PRECISION DRILLING TRUST
Form 6-K
August 29, 2008

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549
FORM 6-K
REPORT OF FOREIGN PRIVATE ISSUER
Pursuant to Section 13a-16 or 15d-16 of the
Securities Exchange Act of 1934
August 29, 2008
Commission File Number: 001-14534
Precision Drilling Trust
(Exact name of registrant as specified in its charter)
4200, 150 - 6th Avenue S.W.
Calgary, Alberta
Canada T2P 3Y7
(Address of principal executive offices)

Indicate by check mark whether the registrant files or will file annual reports under cover Form 20-F or Form 40-F.

Form 20-F o Form 40-F þ

Indicate by check mark if the registrant is submitting the Form 6-K in paper as permitted by Regulation S-T Rule 101(b)(1): ___

Indicate by check mark if the registrant is submitting the Form 6-K in paper as permitted by Regulation S-T Rule 101(b)(7): ___

Indicate by check mark whether the registrant by furnishing the information contained in this Form is also thereby furnishing the information to the Commission pursuant to Rule 12g3-2(b) under the Securities Exchange Act of 1934.

Yes o No þ

If Yes is marked, indicate below the file number assigned to the registrant in connection with Rule 12g3-2(b): 82- N/A .

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

PRECISION DRILLING TRUST
By its Administrator PRECISION DRILLING CORPORATION

Dated: August 29, 2008

By: /s/ Darren Ruhr

Name: Darren Ruhr
Title: Corporate Secretary

INDEX TO EXHIBITS

Exhibit Number	Description of Exhibit
1	Material Change Report dated August 28, 2008.
2	Agreement and Plan of Merger, dated August 24, 2008, by and among Precision Drilling Trust, Grey Wolf, Inc., Precision Drilling Corporation and Precision Lobos Corporation.

Exhibit 1

FORM 51-102F3

MATERIAL CHANGE REPORT

1. **Name and Address of Company:**

   Precision Drilling Trust (the **Trust**)
   4200, 150-6th Avenue S.W.
   Calgary, AB T2P 3Y7

2. **Date of Material Change:**

   August 24, 2008.

3. **News Release:**

   A press release disclosing the material change, a copy of which is attached hereto, was issued on August 25, 2008 through the facilities of MarketWire and was filed with the applicable securities regulatory authorities via SEDAR on the same date.

4. **Summary of Material Change:**

   The Trust has entered into an agreement and plan of merger dated August 24, 2008 (the **Merger Agreement**) with Grey Wolf, Inc. (**Grey Wolf**), Precision Drilling Corporation (the **Corporation**) and Precision Lobos Corporation (**Lobos**), pursuant to which the Trust will indirectly acquire Grey Wolf.

5. **Full Description of the Material Change:**

   The Trust has entered into the **Merger Agreement** with Grey Wolf, the Corporation and Lobos, pursuant to which the Trust will indirectly acquire Grey Wolf (the **Acquisition**).

   The Acquisition will be completed by way of a merger under the applicable laws of the State of Texas. Pursuant to the Acquisition, Grey Wolf will be merged with and into Lobos pursuant to the *Texas Business Corporations Act* and the *Texas Corporation Law*. Lobos is a direct, wholly-owned subsidiary of the Trust. Following the completion of the Acquisition, the separate legal existence of Grey Wolf shall cease and Lobos shall be the surviving corporation.

   Under the terms of the Merger Agreement, shareholders of Grey Wolf may elect to receive either cash or trust units of the Trust (the **Trust Units**) in exchange for their shares of Grey Wolf common stock. Each share of Grey Wolf common stock will be convertible, at the option of the holder, into U.S.$9.02 in cash or 0.4225 Trust Units, subject to proration. The maximum amount of cash to be paid by the Trust will be approximately U.S.$1.12 billion and the maximum number of Trust Units to be issued will be approximately 42 million. These maximum amounts translate to U.S.$5.00 in cash and 0.1883 of a Trust Unit for each share of Grey Wolf common stock.

   Upon completion of the Acquisition, the former shareholders of Grey Wolf common stock will own approximately 25% of the issued and outstanding Trust Units.

The Trust, the Corporation, Lobos and Grey Wolf have each made customary representations, warranties and covenants in the Merger Agreement, including, among others, covenants to conduct their businesses in the ordinary course between the execution of the Merger Agreement and the consummation of the Acquisition and covenants not to engage in certain kinds of transactions during that period.

Completion of the Acquisition is subject to customary conditions, including, among others, (i) approval of the Merger Agreement by shareholders of Grey Wolf, (ii) the receipt of required regulatory approvals, (iii) the effectiveness of the registration statement that will be filed by the Trust for the issuance of the Trust Units as consideration in the Acquisition and the approval of the listing of the Trust Units on the New York Stock Exchange and Toronto Stock Exchange and (iv) the absence of any material adverse effect with respect to Grey Wolf s and the Trust s business, as applicable.

Financing is not a condition to consummation of the Acquisition. The Trust has received commitments from Deutsche Bank Securities, Royal Bank of Canada, HSBC Bank and The Toronto Dominion Bank to finance the cash portion of the merger consideration.

The Merger Agreement contains certain termination rights for the Trust. Upon termination of the Merger Agreement under certain specified circumstances, Grey Wolf would be required to pay the Trust a termination fee of up to U.S.$64.0 million.

It is anticipated that a proxy statement will be mailed to Grey Wolf shareholders by the end of the third quarter with the special meeting of Grey Wolf shareholders to consider the Merger Agreement to be held before the end of 2008. No vote of holders of Trust Units is required in connection with the Acquisition.

The foregoing description of the Merger Agreement does not purport to be complete and is qualified in its entirety by reference to the Merger Agreement which has been filed on SEDAR and is available at www.sedar.com.

6. **Reliance on Subsection 7.1(2) or (3) of National Instrument 51-102:**

Not applicable.

7. **Omitted Information:**

Not applicable.

8. **Executive Officer:**

For further information, please contact Darren Ruhr, Vice President, Corporate Services and Corporate Secretary, at (403) 716-4500.

9. **Date of Report:**

August 28, 2008.

Exhibit 2
EXECUTION VERSION

AGREEMENT AND PLAN OF MERGER
BY AND AMONG
PRECISION DRILLING TRUST,
GREY WOLF, INC.
PRECISION DRILLING CORPORATION
AND
PRECISION LOBOS CORPORATION
DATED AUGUST 24, 2008

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Exhibit 2.5	Certain Officers of the Surviving Corporation
Exhibit 3.3	Grey Wolf Voting Agreements

Schedules

Schedule A	Directors and Executive Officers Executing Voting Agreements

AGREEMENT AND PLAN OF MERGER

This Agreement and Plan of Merger (as amended, supplemented or modified from time to time, this *Agreement*), dated as of August 24, 2008, is by and among PRECISION DRILLING TRUST, an Alberta unincorporated open-ended investment trust (*Precision*), GREY WOLF, INC., a Texas corporation (G*rey Wolf*), PRECISION DRILLING CORPORATION, a corporation amalgamated under the laws of the Province of Alberta and the administrator of Precision (*PDC*) and PRECISION LOBOS CORPORATION, a Texas corporation (*Lobos*) and a direct, wholly-owned subsidiary of Precision.

WHEREAS, the board of trustees of Precision and the boards of directors of each of PDC, on behalf of PDC and on behalf of Precision in PDC s capacity as administrator of Precision, Lobos and Grey Wolf have approved this Agreement and the merger of Grey Wolf with and into Lobos, with Lobos continuing as the surviving corporation, upon the terms and subject to the conditions of this Agreement and the Texas Business Corporation Act, as amended, or any successor law thereto (the *TBCA*) and the Texas Corporation Law, as amended, or any successor law thereto (the *TCL*);

WHEREAS, the board of trustees of Precision and the boards of directors of each of PDC, on behalf of PDC and on behalf of Precision in PDC s capacity as administrator of Precision, Lobos and Grey Wolf have determined that this Agreement, the merger herein provided for, and the other transactions contemplated hereby are advisable and in the best interests of their respective companies and their unitholders and shareholders, respectively; and

WHEREAS, for U.S. federal income Tax purposes, it is intended that the Merger qualify as a reorganization involving Precision and Grey Wolf within the meaning of Section 368(a) of the Internal Revenue Code of 1986, as amended (the *Code*);

NOW, THEREFORE, for and in consideration of the foregoing and the representations, warranties, covenants and agreements set forth in this Agreement, the parties to this Agreement (each a *Party*, and collectively, the *Parties*) agree as follows:

ARTICLE I
DEFINITIONS

Section 1.1 Defined Terms.

(a) As used in this Agreement, capitalized terms shall have the meanings set forth below:

Acquisition Proposal means any Contract, proposal, offer or other inquiry or indication of interest (regardless of whether in writing and regardless of whether delivered to the shareholders) relating to any of the following (other than the transactions contemplated by this Agreement or the Merger): (a) any merger, reorganization, share exchange, take-over bid, tender offer, recapitalization, consolidation, liquidation, dissolution or other business combination, purchase or similar transaction or series of transactions, directly or indirectly, involving 20% or more of the assets, net revenues or net income of Grey Wolf and the Grey Wolf Subsidiaries, taken as a whole; (b) the sale, lease, exchange, transfer or other disposition, directly or indirectly, of any business or assets that generate 20% or more of the consolidated net revenues or net income, or of assets representing 20% or more of the book value of the consolidated assets, of Grey Wolf and the Grey Wolf Subsidiaries, taken as a whole, or any license, lease, exchange, mortgage, pledge or other agreement or arrangement having a similar economic effect, in each case in a single transaction or a series of related transactions; or (c) any direct or indirect acquisition of beneficial ownership (as defined in Section 13(d) of the Exchange Act) or any direct or indirect acquisition of the right to acquire beneficial ownership (as defined in Section 13(d) of the Exchange Act) by any Person or any group (as defined in the Exchange Act) of 20% or more of the shares of any class of the issued and outstanding Equity Interests of Grey Wolf, whether in a single transaction or a series of related transactions.

Administration Agreement means that certain Administration Agreement between Precision and PDC dated as of November 7, 2005, as amended on April 22, 2008.

Affiliate means, with respect to any Person, each other Person that, directly or indirectly, Controls, is Controlled by or is under common Control with such Person.

AMEX means the American Stock Exchange LLC.

Applicable Canadian Securities Laws means, collectively, and as the context may require, the applicable securities legislation of each of the provinces and territories of Canada, and the rules, regulations, instruments, orders and policies published or promulgated thereunder, as such may be amended from time to time prior to the Effective Time.

Applicable Law means with respect to any Person, any international, national, federal, state, provincial, territorial, local or foreign statute, code, ordinance, rule, regulation, by-law, consent, approval, judgment, Order, ordinance, protocol, directive or other authorization, treaty, convention, or governmental requirement of any Governmental Authority that is binding upon, or applicable to, such Person.

Available Cash Consideration means $1,115,380,707.

Beneficial Owner means, with respect to a security, any Person who, directly or indirectly, through any contract, relationship or otherwise, has or shares (a) the power to vote, or to direct the voting of, such security, (b) the power to dispose of, or to direct the disposition of, such security or (c) the ability to profit or share in any profit derived from a transaction in such security.

Benefit Plan means any qualified or non-qualified employee benefit plan, program, policy, practice, agreement, Contract or other arrangement, regardless of whether written, regardless of whether U.S.-based, including any employee welfare benefit plan within the meaning of Section 3(1) of ERISA (including post-retirement medical and life insurance), any employee pension benefit plan within the meaning of Section 3(2) of ERISA (regardless of whether such plan is subject to ERISA), including any multiemployer plan (as defined in Section 3(37) of ERISA) or multiple employer plan (within the meaning of Section 413(c) of the Code), any employment or severance agreement or other arrangement, and any employee benefit, bonus, incentive, deferred compensation, profit sharing, vacation, stock, stock purchase, stock option, severance, change of control, fringe benefit or other plan, program, policy, practice, agreement, Contract, or other arrangement, regardless of whether subject to ERISA and regardless of whether funded.

Business Day means any day other than a Saturday, Sunday or any day on which banks in (i) the State of New York are authorized or required by federal law to be closed in New York, New York, or (ii) the Province of Alberta are authorized or required by law to be closed in Calgary, Alberta.

Canadian GAAP means generally accepted accounting principles, as recognized by the Canadian Institute of Chartered Accountants, applied on a consistent basis.

