDENSED FINANCIAL STATEMENTS  
FOR THREE MONTH PERIODS ENDED MARCH 31, 2004 AND 2003  
(UNAUDITED)  
(U.S. dollars in thousands, except per share amounts)**

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Certain information and footnote disclosures normally included in financial statements prepared in accordance with accounting principles generally accepted in the United States of America have been condensed or omitted. These statements should be read in conjunction with the Company's December 31, 2003 financial statements and notes thereto. The year-end condensed balance sheet was derived from audited financial statements, but does not include all disclosures required by accounting principles generally accepted in the United States of America. The results of operations for the periods ended March 31, 2004 and 2003 are not necessarily indicative of the operating results for the full year.

The preparation of condensed financial statements requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates. Any such adjustments are reflected in income in the period in which the adjustments are made. The financial statement estimates subject to most uncertainty are estimates for loss reserves and calculation of the fair value of credit derivative instruments.

### **Acquisition Costs**

Certain costs incurred, relating to and varying with the production of new business, have been deferred. These costs include ceding commissions paid to the reinsured. The Company considers the present value of future premiums under installment contracts written when determining the recoverability of deferred acquisition costs. The deferred acquisition costs are amortized over periods in which the related premiums are earned, except for acquisition costs incurred from business assumed from XL Capital Assurance, Inc., which are amortized over a straight-line basis over the average maturity of the Company's portfolio of reinsured transactions.

### **Recent Accounting Pronouncements**

In May 2003, the Financial Accounting Standards Board issued Statement of Financial Accounting Standards No. 150, Accounting for Certain Financial Instruments with Characteristics of both Liabilities and Equity (FAS 150). FAS 150 establishes standards for how an issuer classifies and measures certain financial instruments with characteristics of both liabilities and equity. FAS 150 does not affect the classification or measurement of shares that are conditionally redeemable, such as the Company's preferred shares, but rather addresses the classification and measurement of mandatorily redeemable financial instruments. Under FAS 150, mandatorily redeemable financial instruments are classified as a liability unless the redemption is required to occur only upon the liquidation or termination of the reporting entity. A financial instrument issued in the form of shares is mandatorily redeemable if it embodies an unconditional obligation requiring the issuer to redeem the instrument by transferring its assets at a specified or determinable date (or dates) or upon an event certain to occur. Under the terms of the Company's preferred shares, the instrument may be callable and/or puttable at certain dates. However, the combination of these embedded features does not render the shares mandatorily redeemable because the redemption features are considered conditional. The Company's preferred shares would be considered mandatorily redeemable on the date the condition is resolved (when either party exercises its option). As at March 31, 2004, the Company was not required to reclass its redeemable preferred shares to Shareholder's Equity.

In April 2003, FASB issued Statement No. 149, "Amendment of Statement 133 on Derivative Instruments and Hedging Activities" ("SFAS 149"). SFAS amends and clarifies financial accounting and reporting for derivative instruments, including certain derivative instruments embedded in other contracts and for hedging activities under SFAS 133. SFAS 149 also clarifies the types of financial guarantee contracts that are included in the scope exception of SFAS 133 and the characteristics of a derivative that contains financing components. SFAS 149 is effective for contracts entered into or modified after June 30, 2003 and should be applied prospectively. The adoption of SFAS 149 did not have a material effect on the Company's financial condition and results of operations.

In January 2003, FASB issued Interpretation No. 46, "Consolidation of Variable Interest Entities", ("FIN 46"). The objective of FIN 46 is to improve financial reporting by companies involved with variable interest entities. This new model for consolidation applies to an entity which either (1) the powers or rights of the equity holders do not give them sufficient decision making powers or (2) the equity investment at risk is insufficient to finance that entity's activities without receiving additional subordinated financial support from other parties. FIN 46 requires a

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## **XL FINANCIAL ASSURANCE LTD.**

### **NOTES TO CONDENSED FINANCIAL STATEMENTS FOR THREE MONTH PERIODS ENDED MARCH 31, 2004 AND 2003**

(UNAUDITED)