Canadian Securities Regulatory Authorities means, collectively, the securities commission or similar regulatory authorities in each of the provinces or territories of Canada.

Certificates means certificates representing shares of Grey Wolf Common Stock or Precision Trust Units, as applicable.

CFIUS means The Committee on Foreign Investments in the United States.

Competition Act means the *Competition Act*, R.S.C. 1985, c. C-34, as amended.

Confidentiality Agreement means the Confidentiality Agreement, dated as of February 13, 2008, between Precision and Grey Wolf.

Contract means any agreement, arrangement, commitment or instrument, written or oral, including, without limitation, any loan or credit agreement or other agreement evidencing Indebtedness, promissory note, bond, mortgage, indenture, guarantee, permit, lease, sublease, license, agreement to render services, or other agreement, arrangement, commitment or instrument evidencing rights or obligations of any kind or nature, including all amendments, modifications, supplements and options relating thereto.

Control (and related terms) means the possession, directly or indirectly, of the power to direct or cause the direction of the management policies of a Person, whether through the ownership of stock, by contract, credit arrangement or otherwise.

Disclosure Letter means, as applicable, the Grey Wolf Disclosure Letter or the Precision Disclosure Letter.

DOJ means the United States Department of Justice.

Election Deadline means 5:00 p.m., local time in Houston, Texas, on the second Business Day prior to the Effective Time.

Environmental, Health and Safety Laws means any present or future Applicable Laws relating to (a) emissions, discharges, releases or threatened releases of Hazardous Materials into the environment, including into ambient air, soil, sediments, land surface or subsurface, buildings or facilities, surface water, groundwater, publicly-owned treatment works, or septic systems, (b) the generation, treatment, storage, disposal, use, handling, manufacturing, recycling, transportation or shipment of Hazardous Materials, (c) occupational health and safety, or (d) the pollution of the environment, solid waste handling, treatment or disposal, reclamation or remediation activities, or protection or restoration of, or damage to, the environment, environmentally sensitive areas or natural resources.

Equity Interests means (a) with respect to a corporation, any and all shares, interests, participation, phantom stock plans or arrangements or other equivalents (however designated) of corporate stock, including all common stock, preferred stock and other equity and voting interests, and warrants, options, calls, subscriptions or other convertible securities or other rights to acquire any of the foregoing, (b) with respect to a partnership, limited liability company, trust or similar Person, any and all units, membership or other interests, including rights to purchase, warrants, options, calls, subscriptions or other equivalents of, or other interests convertible into, any beneficial or legal ownership interest in such Person.

ERISA means the Employee Retirement Income Security Act of 1974, as amended, and any regulations promulgated pursuant thereto.

ERISA Affiliate means any trade or business, regardless of whether incorporated, which is required to be treated as a single employer together with an entity pursuant to Section 414(b), (c), (m) or (o) of the Code or Section 4001(b)(1) of ERISA.

Exchange Act means the Securities Exchange Act of 1934, as amended.

Exchange Ratio means 0.4225 Precision Trust Units per share of Grey Wolf Common Stock.

Exon-Florio Amendment means Section 721 of Title VII of the Defense Production Act of 1950, as amended.

FCPA means the Foreign Corrupt Practices Act of 1977.

Financing means the debt and/or equity financing(s) to be completed by Precision and/or the Precision Subsidiaries in connection with the transactions contemplated by this Agreement, including the debt financing set forth in the commitment letter dated August 24, 2008, from Royal Bank of Canada, RBC Capital Markets, Deutsche Bank AG Cayman Islands Branch, Deutsche Bank Securities Inc., HSBC Bank Canada, HSBC Bank USA National Association and Toronto-Dominion Bank, to provide senior secured credit facilities comprised of $800 million of term loan facilities and a $400 million revolving credit facility as well as a $400 million senior unsecured facility, as such commitment letter may be amended, supplemented or replaced from time to time.

FTC means the United States Federal Trade Commission.

Governmental Authority means any national, state, provincial, territorial, regional, local, county, parish or municipal government, domestic or foreign, any agency, board, bureau, commission, court, tribunal, subdivision, department or other governmental or regulatory authority or instrumentality, or any arbitrator in any case that has jurisdiction over any of the

Grey Wolf Companies or Precision Companies, as the case may be, or any of their respective properties or assets.

Grey Wolf 1996 Stock Plan means the Grey Wolf, Inc. 1996 Employee Stock Option Plan.

Grey Wolf 2003 Stock Plan means the Grey Wolf, Inc. 2003 Incentive Plan.

Grey Wolf 3.75% Notes Indenture means the Indenture dated as of May 7, 2003, between Grey Wolf, The Bank of New York Trust Company, N.A. and the guarantors party thereto pursuant to which Grey Wolf issued $150,000,000 principal amount of the Grey Wolf 3.75% Notes, and all supplemental indentures thereto.

Grey Wolf Benefit Plan means a Benefit Plan (a) providing benefits to (i) any current or former employee, officer or director of Grey Wolf or any of the Grey Wolf Subsidiaries or ERISA Affiliates or (ii) any beneficiary or dependent of any such employee, officer or director that is sponsored, maintained or contributed to by Grey Wolf or any of the Grey Wolf Subsidiaries or ERISA Affiliates or to which Grey Wolf or any of the Grey Wolf Subsidiaries or ERISA Affiliates is a party or is obligated to contribute, or (b) with respect to which Grey Wolf or any of the Grey Wolf Subsidiaries or ERISA Affiliates has any liability, whether direct or indirect, contingent or otherwise.

Grey Wolf Board means the board of directors of Grey Wolf.

Grey Wolf Common Stock means the common stock, par value $0.10 per share, of Grey Wolf.

Grey Wolf Companies means Grey Wolf and each of the Grey Wolf Subsidiaries.

Grey Wolf Credit Agreement means the Revolving Credit Agreement, dated as of January 14, 1999, among Grey Wolf Drilling, LP (as borrower), Grey Wolf (as guarantor), The CIT Group/Business Credit, Inc. (as agent) and various financial institutions (as lenders), as amended.

Grey Wolf Derivative Security Holder means the holder of a Grey Wolf Option or a Grey Wolf Convertible Note.

Grey Wolf Dissenting Shareholder means any holder of shares of Grey Wolf Common Stock who does not vote in favor of the Merger (or consent thereto in writing) and who is entitled to demand and prior to the Grey Wolf Meeting files with Grey Wolf a written objection to the Merger, setting out that the right to dissent of such holder of shares of Grey Wolf Common Stock will be exercised if the Merger becomes effective, and otherwise complies in all respects with, the provisions of Article 5.12 of the TBCA required to be complied with by such holder prior to the Grey Wolf Meeting.

Grey Wolf Dissenting Shares means any shares of Grey Wolf Common Stock held by a Grey Wolf Dissenting Shareholder as of the Effective Time.

Grey Wolf Employees means the individuals who are employed as employees by Grey Wolf or any of the Grey Wolf Subsidiaries immediately prior to the Effective Time who remain employed as employees of the Surviving Corporation or any of its Subsidiaries immediately after the Effective Time.

Grey Wolf Floating Rate Notes Indenture means the Indenture dated as of March 31, 2004, between Grey Wolf, The Bank of New York Trust Company, N.A. and the guarantors party thereto pursuant to which Grey Wolf issued $125,000,000 principal amount of the Grey Wolf Floating Rate Contingent Convertible Senior Notes.

Grey Wolf Leased Real Property means all real property leased by Grey Wolf or any of the Grey Wolf Subsidiaries.

Grey Wolf Material Adverse Effect means a Material Adverse Effect with respect to Grey Wolf.

Grey Wolf Meeting means a meeting of the shareholders of Grey Wolf duly called and held for the purposes set forth in the Proxy Statement/Prospectus.

Grey Wolf Options means, collectively, Grey Wolf 1996 Options and Grey Wolf 2003 Options.

Grey Wolf Owned Real Property means all real property owned by Grey Wolf or any of the Grey Wolf Subsidiaries.

Grey Wolf Preferred Stock means shares of preferred stock, par value $1.00 per share, of Grey Wolf.

Grey Wolf Proposal means the proposal to approve this Agreement which proposal is to be presented to the shareholders of Grey Wolf in the Proxy Statement/Prospectus and voted on at the Grey Wolf Meeting.

Grey Wolf Real Property means Grey Wolf Leased Real Property and Grey Wolf Owned Real Property.

Grey Wolf Representative means a Representative of Grey Wolf or the Grey Wolf Subsidiaries.

Grey Wolf Restricted Stock means the shares of restricted Grey Wolf Common Stock issued pursuant to a Grey Wolf Stock Plan.

Grey Wolf Senior Notes Indentures means the Grey Wolf 3.75% Notes Indenture and the Grey Wolf Floating Rate Notes Indenture.

Grey Wolf Stock Plans means (a) the Grey Wolf 1996 Stock Plan and (b) the Grey Wolf 2003 Stock Plan.

Grey Wolf Subsidiary means a Subsidiary of Grey Wolf.

Grey Wolf Subsidiary Charter Documents means the certificate of incorporation, articles of incorporation, certificate of formation, certificate of limited partnership, bylaws, limited liability company agreement, operating agreement, partnership agreement or other governing or organizational documents of each of the Grey Wolf Subsidiaries.

Hazardous Materials means any chemical, pollutant, contaminant, material, waste or substance regulated by any Governmental Authority under Environmental, Health and Safety Law, including, but not limited to, any hazardous waste, hazardous substance, toxic substance, radioactive material (including any naturally occurring radioactive material), asbestos-containing materials in any form or condition, polychlorinated biphenyls in any form or condition, or petroleum, petroleum hydrocarbons, petroleum products or any fraction or byproducts thereof.

Income Tax Act means the *Income Tax Act* (Canada), R.S.C. 1985, c. 1 (5th Supp.), as amended, including the regulations promulgated thereunder, as amended from time to time.

Indebtedness of any Person means and includes any obligations consisting of (a) the outstanding principal amount of and accrued and unpaid interest on, and other payment obligations for, borrowed money, or payment obligations issued or incurred in substitution or exchange for payment obligations for borrowed money, (b) amounts owing as deferred purchase price for property or services, including earn out payments, (c) payment obligations evidenced by any promissory note, bond, debenture, mortgage or other debt instrument or debt security, (d) commitments or obligations by which such Person assures a creditor against loss, including contingent reimbursement obligations with respect to letters of credit, (e) payment obligations secured by a Lien, other than a Permitted Lien, on assets or properties of such Person, (f) obligations to repay deposits or other amounts advanced by and owing to third parties, (g) obligations under capitalized leases, (h) obligations under any interest rate, currency or other hedging agreement or derivatives transaction, (i) guarantees or other contingent liabilities with respect to any amounts of a type described in clauses (a) through (h) above, and (j) any change of control payments or prepayment premiums, penalties, charges or equivalents thereof with respect to any indebtedness, obligation or liability of a type described in clauses (a) through (i) above that are required to be paid at the time of, or the payment of which would become due and payable solely as a result of, the execution of this Agreement or the consummation of the transactions contemplated by this Agreement at such time, in each case determined in accordance with U.S. GAAP, or, in the case of Precision, Canadian GAAP; provided, however, that Indebtedness shall not include accounts payable to trade creditors and accrued expenses arising in the ordinary course of business consistent with past practices and shall not include the endorsement of negotiable instruments for collection in the ordinary course of business.

Intellectual Property means all United States and foreign (a) patents and patent applications and all reissues, renewals, divisions, extensions, provisionals, continuations and continuations in part thereof, (b) inventions (regardless of whether patentable), invention disclosures, trade secrets, proprietary information, industrial designs and registrations and applications, mask works and applications and registrations therefor, (c) copyrights and copyright applications and corresponding rights, (d) trade dress, trade names, logos, URLs, common law trademarks and service marks, registered trademarks and trademark applications, registered service marks and service mark applications, (e) domain name rights and registrations,

(f) databases, customer lists, data collections and rights therein, and (g) confidentiality rights or other intellectual property rights of any nature, in each case throughout the world.

Joint Lead Arrangers means Deutsche Bank Securities Inc. and RBC Capital Markets.

Lien means any lien, mortgage, security interest, indenture, deed of trust, pledge, deposit, restriction, burden, license, lease, sublease, right of first refusal, right of first offer, charge, privilege, easement, right of way, reservation, option, preferential purchase right, right of a vendor under any title retention or conditional sale agreement, or other arrangement substantially equivalent thereto, in each case regardless of whether relating to the extension of credit or the borrowing of money.

Lobos Common Stock means the common stock, par value $0.10 per share, of Lobos.

Material Adverse Effect means, with respect to any Person, a material adverse effect on the business, results of operations, or condition (financial or otherwise) of such Person and its Subsidiaries, taken as a whole, except to the extent any such effect results from: (a) changes in the industry in which such Person or its Subsidiaries operate or in the economy or the financial, securities or credit markets in the U.S. or elsewhere in the world, including any regulatory or political conditions or developments, or any outbreak or escalation of hostilities or declared or undeclared acts of war, terrorism, insurrection or natural disasters, that do not disproportionately affect the business, results of operations or condition (financial or otherwise) of such Person and its Subsidiaries, taken as a whole, relative to other industry participants, in any material respect (b) the execution or public disclosure of this Agreement or the consummation or the pendency of the transactions contemplated hereby, (c) fluctuations in the price or trading volume of shares of any trading stock of such Person (provided, however, that the exception in this clause (c) shall not prevent or otherwise affect a determination that any fact, circumstance, event, change, effect or occurrence underlying such fluctuation has resulted in, or contributed to, a Material Adverse Effect), (d) changes in Applicable Law or in U.S. GAAP, or, in the case of Precision, Canadian GAAP, (or the interpretation thereof) after the date hereof that do not disproportionately affect the business, results of operations or condition (financial or otherwise) of such Person and its Subsidiaries, taken as a whole, relative to other industry participants, in any material respect, (e) any legal proceedings made or brought by any of the current or former holders of Equity Interests of such Person (or on their behalf or on behalf of such Persons) arising out of or related to this Agreement or any of the transactions contemplated hereby, or (f) any failure by such Person to meet any published analyst estimates or expectations regarding such Person s revenue, earnings or other financial performance or results of operations for any period or any failure by such Person to meet its internal budgets, plans or forecasts regarding its revenues, earnings or other financial performance or results of operations (provided, however, that the exception in this clause (f) shall not prevent or otherwise affect a determination that any fact, circumstance, event, change, effect or occurrence underlying such failure has resulted in, or contributed to, a Material Adverse Effect with respect to such Person).

Notes Shares means the number of shares of Grey Wolf Common Stock that the Grey Wolf Convertible Notes that have not been converted at least two Business Days before the Closing Date are convertible into following the Effective Time in accordance with the terms of the Grey Wolf Senior Notes Indentures.

NYSE means the New York Stock Exchange, Inc.

Order means any order, writ, fine, injunction, decree, judgment, award, ruling or enforceable determination of any Governmental Authority.

PDC Common Shares means the common shares in the capital of PDC.

PDLP means Precision Drilling Limited Partnership, a limited partnership formed under the laws of the Province of Manitoba.

PDLP Exchangeable Units means the Class B limited partnership units of PDLP that are exchangeable for Precision Trust Units on a one-for-one basis.

Per Share Cash Consideration means $9.02.

Permitted Distributions means (i) distributions by Precision (and the corresponding distributions by PDLP) to the holders of Precision Trust Units (and PDLP Exchangeable Units, respectively), (ii) distributions by PDLP to Precision and (iii) the payment of dividends and interest and the repayment of outstanding indebtedness by PDC to PDLP, in each case in the ordinary course of business and consistent with past practices.

Permitted Liens means (a) Liens for Taxes, assessments or other governmental charges or levies that are not yet due and payable or that are being contested in good faith by appropriate proceedings and for which adequate reserves in accordance with U.S. GAAP, or, in the case of Precision, Canadian GAAP, have been established and described in the applicable Disclosure Letter, (b) Liens in connection with workmen s compensation, unemployment insurance or other social security, old age pension or public liability obligations not yet due or which are being contested in good faith by appropriate proceedings and for which adequate reserves in accordance with U.S. GAAP, or, in the case of Precision, Canadian GAAP, have been established and described in the applicable Disclosure Letter, (c) operators , vendors , suppliers , carriers , warehousemen s, repairmen s, mechanics , workmen s, materialmen s, or construction Lie (during repair or upgrade periods) or other like Liens arising by operation of Applicable Law in the ordinary course of business or statutory landlord s Liens, each of which is in respect of obligations that have not been outstanding more than 90 days (so long as no action has been taken to file or enforce such Liens within said 90-day period) or which are being contested in good faith, or (d) any other Lien, encumbrance or other imperfection of title that does not materially affect the value or use of the property subject thereto.

Person means any natural person, corporation, company, limited or general partnership, joint stock company, joint venture, association, limited liability company, trust, bank, trust company, land trust, business trust or other entity or organization.

Precision Benefit Plan means a Benefit Plan (a) providing any benefits to (i) any current or former employee, officer, director or trustee of Precision or any of the Precision Subsidiaries or (ii) any beneficiary or dependent of any such employee, officer, director or trustee that is sponsored, maintained or contributed to by Precision or any of the Precision Subsidiaries; or (b) with respect to which Precision or any of the Precision Subsidiaries has any liability, whether direct or indirect, contingent or otherwise.

Precision Board means the board of trustees of Precision.

Precision Companies means Precision and each of the Precision Subsidiaries.

Precision Declaration of Trust means the declaration of trust of Precision dated as of September 22, 2005 between Robert J.S. Gibson, H. Garth Wiggins and Patrick M. Murray, as initial trustees, and Brian E. Roberts, as initial unitholder, as amended.

Precision Leased Real Property means all real property leased by Precision or any of the Precision Subsidiaries.

Precision Material Adverse Effect means a Material Adverse Effect with respect to Precision.

Precision Owned Real Property means all real property owned by Precision or any of the Precision Subsidiaries.

Precision Real Property means the Precision Leased Real Property and the Precision Owned Real Property.

Precision Representatives means a Representative of Precision or the Precision Subsidiaries.

Precision Special Voting Units means the special voting units of Precision, as presently constituted, authorized and issued pursuant to the Precision Declaration of Trust.

Precision Subsidiary means a Subsidiary of Precision. For the avoidance of doubt, PDC, PDLP and Lobos and each of their respective Subsidiaries shall be deemed to be a Precision Subsidiary.

Precision Subsidiary Charter Documents means the certificate of incorporation, articles of incorporation, certificate of formation, certificate of limited partnership, bylaws, limited liability company agreement, operating agreement, partnership agreement or other governing or organizational documents of each of the Precision Subsidiaries.

Precision Trust Units means the trust units of Precision, as presently constituted, each representing an equal, undivided beneficial interest in Precision.

Precision Unit Appreciation Rights means unit appreciation rights that entitle the holder thereof to receive, in cash, a value equal to the product of (i) the difference between the per unit closing sales price of the Precision Trust Units on the NYSE on the date of exercise, as reported in the Wall Street Journal, and the exercise price of such unit appreciation right; and (ii) and the number of units specified in such unit appreciation right agreement.

Proxy Statement/Prospectus means a proxy statement in definitive form relating to the Grey Wolf Meeting, which proxy statement will be included in the prospectus contained in the Registration Statement.

Registration Statement means the Registration Statement on Form F-4 under the Securities Act and to be filed by Precision with respect to the Precision Trust Units issuable in the Merger.

Representative means any trustee, director, officer, employee, agent, advisor (including legal, accounting and financial advisors) or other representative.

Responsible Officers means (a) for Precision and PDC, each of the Chief Executive Officer, Chief Operating Officer and Chief Financial Officer of PDC, and (b) for Grey Wolf, each of the Chief Executive Officer, Chief Operating Officer and Chief Financial Officer of Grey Wolf.

SEC means the United States Securities and Exchange Commission.

Securities Act means the Securities Act of 1933, as amended.

SEDAR means the System for Electronic Document Analysis and Retrieval of the Canadian Securities Administrators.

SOX means the Sarbanes-Oxley Act of 2002, as amended, and the rules and regulations promulgated thereunder.

Subsidiary means for any Person at any time (a) any corporation of which such Person owns, either directly or through its Subsidiaries, more than 50% of the total combined voting power of all classes of voting securities of such corporation, or (b) any partnership, association, joint venture, limited liability company or other business organization, regardless of whether such constitutes a legal entity, in which such Person directly or indirectly owns more than 50% of the total Equity Interests.

Superior Proposal means a bona fide written Acquisition Proposal (with all percentages used in the definition of Acquisition Proposal increased to 50% for purposes of this definition) made by a Third Party after the date of this Agreement through the Effective Time (or such earlier date that this Agreement is terminated in accordance with the terms set forth herein), if the Grey Wolf Board determines in good faith and after consultation with a financial advisor of national reputation, and taking into account all legal, financial, regulatory and other aspects of the Acquisition Proposal that such Acquisition Proposal (a) would, if consummated in accordance with its terms, be more favorable, from a financial point of view, to the holders of the Grey Wolf Common Stock than the transactions contemplated by this Agreement (taking into account any amounts payable pursuant to Section 7.3 and any Precision Revised Offer made under Section 5.5(e), as the case may be), (b) contains conditions which are all reasonably capable of being satisfied in a timely manner, and (c) is not subject to any financing contingency or, to the extent financing for such proposal is required, that such financing is then committed in writing by financially sound financial institutions of national reputation.

Tax or *Taxes* (including with correlative meaning, *Taxable*) means (a) any federal, foreign, state, provincial, territorial, municipal, or local tax, including any income, gross income, gross receipts, ad valorem, excise, sales, use, value added, admissions, business, occupation, license, franchise, margin, capital, net worth, customs, premium, real property, personal property, intangibles, capital stock, transfer, profits, windfall profits, environmental, severance, fuel, utility, payroll, social security, employment insurance, unemployment insurance, social insurance, pension plan, employment, withholding, disability, stamp, rent, recording, registration, alternative minimum, unclaimed property, add-on minimum, or other tax, assessment, duty, fee, levy, premium, contribution or other governmental charge of any kind whatsoever imposed by a Governmental Authority (a *Tax Authority*), together with and including, without limitation, any and all interest, fines, penalties, assessments and additions to tax resulting from, relating to, or incurred in connection with any such tax or any contest or dispute thereof, (b) any liability for the payment of any amount of the type described in the immediately preceding clause (a) as a result of being a member of a consolidated, affiliated, unitary or combined group with any other corporation or entity at any time prior to and through the Closing Date, and (c) any liability for the payment of any amount of the type described in the preceding clauses (a) or (b) as a result of a contractual obligation to any other Person or of transferee, successor or secondary liability.

Tax Law means all Applicable Laws with respect to Taxes.

Tax Return means any report, return, estimate, election, designation, form, document, declaration or other information (including any attached schedules and any amendments to such report, return, document, declaration or other information) required to be supplied to or filed with any Tax Authority with respect to any Tax, including an information return and any document with respect to or accompanying payments, deposits or estimated Taxes, or with respect to or accompanying requests for the extension of time in which to file any such report, return, document, declaration or other information.

Third Party means a Person other than any of the Grey Wolf Companies or any of the Precision Companies.

Treasury Regulations means the regulations promulgated by the United States Treasury Department under the Code.

TSX means the Toronto Stock Exchange.

U.S. means the United States of America.

U.S. GAAP means generally accepted accounting principles, as recognized by the U.S. Financial Accounting Standards Board (or any generally recognized successor) applied on a consistent basis.

Uncertificated Shares means shares of Grey Wolf Common Stock that are held in book-entry form.