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

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variable interest entity to be consolidated by a company if that company is subject to a majority of the risk of loss from the variable interest entity's activities or entitled to receive a majority of the entity's residual returns or both. In December 2003, FASB issued a revision to FIN 46 (FIN 46-R) which clarified several provisions of FIN 46, superceded the related FASB Staff Positions (FSPs), and amended the effective date and transition of the pronouncement, except for certain types of entities. The Company was required to apply the provisions of FIN 46-R not later than March 31, 2004. However, the Company has applied the provisions of FIN 46 or FIN 46-R to those entities that are considered to be special-purpose entities as at March 31, 2004. The adoption of FIN 46 did not have a material effect on the Company's financial condition and results of operations.

#### **3. Derivative Instruments**

Credit derivatives issued by the Company meet the definition of a derivative under FAS 133. The Company has recorded these products at fair value, modeled on prevailing market conditions and certain other factors relating to the structure of the transaction. The Company considers credit derivatives to be financial guaranty contracts, in substance, as the Company intends to hold them to maturity. The Company determines fair value using a model which calculates the difference between the actual remaining present value of installment premiums and an estimated remaining present value of installment premiums under current market conditions. In essence, the model estimates the cost of an offsetting position to the original credit derivatives from other comparable counterparties under the current market environment. The model is dependent upon a number of factors including changes in credit spreads, changes in credit quality, foreign exchange and other market factors.

The Company's credit derivatives portfolio generally requires the Company to meet payment obligations for referenced credits within the portfolio in the event of specific credit events after erosion or exhaustion of various first loss protection levels. These credit events are contract specific, but generally cover bankruptcy, failure to pay and repudiation. The notional exposure of the credit derivatives portfolio as of March 31, 2004 was \$4.2 billion. Approximately 95% of the portfolio is rated AAA, with the remainder being split amongst AA, A and BBB respectively. The weighted average term of the contracts in force was 5.22 years.

The net fair value adjustment for the periods ended March 31, 2004 and 2003 was an unrealized gain (loss) of \$6,029 and (\$732), respectively. At March 31, 2004 and 2003, the Company had a net derivatives asset (liability) of \$3,837 and (\$12,081), respectively.

#### **4. Variable Interest Entities**

The Company primarily provides financial guaranty reinsurance or enters into a credit derivative on the senior interests, which would otherwise be rated investment grade. The obligations related to these transactions are often securitized through variable interest entities. The Company does not hold any equity positions or subordinated debt in these arrangements. Accordingly, the Company's interest in these variable interest entities is not significant and therefore, not consolidated.

The Company provides insurance, reinsurance and a liquidity facility to a variable interest entity domiciled in the Cayman Islands. The variable interest entity was established primarily as a pass-through vehicle associated with a Medium Term Note program backed by a portfolio of investment grade bank perpetual securities and zero coupon notes. The variable interest entity had assets of approximately \$1.4 billion as of March 31, 2004. The Company's maximum exposure to loss as a result of its insurance and reinsurance agreements with this variable interest entity was \$348.9 million as of March 31, 2004. The Company could experience a loss in the event that the underlying assets do not perform as expected.

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## **XL FINANCIAL ASSURANCE LTD.**

### **NOTES TO CONDENSED FINANCIAL STATEMENTS FOR THREE MONTH PERIODS ENDED MARCH 31, 2004 AND 2003**

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## 5. Reinsurance

The effect of reinsurance on premiums written and earned for the three month periods ended March 31, 2004 and 2003 is shown below:

	<b>Assumed</b>		<b>Ceded</b>		<b>Net</b>
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Three months ended March 31, 2004					
Premium written	\$ 47,067	\$	(6,998)	\$	40,069
Premium earned	26,464		(6,784)		19,680
Losses and loss adjustment expenses	1,844		(553)		1,291
Three months ended March 31, 2003					
Premium written	\$ 38,793	\$	(8,298)	\$	30,495
Premium earned	20,290		(7,102)		13,188
Losses and loss adjustment expenses	7,602		(1,741)		5,861
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