Term	Section
Acquisition Agreement	Section 5.5(c)(ii)
Acquisition Proposal Recommendation	Section 5.5(c)(ii)
Adverse Recommendation Change	Section 5.5(c)(ii)
Agreement	Preamble

Term	Section
Junior Preferred Stock	Section 3.3(a)
Letter of Transmittal	Section 2.9(b)
Lobos	Preamble
Lobos Bylaws	Section 2.3
Lobos Charter	Section 2.3
Lobos Charter Documents	Section 2.3
Mailing Date	Section 2.7(a)
Merger	Section 2.1(a)
Merger Consideration	Section 2.6(a)
No Election Available Cash	Section 2.6(a)(iv)(2)(B)
No Election Shares	Section 2.7(b)
No Election Value	Section 2.6(a)(iv)(2)(B)
Notification and Report Forms	Section 3.6(b)
Optionholder	Section 2.6(d)(vi)
Parties	Recitals
Party	Recitals
PDC	Preamble
PDC Board	Section 2.4(a)
PDC Charter Documents	Section 4.1
Per Share Unit Consideration	Section 2.6(a)(i)
Precision	Preamble
Precision Disclosure Letter	Preamble to Article IV
Precision Financial Statements	Section 4.7(a)
Precision Information	Section 5.4(a)
Precision Material Contracts	Section 4.17
Precision Permits	Section 4.5(b)
Precision Regulatory Filings	Section 4.6(b)
Precision Reports	Section 4.7(a)
Precision Revised Offer	Section 5.5(e)(ii)
Precision Voting Debt	Section 4.3(b)
Regulatory Filings	Section 5.9(a)
Related Documents	Section 3.2(a)
Required Grey Wolf Vote	Section 3.19
Surviving Corporation	Section 2.1(a)
TBCA	Recitals
TCL	Recitals
Termination Date	Section 7.1(b)(i)
Unit Election Shares	Section 2.7(b)

Section 1.2 References and Titles.

(a) All references in this Agreement to Exhibits, Schedules, Articles, Sections, subsections and other subdivisions refer to the corresponding Exhibits, Schedules, Articles, Sections, subsections and other subdivisions of or to this Agreement, unless expressly provided otherwise. Titles appearing at the beginning of any Articles, Sections, subsections or other subdivisions of this Agreement are for convenience only, do not constitute any part of this Agreement, and shall be disregarded in construing the language hereof. The words this Agreement, herein, hereby, hereunder and hereof, and words of similar import, refer to this Agreement as a whole and not to any particular Article, Section, subsection or subdivision unless expressly so limited. The words this Article and this Section, and words of similar import, refer only to the Article, Section or subsection hereof in which such words occur.

(b) The word or is not exclusive, and the word including (in its various forms) means including without limitation. Pronouns in masculine, feminine or neuter genders shall be construed to state and include any other gender, and words, terms and titles (including terms defined herein) in the singular form shall be construed to include the plural and vice versa, unless the context otherwise requires.

(c) As used in the representations and warranties contained in this Agreement, the phrase to the knowledge of the representing Party or known to a representing Party shall mean to the actual knowledge (and not constructive or imputed knowledge) of one or more of the Responsible Officers of the representing Party.

(d) The Parties have participated jointly in negotiating and drafting this Agreement. In the event an ambiguity or a question of intent or interpretation arises, this Agreement shall be construed as if drafted jointly by the Parties, and no presumption or burden of proof shall arise favoring or disfavoring any Party by virtue of the authorship of any provision(s) of this Agreement.

(e) All references to dollar or $ shall mean U.S. dollars.

ARTICLE II
THE MERGER

Section 2.1 The Merger.

(a) *The Merger*. Upon the terms and subject to the terms and conditions set forth in this Agreement, at the Effective Time, Grey Wolf shall be merged with and into Lobos (the *Merger*) in accordance with the provisions of this Agreement, and the separate corporate existence of Grey Wolf shall thereupon cease. Lobos shall be the surviving corporation in the Merger and, after the Merger, Lobos shall be referred to from time to time herein as the *Surviving Corporation*. The Merger shall have the effects specified herein, in the TBCA and in the TCL.

(b) *Filings for the Merger; Effective Time*. As soon as practicable following the satisfaction or waiver (subject to Applicable Laws) of the conditions set forth in this Agreement, at the Closing, the Parties hereto shall cause a properly executed certificate of merger and articles of merger meeting the requirements of Article 5.04 of the TBCA and Section 10.151 of the TCL (the *Certificate of Merger*) to be filed in accordance therewith. The Merger shall become effective (the *Effective Time*) upon the issuance of the Certificate of Merger under the TBCA and the acceptance of the filing of the

Certificate of Merger under the TCL, in each case by the Secretary of State of the State of Texas, or at such time thereafter as is agreed to by Precision and Grey Wolf and provided in such Certificate of Merger.

Section 2.2 Closing. Subject to the terms and conditions of this Agreement, the closing of the Merger (the *Closing*) shall take place (a) at the offices of Mayer Brown LLP, 700 Louisiana, Suite 3400, Houston Texas as soon as practicable after 10:00 A.M., local time, on the first Business Day immediately following the day on which all of the conditions set forth in Article VI have been satisfied or waived (by the party entitled to waive the condition) (except for those conditions that by their nature cannot be satisfied until the Closing, but subject to the satisfaction or waiver of those conditions) or (b) at such other time, date or place as Precision and Grey Wolf may agree in writing. The date on which the Closing occurs is hereinafter referred to as the *Closing Date.*

Section 2.3 Governing Instruments of the Surviving Corporation. At the Effective Time, the certificate of formation of Lobos shall be in the form set forth on Exhibit 2.3(a) (the *Lobos Charter*), and shall remain the certificate of formation of the Surviving Corporation until thereafter amended as provided by the TCL and the Lobos Charter. At the Effective Time, the bylaws of the Surviving Corporation shall be in the form set forth on Exhibit 2.3(b) (the *Lobos Bylaws,* and together with the Lobos Charter, the *Lobos Charter Documents*), and shall remain the bylaws of Lobos until thereafter amended as provided by the TCL and the Lobos Charter Documents.

Section 2.4 Directors of the Surviving Corporation and PDC.

(a) The board of directors of Lobos immediately prior to the Effective Time shall continue to be the board of directors of the Surviving Corporation from the Effective Time until their respective successors have been duly elected or appointed.

(b) At the Effective Time, the board of directors of PDC (the *PDC Board*) shall consist of twelve members that Precision and PDC shall cause to be comprised of three current members of the Grey Wolf Board designated by Grey Wolf (each a *Grey Wolf Designated Director*), after consultation with Precision and before mailing of the Proxy Statement/Prospectus.

(c) If prior to the Effective Time, any Grey Wolf Designated Director is unwilling or unable to serve (or to continue to serve) as a director of PDC as a result of illness, death, resignation or any other reason, then, any replacement for such Person shall be selected by the Grey Wolf Board, after consultation with Precision, and such replacement shall constitute a Grey Wolf Designated Director.

(d) At the Effective Time, one Grey Wolf Designated Director shall become a member of the Audit Committee, a second Grey Wolf Designated Director shall become a member of the Nominating and Corporate Governance Committee and a third Grey Wolf Designated Director shall become a member of the Compensation Committee of the PDC Board, as determined by the Nominating and Governance Committee of the PDC Board in light of the requirements of the PDC Board and the committees of the PDC

Board, the qualifications and experience of the Grey Wolf Designated Directors, the recommendations of Grey Wolf and the requirements of Applicable Canadian Securities Laws, the TSX and the NYSE.

(e) Precision shall ensure that appropriate steps are taken by the general partner of PDLP, on behalf of PDLP, to nominate the Grey Wolf Designated Directors for election to the PDC Board at the first annual meeting of the holders of Precision Trust Units held following the Closing Date.

Section 2.5 Certain Officers of the Surviving Corporation. At the Effective Time, the individuals listed on Exhibit 2.5 hereto shall have the executive officer positions with the Surviving Corporation set forth opposite their respective names, and each such executive officer shall serve until such executive officer s successor shall be elected and qualified or such executive officer s earlier death, resignation, retirement, disqualification or removal. If, at or before the Effective Time, any such Person is unable or unwilling to serve as an executive officer of the Surviving Corporation in the capacity set forth on Exhibit 2.5, then a substitute executive officer shall be selected by the board of directors of the Surviving Corporation after the Effective Time.

Section 2.6 Effect on Grey Wolf Equity Securities.

(a) *Grey Wolf Common Stock*. At the Effective Time, subject to the provisions of this Article II, each share of Grey Wolf Common Stock issued and outstanding immediately prior to the Effective Time, or that is deemed to be issued and outstanding immediately prior to the Effective Time under the terms of the Grey Wolf Senior Notes Indentures in connection with the conversion procedures for the Grey Wolf Convertible Notes, and the Grey Wolf Options (other than Grey Wolf Dissenting Shares and shares of Grey Wolf Common Stock to be cancelled without payment of any consideration therefor pursuant to Section 2.6(c)), shall represent the right to receive the following consideration (collectively, the *Merger Consideration*):

(i) each Unit Election Share shall be converted into the right to receive the number of Precision Trust Units equal to the Exchange Ratio (the *Per Share Unit Consideration*), subject to adjustment in accordance with this Section 2.6(a) and Section 2.10;

(ii) each Cash Election Share shall be converted into the right to receive the Per Share Cash Consideration in cash, without interest, subject to adjustment in accordance with this Section 2.6(a) and Section 2.10;

(iii) each No Election Share shall be converted into the right to receive the Per Share Unit Consideration and/or the Per Share Cash Consideration in cash, without interest, as provided in this Section 2.6(a) below, subject to adjustment in accordance with Section 2.10;

(iv) Notwithstanding the foregoing, if:

(1) the sum of (i) the product of (x) the total number of Cash Election Shares and (y) the Per Share Cash Consideration (such product being the *Elected Cash Consideration*) that would be paid upon conversion of the Cash Election Shares in the Merger plus (ii) the product of (x) the total number of Grey Wolf Dissenting Shares and (y) the Per Share Cash Consideration (the *Dissenting Cash Consideration*) exceeds the Available Cash Consideration, then:

(A) each Unit Election Share and each No Election Share shall be converted into the right to receive the Per Share Unit Consideration; and

(B) each Cash Election Share shall be converted into the right to receive (i) an amount of cash (without interest) equal to the product of (w) the Per Share Cash Consideration multiplied by (x) a fraction, the numerator of which shall be the difference between the Available Cash Consideration and the Dissenting Cash Consideration and the denominator of which shall be the Elected Cash Consideration (the fraction described in this clause (x) being referred to as the *Cash Fraction*) and (ii) a number of Precision Trust Units equal to the product of (y) the Exchange Ratio multiplied by (z) one (1) minus the Cash Fraction; or

(2) the sum of the Elected Cash Consideration and the Dissenting Cash Consideration is less than the Available Cash Consideration, then:

(A) each Cash Election Share shall be converted into the right to receive the Per Share Cash Consideration;

(B) if (a) the product of (x) the number of No Election Shares plus the number of the Notes Shares and (y) the Per Share Cash Consideration (the *No Election Value*) equals or exceeds (b) the difference between the Available Cash Consideration and the sum of the Elected Cash Consideration and the Dissenting Cash Consideration (the *No Election Available Cash*), then (i) on a pro rata basis, a number of No Election Shares equal to (1) the No Election Available Cash divided by the Per Share Cash Consideration multiplied by (2) a fraction the numerator of which shall be the number of No Election Shares and the denominator of which shall be the number of No Election Shares plus the number of Notes Shares shall each be converted into the right to receive the Per Share Cash Consideration, with the remainder of the No Election Shares each being converted into the right to receive the Per Share Unit Consideration and (ii) each Unit Election Share shall be converted into the right to receive the Per Share Unit Consideration; and

(C) if the No Election Value is less than the No Election Available Cash, then (i) each No Election Share shall be converted into the right to receive the Per Share Cash Consideration and (ii) each Unit Election Share shall be converted into the right to receive (a) an amount of cash (without interest) equal to (x) the difference between the No Election Available Cash and the No Election Value divided by (y) the number of Unit Election Shares and (b) a number of Precision Trust Units equal to the product of (x) the Exchange Ratio and (y) one (1) minus the fraction determined by dividing the amount of cash determined pursuant to the preceding clause (a) by the Per Share Cash Consideration.

(3) the sum of the Elected Cash Consideration and the Dissenting Cash Consideration equals the Available Cash Consideration, then:

(A) each Cash Election Share shall be converted into the right to receive the Per Share Cash Consideration; and

(B) each Unit Election Share and No Election Share shall be converted into the right to receive the Per Share Unit Consideration; and

(v) notwithstanding the definition of Available Cash Consideration, Precision shall have the option, in its sole discretion, to increase the amount of the Available Cash Consideration to any amount up to and including the amount of the sum of the Elected Cash Consideration and the Dissenting Cash Consideration plus the product of (1) the No Election Shares and (2) the Per Share Cash Consideration; provided that Precision may not increase the Available Cash Consideration to an amount that, in the reasonable opinion of counsel to Precision and counsel to Grey Wolf, would cause such counsel to be unable to render the opinions described in Section 6.2(d) and Section 6.3(d), respectively.

(b) From and after the Effective Time, the Grey Wolf Common Stock converted into the Merger Consideration pursuant to this Article II shall no longer remain outstanding and shall automatically be cancelled and shall cease to exist, and each holder of a Certificate previously representing any such Grey Wolf Common Stock or Uncertificated Shares shall thereafter cease to have any rights with respect to such securities, except the right to receive (i) the Merger Consideration to which such holder may be entitled pursuant to this Section 2.6, (ii) any dividends and other distributions in accordance with Section 2.9(c) and (iii) any cash to be paid in lieu of any fractional Precision Trust Units in accordance with Section 2.9(e).

(c) *Grey Wolf Treasury Stock*. At the Effective Time, all shares of Grey Wolf Common Stock that are held immediately prior to the Effective Time by Grey Wolf or any of the Grey Wolf Subsidiaries shall be cancelled and no payment shall be made in respect thereof.

(d) *Grey Wolf Stock Options*.

(i) All holders of Grey Wolf 1996 Options will be given the opportunity to exercise any such options, to the extent that the option is outstanding, for a reasonable period which is at least 10 days prior to the Effective Time. Any such holder who exercises an outstanding Grey Wolf 1996 Option prior to the Effective Time shall be eligible to participate in the Merger as a holder of record of Grey Wolf Common Stock in accordance with Section 2.7 and the other terms and conditions of this Agreement. Any Grey Wolf 1996 Options that are outstanding as of the Effective Time shall be terminated as of the Effective Time such that, as of the Effective Time, no Grey Wolf 1996 Options shall be outstanding. Grey Wolf shall provide notice of the termination to each holder of a Grey Wolf 1996 Option and shall take all actions necessary to effect such termination. For purposes of this Agreement, *Grey Wolf 1996 Options* means options to acquire shares of Grey Wolf Common Stock identified in Section 3.3(b) of the Grey Wolf Disclosure Letter that (A) were issued under the Grey Wolf 1996 Stock Plan or (B) that are nonqualified stock options issued pursuant to agreements with non-employee directors and not issued under either Grey Wolf Stock Plan.

(ii) All options to acquire shares of Grey Wolf Common Stock (A) identified in Section 3.3(b) of the Grey Wolf Disclosure Letter that were issued under the Grey Wolf 2003 Stock Plan, (B) that are issued after the date hereof under the Grey Wolf 2003 Stock Plan or (C) that are otherwise issued after the date hereof, only if issued in accordance with Section 5.2(d) (collectively, the *Grey Wolf 2003 Options*) shall, in each case set forth in clauses (A), (B) and (C) of this paragraph, to the extent they are outstanding as of the Effective Time, be converted into Precision Unit Appreciation Rights pursuant to the terms of Section 2.6(d)(iii). Holders of Grey Wolf 2003 Options who exercise outstanding Grey Wolf 2003 Options prior to the Effective Time shall be eligible to participate in the Merger as a holder of record of Grey Wolf Common Stock in accordance with Section 2.7 and the other terms and conditions of this Agreement.

(iii) Grey Wolf 2003 Options that are not exercised prior to the Effective Time pursuant to Section 2.6(d)(ii) and that remain outstanding as of the Effective Time shall be converted into Precision Unit Appreciation Rights pursuant to this Section 2.6(d)(iii). Each Precision Unit Appreciation Right into which an outstanding Grey Wolf 2003 Option is converted (A) shall be subject to the same term and vesting schedule as applied to the corresponding Grey Wolf 2003 Option; (B) shall be settled in cash; (C) shall have an exercise price per unit equal to the exercise price per share of Grey Wolf Common Stock applicable under the corresponding Grey Wolf 2003 Option immediately prior to the Effective Time divided by the Exchange Ratio (the exercise price per unit determined by the foregoing being rounded up to the nearest whole cent); and (D) shall apply to that number of Precision Trust Units equal to the number of shares of Grey Wolf Common Stock subject to the corresponding Grey Wolf 2003 Option as of the Effective Time multiplied by the Exchange Ratio (rounded down to the nearest whole unit). Precision shall establish a plan pursuant to which the Precision Unit Appreciation Rights will be issued, which plan shall include terms and conditions that are substantially similar in all material respects to the terms and conditions of the Grey Wolf 2003 Stock Plan as applied to the Grey Wolf 2003 Options taking into account the provisions of this Section 2.6(d)(iii) and the difference in the nature of the awards. Precision shall take all necessary actions to ensure that the plan is effective as of the Effective Time. It is intended that the conversion of Grey Wolf 2003 Options into Precision Unit Appreciation Rights shall be effected in a manner which is consistent with sections 424(a) and 409A of the Code and such conversion shall be effected in such manner, including a reasonable good faith interpretation by Precision of guidance under section 409A that the Precision Trust Units constitute service recipient stock within the meaning of section 409A and applicable guidance, and the provisions of this Section 2.6(d) shall be interpreted accordingly.

(iv) As soon as practicable following the Effective Time, Precision shall deliver to the holders of Grey Wolf 2003 Options to be converted into Precision Unit Appreciation Rights pursuant to this Section 2.6(d) appropriate notices setting forth such holders rights with respect to such Precision Unit Appreciation Rights and the agreements evidencing the grants of such Precision Unit Appreciation Rights effective as of the Effective Time.

(v) From and after the date of this Agreement, Grey Wolf and the Grey Wolf Subsidiaries shall not take any action to provide for (A) the acceleration of the exercisability of any Grey Wolf Option in connection with the Merger or otherwise, unless such acceleration is already provided for under the terms of such Grey Wolf Options or change in control agreements in existence on the date of this Agreement, or (B) the extension of the term or period of exercise of any Grey Wolf Option.

(vi) The holders of outstanding Grey Wolf Options (each an *Optionholder*) shall be given the ability to elect to exercise Grey Wolf Options contingent on the transactions contemplated by this Agreement. If an Optionholder elects to exercise a Grey Wolf Option contingent on the transactions contemplated by this Agreement, at the Optionholder s election, any Merger Consideration to which such Optionholder is otherwise entitled under this Agreement shall be reduced by the sum of (A) the aggregate exercise price of the Grey Wolf Options that are so exercised, and (B) the amount of any withholding taxes attributable to the such exercise, with any such reduction first being made from any Merger Consideration payable in cash and, if such cash Merger Consideration is not sufficient to satisfy the obligations, from any Merger Consideration payable in Precision Trust Units. Grey Wolf shall use commercially reasonable best efforts to encourage each holder of Grey Wolf Options who intends to exercise Grey Wolf Options prior to the Effective Time to deliver a notice of option exercise to Grey Wolf at least two Business Days prior to the Effective Time.

(e) *Grey Wolf Restricted Stock*. At the Effective Time, each share of Grey Wolf Restricted Stock that is outstanding immediately prior to the Effective Time shall vest in full and the restrictions thereon shall lapse, and, as of the Effective Time, each share of Grey Wolf Common Stock that was formerly Grey Wolf Restricted Stock shall be entitled to receive the Merger Consideration determined in accordance with Section 2.6 based on the holder s election in accordance with Section 2.7; provided, however, that, upon the lapsing of restrictions with respect to each share of Grey Wolf Restricted Stock, Grey Wolf shall be entitled to deduct and withhold such amounts as may be required to be deducted and withheld under the Code and any applicable state or local Tax Law with respect to the lapsing of such restrictions.

(f) *Grey Wolf Dissenting Shares.* Grey Wolf Dissenting Shares shall not be converted into or represent the right to receive any Merger Consideration, but instead shall represent only the right to receive the amount determined pursuant to the provisions of Article 5.12 of the TBCA. At the Effective Time, any Grey Wolf Dissenting Shareholder shall not thereafter be entitled to vote or exercise any other rights of a shareholder except the right to receive payment for such Grey Wolf Dissenting Shareholder s Grey Wolf Dissenting Shares in accordance with Article 5.12 of the TBCA. If a Grey Wolf Dissenting Shareholder has so failed to perfect or lost his right to receive, or has effectively withdrawn his demand for, the amount determined under Article 5.12 of the TBCA, the shares of Grey Wolf Common Stock held by such holder shall cease to be Grey Wolf Dissenting Shares and shall entitle such holder to receive the Merger Consideration in respect of such shares as received by the No Election Shares pursuant to Section 2.6(a), and promptly following the occurrence of such event and upon the surrender of the Certificate(s) representing such shares, the Exchange Agent and the Surviving Corporation shall deliver to such holder the Merger Consideration in respect of such shares. Grey Wolf shall comply with those provisions of Article 5.12 of the TBCA which are required to be performed by Grey Wolf prior to the Effective Time to the reasonable satisfaction of Precision. Grey Wolf shall give Precision (i) prompt notice of any written demands to exercise dissenter s rights and (ii) an opportunity to participate at its own expense in all negotiations and proceedings with respect to demands for fair value under the TBCA. Grey Wolf shall not, except with the prior written consent of Precision (such consent not to be unreasonably withheld, conditioned or delayed), voluntarily make any payment with respect to demands for fair value under the TBCA or offer to settle or settle any such claims.

Section 2.7 Election Procedures.

(a) Not less than thirty (30) days prior to the anticipated Effective Time (the *Mailing Date*), an election form in such form as Precision shall specify and as shall be reasonably acceptable to Grey Wolf (the *Election Form*) shall be mailed to each holder of record of shares of Grey Wolf Common Stock as of five (5) Business Days prior to the Mailing Date (the *Election Form Record Date*) and Grey Wolf Derivative Security Holders with respect to Grey Wolf Derivative Securities that have not been exercised or converted, as applicable, as of the Election Form Record Date and which are exercisable prior to the Effective Time.

(b) Each Election Form shall permit the holder (or the Beneficial Owner through appropriate and customary documentation and instructions) of Grey Wolf Common Stock and each Grey Wolf Derivative Security Holder to specify (i) the number of shares of such holder s Grey Wolf Common Stock with respect to which such holder elects to receive the Per Share Unit Consideration (the *Unit Election Shares*), (ii) the number of shares of such holder s Grey Wolf Common Stock with respect to which such holder elects to receive the Per Share Cash Consideration (the *Cash Election Shares*) or (iii) that such holder makes no election with respect to such holder s Grey Wolf Common Stock (the *No Election Shares*). Any Grey Wolf Common Stock with respect to which the Exchange Agent does not receive an effective, properly completed Election Form during the period from the Mailing Date to the Election Deadline (the *Election Period*) shall be deemed to be No Election Shares. Precision and Grey Wolf shall publicly announce the anticipated Election Deadline at least five (5) Business Days prior to the anticipated Effective Time. If the Effective Time is delayed to a subsequent date, the Election Deadline shall be similarly delayed to a subsequent date, and Precision shall promptly announce any such delay and, when determined, the rescheduled Election Deadline.

(c) Precision shall make available one or more Election Forms as may reasonably be requested from time to time by all Persons who become holders (or Beneficial Owners) of Grey Wolf Common Stock or Grey Wolf Stock Options during the Election Period, and Grey Wolf shall provide to the Exchange Agent all information reasonably necessary for it to perform as specified herein.

(d) Any election made pursuant to this Section 2.7 shall have been properly made only if the Exchange Agent shall have actually received a properly completed Election Form during the Election Period. Any Election Form may be revoked or changed by the Person submitting such Election Form, by written notice received by the Exchange Agent during the Election Period. In the event an Election Form is revoked during the Election Period, the shares of Grey Wolf Common Stock represented by such Election Form shall become No Election Shares, except to the extent (if any) a subsequent election is properly made during the Election Period with respect to any or all of such shares of Grey Wolf Common Stock. Subject to the terms of this Agreement and of the Election Form, the Exchange Agent shall have reasonable discretion to determine whether any election, revocation or change has been properly or timely made and to disregard immaterial defects in the Election Forms, and any good faith decisions of the Exchange Agent regarding such matters shall be binding and conclusive. None of Precision or Grey Wolf or the Exchange Agent shall be under any obligation to notify any Person of any defect in an Election Form.

Section 2.8 Effect on Grey Wolf Debt Securities. Effective as of the Effective Time, Surviving Corporation shall execute and deliver supplemental indentures whereby it shall agree to be bound by the conversion provisions of each of the Grey Wolf Senior Notes Indentures and take all other action necessary, such that following the Effective Time, each outstanding Grey Wolf Convertible Note will be convertible into the kind and amount of Merger Consideration, in accordance with Section 2.6 and Section 2.7, that a holder of such Grey Wolf Convertible Note would have had the right to receive had such Grey Wolf Convertible Note been converted into Grey Wolf Common Stock immediately prior to the Effective Time as No Election Shares. At or before the Effective Time, Grey Wolf shall comply with all other provisions of the Grey Wolf Senior Notes Indentures relating to the Merger and the assumption by the Surviving Corporation of the obligations under the Grey Wolf Senior Notes Indentures in connection with the Merger.

Section 2.9 Exchange of Certificates.

(a) Prior to the Effective Time, Precision shall appoint a bank or trust company reasonably satisfactory to Precision and Grey Wolf to act as exchange agent (the *Exchange Agent*). Precision shall deposit, or cause to be deposited with the Exchange Agent, for the benefit of the holders of shares of Grey Wolf Common Stock for exchange in accordance with this Article II, (i) Certificates representing the aggregate number of Precision Trust Units to be issued as Merger Consideration pursuant to Section 2.6(a) and Section 2.8 and delivered pursuant to this Section 2.9 in exchange for outstanding shares of Grey Wolf Common Stock (including shares of Grey Wolf Common Stock issued as a result of the exercise of Grey Wolf Stock Options prior to the Effective Time), the Grey Wolf Restricted Stock and the Grey Wolf Convertible Notes, (ii) cash in the aggregate amount of the cash portion of the Merger Consideration pursuant to Section 2.6(a) and Section 2.8, and (iii) when and as needed, Precision shall provide the Exchange Agent cash sufficient to pay cash in lieu of fractional Precision Trust Units (such cash and Certificates for Precision Trust Units, together with any dividends or distributions with respect thereto, being hereinafter referred to as the *Exchange Fund*).

(b) Promptly after the Effective Time, Precision shall cause the Exchange Agent to mail to each holder of shares of Grey Wolf Common Stock (including holders of shares of Grey Wolf Common Stock acquired as a result of the exercise of Grey Wolf

Stock Options prior to the Effective Time) and the Grey Wolf Restricted Stock: (i) a letter of transmittal (the *Letter of Transmittal*), which shall specify that delivery shall be effected, and risk of loss and title shall pass, only upon delivery of the Certificates or transfer of the Uncertificated Shares to the Exchange Agent and shall be in such form and have such other provisions as Precision may reasonably specify, and (ii) instructions for use in effecting the surrender of the Certificates or transfer of the Uncertificated Shares in exchange for Precision Trust Units, the cash portion of the Merger Consideration, any unpaid dividends and distributions on Precision Trust Units in accordance with this Section 2.9 and cash in lieu of fractional Precision Trust Units in accordance with this Section 2.9. Upon surrender of a Certificate or transfer of the Uncertificated Shares for cancellation to the Exchange Agent together with such Letter of Transmittal, duly executed and completed in accordance with the instructions thereto, the holder of such Grey Wolf Common Stock or Grey Wolf Restricted Stock shall be entitled to receive in exchange therefor (A) Precision Trust Units, and (B) a check representing the amount of cash (including the cash portion of the Merger Consideration and cash in lieu of fractional units, if any), and unpaid dividends and distributions (if any), which such holder has the right to receive pursuant to the provisions of this Article II, after giving effect to any required withholding tax and other reductions, and, if applicable, the Certificate so surrendered shall forthwith be cancelled. No interest will be paid or accrued on the cash portion of the Merger Consideration, cash in lieu of fractional shares and unpaid dividends and distributions, if any, payable to holders of Grey Wolf Common Stock. In the event of a transfer of ownership of Grey Wolf Common Stock that is not registered in the transfer records of Grey Wolf, the proper number of Precision Trust Units, together with a check for the cash portion of the Merger Consideration, as the case may be, and cash to be paid in lieu of fractional units and unpaid dividends and distributions (if any), may be issued to such a transferee if the Certificate or Uncertificated Share representing such Grey Wolf Common Stock is presented to the Exchange Agent, accompanied by all documents required to evidence and effect such transfer and to evidence that any applicable stock transfer taxes have been paid. The Precision Trust Units constituting part of the Merger Consideration shall be certificated.

(c) Notwithstanding any other provisions of this Agreement, no dividends or other distributions declared or made after the Effective Time with respect to Precision Trust Units with a record date after the Effective Time shall be paid to the holder of any unsurrendered Certificate or any Uncertificated Shares not transferred with respect to the Precision Trust Units issuable upon surrender of such Certificate or transfer of such Uncertificated Share as a result of the conversion provided in this Article II until such Certificate is surrendered or Uncertificated Share is transferred as provided herein. Following such surrender or transfer, there shall be paid, without interest, to the Person in whose name such Precision Trust Units have been registered, (i) promptly after the time of such surrender or transfer, the amount of any cash payable in lieu of fractional Precision Trust Units to which such Person is entitled pursuant to this Section 2.9 and the amount of all dividends or other distributions with a record date after the Effective Time and paid prior to the time of such surrender or transfer with respect to such Precision Trust Units, and (ii) at the appropriate payment date, the amount of all dividends or other distributions with a record date after the Effective Time and prior to the time of such surrender or transfer and with a payment date subsequent to the time of such surrender or transfer payable with respect to such Precision Trust Units.

(d) After the Effective Time there shall be no transfers on the stock transfer books of Grey Wolf of the shares of Grey Wolf Common Stock which were outstanding immediately prior to the Effective Time. If, after the Effective Time, Certificates or Uncertificated Shares are presented to Precision, the presented Certificates or Uncertificated Shares shall be cancelled and exchanged for Precision Trust Units, the cash portion of the Merger Consideration, and cash in lieu of fractional units and unpaid dividends or distributions, if any, deliverable in respect thereof pursuant to this Agreement in accordance with the procedures set forth in this Article II.

(e) No fractional Precision Trust Units shall be issued pursuant to this Agreement. All fractional Precision Trust Units that a holder of shares of Grey Wolf Common Stock would otherwise be entitled to receive as a result of the Merger shall be aggregated and if a fractional share results from such aggregation, such holder shall be entitled to receive, in lieu thereof, an amount in cash without interest equal to such fraction of a Precision Trust Unit multiplied by the closing sale price of a Precision Trust Unit on the NYSE on the trading day immediately preceding the Effective Time.

(f) Any portion of the Exchange Fund (including the proceeds of any investments thereof and any Certificates for Precision Trust Units) that remains undistributed to the former shareholders of Grey Wolf one year after the Effective Time shall be delivered to Precision. Any former shareholders of Grey Wolf who have not theretofore complied with this Section 2.9 shall thereafter look only to Precision for their Precision Trust Units, their cash portion of the Merger Consideration, and cash in lieu of fractional Precision Trust Units and for any unpaid dividends and distributions, if any, on the Precision Trust Units deliverable to such former shareholder pursuant to this Agreement.

(g) None of Precision, Grey Wolf, the Exchange Agent or any other Person shall be liable to any Person for any portion of the Exchange Fund properly delivered to a public official pursuant to applicable abandoned property, escheat or similar laws.

(h) In the event any Certificate shall have been lost, stolen or destroyed, upon the making of an affidavit of that fact by the Person claiming such Certificate to be lost, stolen or destroyed and, if required by Precision, the posting by such Person of a bond in such reasonable amount as Precision may direct as indemnity against any claim that may be made against it with respect to such Certificate, the Exchange Agent will issue in exchange for such lost, stolen or destroyed Certificate, Precision Trust Units, the cash portion of the Merger Consideration, and cash in lieu of fractional Precision Trust Units and unpaid dividends and distributions, if any, on the Precision Trust Units, as provided in this Section 2.9, deliverable in respect thereof pursuant to this Agreement.

(i) If any portion of the cash portion of the Merger Consideration is to be paid to a Person other than the Person in whose name the surrendered Certificate is registered, it shall be a condition to such payment that (i) either such Certificate shall be properly endorsed or shall otherwise be in proper form for transfer and (ii) the Person requesting such payment shall pay to the Exchange Agent any transfer or other Taxes required as a result of such payment to a Person other than the registered holder of such Certificate or establish to the satisfaction of the Exchange Agent that such Tax has been paid or is not payable.

Section 2.10 Adjustment of Exchange Ratio. If, between the date of this Agreement and the Effective Time (and in each case, only as permitted by Section 5.2), the outstanding shares of Grey Wolf Common Stock or the outstanding Precision Trust Units shall have been increased, decreased, changed into or exchanged for a different number of shares or units or different class, in each case, by reason of any reclassification, recapitalization, stock or unit split, split-up, combination or exchange of shares or units or a stock or unit dividend or distribution or dividend or distribution payable in other securities shall be declared with a record date within such period, or any similar event shall have occurred, the Merger Consideration (and as a result, the Exchange Ratio, the Per Share Unit Consideration, the Per Share Cash Consideration and any other similarly depending items) shall be appropriately adjusted to provide to the holders of Grey Wolf Common Stock the same economic effect as contemplated by this Agreement prior to such event.

Section 2.11 Withholding. Each of Precision and the Exchange Agent shall be entitled to deduct and withhold from the consideration otherwise payable pursuant to this Agreement to any Person pursuant to this Article II such amounts as are required to be deducted or withheld under the Code, the Income Tax Act or any provision of state, local or foreign Tax Law with respect to the making of such payment (including withholding Precision Trust Units). Any such withheld amounts shall be treated for all purposes of this Agreement as having been paid to such Person in respect of whom such deduction and withholding was made.

ARTICLE III
REPRESENTATIONS AND WARRANTIES OF GREY WOLF

As an inducement for Precision, PDC and Lobos to enter into this Agreement, Grey Wolf hereby makes the following representations and warranties to Precision, PDC and Lobos; provided, however, that such representations and warranties shall be subject to and qualified by: (a) the disclosure letter delivered by Grey Wolf to Precision as of the date hereof (each section of which qualifies the correspondingly numbered representation and warranty or covenant to the extent specified therein) (the *Grey Wolf Disclosure Letter*) (it being understood that (i) the disclosure of any fact or item in any section of the Grey Wolf Disclosure Letter shall, should the existence of such fact or item be relevant to any other section, be deemed to be disclosed with respect to that other section to the extent that such disclosure is made in a manner that makes its relevance to the other section reasonably apparent and (ii) the disclosure of any matter or item in the Grey Wolf Disclosure Letter shall not be deemed to constitute an acknowledgement that such matter or item is required to be disclosed therein or is material to a representation or warranty set forth in this Agreement and shall not be used as a basis for interpreting the terms *material*, *materially*, *materiality*, *Grey Wolf Material Adverse Effect* or any word or phrase of similar import and does not mean that such matter or item, alone or together with any other matter or item, would constitute a Grey Wolf Material Adverse Effect); and (b) information contained in the Grey Wolf Reports (excluding any exhibits thereto and excluding disclosures under *Risk Factors* and other forward-looking or predictive statements) filed with the SEC prior to the date hereof (but only to the extent that such disclosure on its face appears to constitute information that would reasonably be deemed a qualification or exception to the following representations and warranties).

Section 3.1 Corporate Existence; Good Standing; Corporate Authority. Grey Wolf is a corporation duly incorporated, validly existing and in good standing under the Applicable Laws of the State of Texas. Grey Wolf is duly qualified to conduct business and is in good standing (to the extent such concept exists in the relevant jurisdiction) in each jurisdiction in which the ownership, operation or lease of its property or the nature of Grey Wolf s business requires such qualification, except for jurisdictions in which any failures to be so qualified or to be in good standing, individually or in the aggregate, have not had or caused and would not reasonably be expected to have or cause a Grey Wolf Material Adverse Effect. Grey Wolf has all requisite corporate power and authority to own or lease and operate its properties and assets and to carry on its business as it is currently being conducted. Grey Wolf has delivered to Precision true, accurate and complete copies of the Amended and Restated Articles of Incorporation (including any and all Certificates of Designations), as amended to date (the *Grey Wolf Charter*), and the Amended and Restated Bylaws of Grey Wolf, as amended to date (the *Grey Wolf Bylaws*, and together with the Grey Wolf Charter, the *Grey Wolf Charter Documents*), and each Grey Wolf Charter Document is in full force and effect, has not been amended or modified and has not been terminated, superseded or revoked. Grey Wolf is not in violation of the Grey Wolf Charter Documents.

Section 3.2 Authorization, Validity and Effect of Agreements.

(a) Grey Wolf has the requisite corporate power and authority to execute and deliver this Agreement and all other agreements, instruments, certificates and documents contemplated hereunder (collectively, the *Related Documents*) to which it is, or will become, a party, to perform its obligations hereunder and thereunder and to consummate the Merger and all other transactions contemplated hereunder and thereunder, subject to the approval of the Grey Wolf Proposal by Grey Wolf s shareholders. The execution, delivery and performance of this Agreement and the Related Documents and the consummation of the Merger and the other transactions contemplated hereunder and thereunder have been duly authorized by all requisite corporate action on behalf of Grey Wolf, and no other corporate proceedings by Grey Wolf are necessary to authorize the execution and delivery of this Agreement or the Related Documents or to consummate the Merger and the other transactions contemplated hereunder or under the Related Documents, except for the approval of the Grey Wolf Proposal by Grey Wolf s shareholders, the filing of the Certificate of Merger pursuant to the TBCA and the TCL and the Governmental Authority applications and approvals described in Section 3.6(b).

(b) This Agreement and each of the Related Documents to which Grey Wolf is a party have been or will be duly executed by Grey Wolf and, assuming the due authorization, execution and delivery hereof and thereof by Precision and Lobos to the extent a party hereof and thereof, constitute the valid and legally binding obligations of Grey Wolf, enforceable against Grey Wolf in accordance with their terms, subject to applicable bankruptcy, insolvency, reorganization, moratorium or other Applicable Laws relating to or affecting the rights and remedies of creditors generally and to general principles of equity (regardless of whether considered in a proceeding in equity or at law). Grey Wolf has taken all action necessary to render the restrictions set forth in Article 13.03 of the TBCA inapplicable to this Agreement and the transactions contemplated hereby.

Section 3.3 Capitalization.

(a) The authorized capital stock of Grey Wolf consists of 500,000,000 shares of Grey Wolf Common Stock and 1,000,000 shares of Grey Wolf Preferred Stock, 200,000 shares of which have been designated as Grey Wolf Convertible Redeemable Preferred Stock and 250,000 shares of which have been designated as Series B Junior Participating Preferred Stock (the *Junior Preferred Stock*). As of the close of business on August 21, 2008, there were 198,271,783 issued and outstanding shares of Grey Wolf Common Stock (including 2,683,067 shares of Grey Wolf Restricted Stock), 19,333,954 shares of Grey Wolf Common Stock held by Grey Wolf in its treasury, and no issued or outstanding shares of Grey Wolf Preferred Stock. The shareholders of Grey Wolf previously approved a 1996 Employee Stock Option Plan, as amended (the *Grey Wolf 1996 Plan*), and a 2003 Incentive Plan, as amended (the *Grey Wolf 2003 Plan*). As of August 21, 2008, 680,560 shares of Grey Wolf Common Stock were reserved for future issuance pursuant to outstanding Grey Wolf 1996 Options under the Grey Wolf 1996 Plan, 2,619,838 shares of Grey Wolf Common Stock were reserved for future issuance pursuant to outstanding Grey Wolf 2003 Options granted under the Grey Wolf 2003 Plan, 700,500 shares of Grey Wolf Common Stock were reserved for future issuances pursuant to outstanding Grey Wolf Options not granted under a plan and 178,938 shares of Junior Preferred Stock were reserved for future issuance pursuant to that certain Rights Agreement between Grey Wolf and American Stock Transfer and Trust dated September 21, 1998 (the *Grey Wolf Rights Agreement*). Pursuant to the Grey Wolf Rights Agreement, each outstanding share of Grey Wolf Common Stock is accompanied by one Junior Preferred Stock Purchase Right (the *Grey Wolf Rights*) entitling the holder thereof to purchase, subject to the terms and conditions thereof, Equity Interests of Grey Wolf. As of August 21, 2008, there were no shares of Grey Wolf Common Stock remaining available for the grant of awards under Grey Wolf 1996 Plan and 5,412,524 shares of Grey Wolf Common Stock remaining available for the grant of awards under Grey Wolf 2003 Plan. There are no outstanding or authorized stock appreciation, phantom stock, profit participation or other similar rights with respect to Grey Wolf. All shares of Grey Wolf Common Stock are, and all shares of Grey Wolf Common Stock which may be issued and outstanding immediately prior to the Effective Time as permitted under this Agreement shall be when issued, duly authorized, validly issued, fully paid and nonassessable shares of Grey Wolf Common Stock and not subject to any preemptive rights.

(b) Grey Wolf has no outstanding bonds, debentures, promissory notes or other Indebtedness that are convertible into or exercisable for Equity Interests, except for Grey Wolf s 3.75% Contingent Convertible Senior Notes due 2023 (the *Grey Wolf 3.75% Notes*) and Grey Wolf s Floating Rate Contingent Convertible Senior Notes due

2024 (the *Grey Wolf Floating Rate Notes*, and together with the Grey Wolf 3.75% Notes, the *Grey Wolf Convertible Notes*). Grey Wolf has no outstanding bonds, debentures, promissory notes or other Indebtedness, the holders of which have the right to vote with the shareholders of Grey Wolf on any matter (collectively, the *Grey Wolf Voting Debt*). As of the date of this Agreement, except as set forth in this Section 3.3, Grey Wolf and the Grey Wolf Subsidiaries have not issued, sold, granted or delivered, are not obligated to issue, sell, grant or deliver (or to cause to be issued, sold, granted or delivered), and are not a party to any Contract or other obligation to issue, sell, grant or deliver, any Equity Interest (including, without limitation, any securities, options, warrants, calls, rights, commitments, agreements, arrangements or undertakings of any kind pursuant to which a Person is entitled to acquire an Equity Interest) or Grey Wolf Voting Debt of any nature or any additional shares of capital stock or any other Equity Interest in Grey Wolf or any Grey Wolf Subsidiary. Section 3.3(b) of the Grey Wolf Disclosure Letter sets forth a true, correct and complete list of all outstanding Grey Wolf Options and Grey Wolf Restricted Stock as of August 21, 2008, including grantee name and exercise price (if any). Except under the respective terms of Grey Wolf Convertible Notes and the Grey Wolf Rights, there are no outstanding or authorized (i) contractual or other obligations of Grey Wolf or any of the Grey Wolf Subsidiaries to repurchase, redeem or otherwise acquire any Equity Interest of Grey Wolf or any of the Grey Wolf Subsidiaries or any such securities or agreements referred to in the prior sentence or (ii) voting trusts or similar agreements to which Grey Wolf or any of the Grey Wolf Subsidiaries is a party with respect to the voting of the capital stock of Grey Wolf or any of the Grey Wolf Subsidiaries.

(c) Grey Wolf has received from each of the directors and executive officers of Grey Wolf set forth on Schedule A an executed voting agreement substantially in the form attached hereto as Exhibit 3.3 (the *Grey Wolf Voting Agreements*). Grey Wolf has delivered to Precision true, correct and complete executed copies of the Grey Wolf Voting Agreements.

Section 3.4 Subsidiaries.

(a) Each Grey Wolf Subsidiary is a corporation, limited partnership or other legal entity duly organized or constituted and validly existing under the Applicable Laws of its jurisdiction of incorporation, organization or formation. Each Grey Wolf Subsidiary has all requisite corporate, limited liability company, partnership or other business power and authority to own or lease and operate its properties and assets and to carry on its business as currently conducted, except (with respect to foreign Grey Wolf Subsidiaries only) as would have an immaterial effect on Grey Wolf and the Grey Wolf Subsidiaries, taken as a whole. Each Grey Wolf Subsidiary is duly qualified to conduct business and is in good standing (to the extent such concept exists in the relevant jurisdiction) in each jurisdiction in which the ownership or lease and operation of its property or the nature of its business requires such qualification, except for jurisdictions in which any failures to be so qualified or to be in good standing, individually or in the aggregate, have not had or caused and would not reasonably be expected to have or cause a Grey Wolf Material Adverse Effect. All of the outstanding shares of capital stock of, or other Equity Interests in, each Grey Wolf Subsidiary are duly authorized, validly issued, fully paid and nonassessable and are owned, directly or indirectly, by Grey Wolf (except for Equity Interests representing an immaterial ownership required under the Applicable Laws of any foreign jurisdiction to be owned by others), free and clear of all Liens, except for Permitted Liens and Liens granted under the Grey Wolf Credit Agreement.

(b) Section 3.4(b) of the Grey Wolf Disclosure Letter sets forth all Grey Wolf Subsidiaries and the percentage Equity Interest of such Grey Wolf Subsidiary held, directly or indirectly, by Grey Wolf. Grey Wolf s Subsidiaries are not in violation of their respective Grey Wolf Subsidiary Charter Documents.

Section 3.5 Compliance with Laws; Permits. Except for such matters that, individually or in the aggregate, have not had or caused and would not reasonably be expected to have or cause a Grey Wolf Material Adverse Effect, and except for (x) matters relating to Taxes, which are treated exclusively in Section 3.10, (y) matters relating to Grey Wolf Benefit Plans, which are treated exclusively under Section 3.11 and (z) matters arising under Environmental, Health and Safety Laws, which are treated exclusively in Section 3.13:

(a) Neither Grey Wolf nor any Grey Wolf Subsidiary is in violation of any Applicable Law relating to the ownership or operation of any of its assets or businesses, and no Claim is pending or, to the knowledge of Grey Wolf, threatened with respect to any such matters;

(b) Grey Wolf and each Grey Wolf Subsidiary hold all permits, licenses, certifications, variations, exemptions, Orders, franchises, registrations, filings, approvals, authorizations or other required grant of operating authority required by any Governmental Authority necessary for the conduct of their respective businesses (the *Grey Wolf Permits*). All Grey Wolf Permits are in full force and effect and there exists no default thereunder or breach thereof, and Grey Wolf has no notice or knowledge that such Grey Wolf Permits will not be renewed in the ordinary course after the Effective Time. No Governmental Authority has given, or to the knowledge of Grey Wolf, threatened to give, notice of any action to terminate, cancel or reform any Grey Wolf Permits; and

(c) Grey Wolf and each Grey Wolf Subsidiary possess all Grey Wolf Permits required for the present ownership or lease, as the case may be, and operation of all Grey Wolf Real Property, and there exists no default or breach with respect to, and no Person, including any Governmental Authority, has taken or, to the knowledge of Grey Wolf, threatened to take, any action to terminate, cancel or reform any such Grey Wolf Permit pertaining to Grey Wolf Real Property.

Section 3.6 No Conflict; Consents.

(a) Except as disclosed in Section 3.6(a) of the Grey Wolf Disclosure Letter, the execution and delivery by Grey Wolf of this Agreement and the Related Documents, the performance of the obligations of Grey Wolf hereunder and thereunder and the consummation by Grey Wolf of the Merger and the other transactions contemplated hereby and thereby in accordance with the terms hereof and thereof will not (i) conflict with or result in a breach of any provisions of the Grey Wolf Charter Documents, (ii) conflict with or result in a breach of any provisions of the Grey Wolf Subsidiary Charter Documents, (iii) violate, conflict with, result in a breach of any provision of, constitute a default (or an event which, with notice or lapse of time or both, would constitute a default) under, impair Grey Wolf s rights under, alter the rights or obligations of third parties under, result in the termination of or in a right of termination or cancellation of, give rise to a right of purchase under, or accelerate the performance required by, any Grey Wolf Material Contract or other Contract, (iv) result in the creation of any Lien (other than Permitted Liens) upon any of the properties or assets of Grey Wolf or the Grey Wolf Subsidiaries under any Grey Wolf Material Contract or by which Grey Wolf or the Grey Wolf Subsidiaries or any of their properties is bound or affected, (v) result in any Grey Wolf Material Contract being declared void, voidable, or without further binding effect, (vi) otherwise result in a detriment to Grey Wolf or any of the Grey Wolf Subsidiaries under any of the terms, conditions or provisions of any Grey Wolf Material Contract or other Contract by which Grey Wolf or any of the Grey Wolf Subsidiaries is bound or to which any of their properties is subject or (vii) (assuming that the consents and approvals referred to in Section 3.6(b) are duly and timely made or obtained and that the Grey Wolf Proposal is approved by the requisite vote of the Grey Wolf shareholders) contravene, conflict with or constitute a violation of any provision of any Applicable Law binding upon or applicable to Grey Wolf or any of the Grey Wolf Subsidiaries, other than, in the cases of clauses (ii) through (vii), any such violations, conflicts, breaches, defaults, impairments, alterations, terminations, cancellations, purchase rights, accelerations, Liens, voidings or detriments that, individually or in the aggregate, have not had or caused and would not reasonably be expected to have or cause a Grey Wolf Material Adverse Effect.

(b) Neither the execution and delivery by Grey Wolf of this Agreement or any Related Document nor the consummation by Grey Wolf of the Merger and the other transactions contemplated hereby or thereby in accordance with the terms hereof or thereof will require any consent, approval or authorization of, notice to or filing or registration with any Governmental Authority, other than (i) the filing of the Certificate of Merger with the Secretary of State of the State of Texas and appropriate documents required to be filed as a result of the Merger with the relevant Governmental Authorities in the states and foreign jurisdictions in which Grey Wolf, Lobos or any other Grey Wolf Subsidiary is qualified to conduct business, (ii) the filing of the Proxy Statement/Prospectus with the SEC in accordance with the Exchange Act and the filing and effectiveness of the Registration Statement, (iii) filings required under the U.S. Hart-Scott-Rodino Antitrust Improvements Act of 1976, as amended (the *HSR Act*), including the filing of forms and other documents with the FTC and the Antitrust Division of the DOJ as required by the HSR Act (*Notification and Report Forms*), (iv) filings required under federal and state securities or Blue Sky laws, applicable non-U.S. laws or the rules of the AMEX or NYSE and (v) any other applicable filings or notifications under the antitrust, competition or similar Applicable Laws of foreign jurisdictions ((i), (ii), (iii), (iv) and (v) collectively, the *Grey Wolf Regulatory Filings*), except for any failures to obtain any such consent, approval or authorization or to make any such filing, notification or registration that, individually or in the aggregate, have not had or caused and would not reasonably be expected to have or cause a Grey Wolf Material Adverse Effect.

Section 3.7 SEC Documents.

(a) Grey Wolf has filed with the SEC all documents required to be so filed by it since January 1, 2007 pursuant to Sections 13(a), 14(a) and 15(d) of the Exchange Act, and has made available to Precision each registration statement, periodic or other report, proxy statement, schedule or information statement (other than preliminary materials) it has so filed, each in the form (including exhibits and any amendments thereto) filed with the SEC (collectively, the *Grey Wolf Reports*). As used in this Section 3.7, the term file shall include any reports on Form 8-K furnished to the SEC. As of its respective date or, if amended by a subsequent filing prior to the date hereof, on the date of such filing, each Grey Wolf Report complied in all material respects with the applicable requirements of the Exchange Act, SOX and the rules and regulations thereunder and did not contain any untrue statement of a material fact or omit to state a material fact required to be stated therein or necessary to make the statements made therein, in the light of the circumstances under which they were made, not misleading. Each of the consolidated balance sheets included in or incorporated by reference into the Grey Wolf Reports (including the related notes and schedules) fairly presents in all material respects the consolidated financial position of Grey Wolf and the Grey Wolf Subsidiaries as of its date, and each of the consolidated statements of operations, cash flows and changes in shareholders equity included in or incorporated by reference into the Grey Wolf Reports (including any related notes and schedules) fairly presents in all material respects the results of operations, cash flows or changes in shareholders equity, as the case may be, of Grey Wolf and the Grey Wolf Subsidiaries for the periods set forth therein (such consolidated balance sheets and consolidated statements of operations, cash flows and changes in shareholders equity, each including the notes and schedules thereto, the *Grey Wolf Financial Statements*). The Grey Wolf Financial Statements (i) complied as to form in all material respects with the published rules and regulations of the SEC and (ii) were prepared in accordance with U.S. GAAP consistently applied during the periods involved, except as may be noted in the Grey Wolf Financial Statements or as permitted by Form 10-Q or Form 8-K.

(b) Grey Wolf has not entered into or modified any loans or arrangements with its officers and directors in violation of Section 402 of SOX. Grey Wolf has established and maintains disclosure controls and procedures and internal controls over financial reporting (as such terms are defined in paragraphs (e) and (f), respectively, of Rule 13a-15 under the Exchange Act) as required by Rule 13a-15 under the Exchange Act. Grey Wolf s disclosure controls and procedures are reasonably designed to ensure that all material information required to be disclosed by Grey Wolf in the reports that it files under the Exchange Act are recorded, processed, summarized and reported within the time periods specified in the rules and forms of the SEC, and that all such material information is accumulated and communicated to the management of Grey Wolf as appropriate to allow timely decisions regarding required disclosure and to make the certifications required pursuant to Sections 302 and 906 of SOX. The management of Grey Wolf has completed its assessment of the effectiveness of Grey Wolf s internal controls over financial reporting in compliance with the requirements of Section 404 of SOX for the year ended December 31, 2007, and such assessment concluded that such controls were effective. To the knowledge of Grey Wolf, it has disclosed, based on its most recent evaluations, to Grey Wolf s outside auditors and the audit committee of the Grey Wolf Board (i) all significant deficiencies in the design or operation of internal controls over financial reporting and any material weaknesses, which have more than a remote chance to materially adversely affect Grey Wolf s ability to record, process, summarize and report financial data (as defined in Rule 13a-15(f) of the Exchange Act) and (ii) any fraud, regardless of whether material, that involves management or other employees who have a significant role in Grey Wolf s internal controls over financial reporting.

(c) Since January 1, 2007, to the knowledge of Grey Wolf, neither Grey Wolf nor any of the Grey Wolf Subsidiaries nor any director, officer, employee, auditor, accountant or representative of Grey Wolf or any of the Grey Wolf Subsidiaries has received or otherwise had or obtained knowledge of any material complaint, allegation, assertion or Claim, whether written or oral, regarding the accounting or auditing practices, procedures, methodologies or methods of Grey Wolf or any of the Grey Wolf Subsidiaries, including any material complaint, allegation, assertion or Claim that Grey Wolf or any of the Grey Wolf Subsidiaries has a material weakness (as such terms are defined in the Public Accounting Oversight Board s Auditing Standard No. 2, as in effect on the date hereof), in Grey Wolf s internal controls over financial reporting.

Section 3.8 Litigation. Except (a) matters relating to Tax matters, which are treated exclusively under Section 3.10, (b) matters relating to Grey Wolf Benefit Plans, which are treated exclusively under Section 3.11 and (c) matters arising under Environmental, Health and Safety Laws, which are treated exclusively under Section 3.13, there is no litigation, arbitration, mediation, action, suit, Claim, proceeding or investigation, whether legal or administrative, pending against Grey Wolf or any of the Grey Wolf Subsidiaries or, to Grey Wolf s knowledge, threatened against Grey Wolf or any of the Grey Wolf Subsidiaries or any of their respective assets, properties or operations, at Applicable Law or in equity, before or by any Governmental Authority or any Order of any Governmental Authority that, individually or in the aggregate, and taking into consideration the aggregate amounts reserved for any such matters in Grey Wolf s consolidated balance sheet at December 31, 2007, has had or caused or would reasonably be expected to have or cause a Grey Wolf Material Adverse Effect.

Section 3.9 Absence of Certain Changes. From December 31, 2007 to the date of this Agreement, except as described in the Grey Wolf Reports, there has not been (a) any event or occurrence that has had or caused or would reasonably be expected to have or cause a Grey Wolf Material Adverse Effect, (b) any material change by Grey Wolf or any of the Grey Wolf Subsidiaries, when taken as a whole, in any of its accounting methods, principles or practices or any of its Tax methods, practices or elections, (c) any declaration, setting aside or payment of any dividend or distribution in respect of any capital stock or other Equity Interest of Grey Wolf or any redemption, purchase or other acquisition of any of its Equity Interests except for repurchases of Grey Wolf Common Stock pursuant to Grey Wolf s previously announced stock repurchase program and shares of Grey Wolf Common Stock that were withheld to satisfy federal withholding requirements upon vesting of Grey Wolf Restricted Stock, or (d) except in the ordinary course of business consistent with past practices, any increase in or establishment of any bonus, insurance, severance, deferred compensation, pension, retirement, profit sharing, stock option, stock purchase or other employee benefit plan.

Section 3.10 Taxes.

(a) Except for such matters that, individually or in the aggregate, have not had or caused and would not reasonably be expected to have or cause a Grey Wolf Material Adverse Effect:

(i) The Grey Wolf Companies have timely filed, or have caused to be timely filed on their behalf, all Tax Returns required to be filed by or on behalf of the Grey Wolf Companies (including any Tax Return required to be filed by an affiliated, consolidated, combined, unitary or similar group that included the Grey Wolf Companies) in the manner prescribed by Applicable Law. All such Tax Returns are complete and correct. The Grey Wolf Companies have timely paid (or Grey Wolf has paid on each Grey Wolf Subsidiary s behalf) all Taxes due and owing, and, in accordance with U.S. GAAP, the most recent Grey Wolf Financial Statements contained in the Grey Wolf Reports reflect a reserve (excluding any reserve for deferred Taxes established to reflect timing differences between book and Tax income) for all Taxes payable by the Grey Wolf Companies for all Taxable periods and portions thereof through the date of such Grey Wolf Financial Statements.

(ii) No Tax Return of the Grey Wolf Companies is under audit or examination by any Tax Authority, and no written or, to the knowledge of Grey Wolf, unwritten notice of such an audit or examination has been received by the Grey Wolf Companies. There is no assessed deficiency, refund litigation, proposed adjustment or matter in controversy with respect to any Taxes due and owing by the Grey Wolf Companies.

(iii) Since December 31, 2007, the Grey Wolf Companies have not made or rescinded any election relating to Taxes or settled or compromised any Claim, action, suit, litigation, proceeding, arbitration, investigation, audit or controversy relating to any Taxes, or, except as may be required by Applicable Law, made any change to any of their methods of reporting income or deductions for federal income Tax purposes from those employed in the preparation of their most recently filed federal Tax Returns.

(iv) The Grey Wolf Companies do not have any liability for any Tax under Treasury Regulation Section 1.1502-6 or any similar provision of any other Tax Law, except for Taxes of the Grey Wolf Companies and the affiliated group of which Grey Wolf is the common parent, within the meaning of Section 1504(a)(1) of the Code or any similar provision of any other Tax Law.

(v) There is no agreement or other document extending, or having the effect of extending, the period of assessment or collection of any material Taxes and no power of attorney with respect to any such Taxes has been executed or filed with any Tax Authority by or on behalf of the Grey Wolf Companies.

(vi) Except for statutory Liens for Taxes not yet due, no Liens for Taxes exist with respect to any assets or properties of the Grey Wolf Companies.

(vii) Except for any agreements or arrangements (A) with customers, vendors, lessors or similar persons entered into in the ordinary course of business or (B) among the Grey Wolf Companies, none of the Grey Wolf Companies is a party to or bound by any Tax sharing agreement, Tax indemnity obligation or agreement or arrangement with respect to Taxes (including any advance pricing agreement, closing agreement or other agreement relating to Taxes with any Tax Authority).

(viii) The Grey Wolf Companies have complied with all Applicable Law relating to the payment and withholding of Taxes (including withholding of Taxes pursuant to Sections 1441, 1442 and 3402 of the Code or similar provisions of any other Tax Law) and have, within the time and the manner prescribed by applicable Tax Law, withheld from and paid over to the proper Tax Authorities all amounts required to be so withheld and paid over under applicable Tax Law.

(ix) None of the Grey Wolf Companies is or has been a United States real property holding corporation within the meaning of Section 897(c)(2) of the Code.

(x) None of the Grey Wolf Companies shall be required to include in a Taxable period ending after the Closing Date any item of income that accrued in a prior Taxable period but was not recognized in any prior Taxable period as a result of the installment method of accounting, the long-term contract method of accounting, the cash method of accounting or Section 481 of the Code or comparable provisions of any other Tax Law.

(xi) None of the Grey Wolf Companies has participated in any reportable transaction as defined in Treasury Regulation Section 1.6011-4.

(b) Since December 31, 2005, none of the Grey Wolf Companies has been a distributing corporation or a controlled corporation in connection with a distribution described in Section 355 of the Code.

(c) None of the Grey Wolf Companies knows of any fact, agreement, plan, or other circumstance, or has taken or failed to take any action, that would reasonably be expected to prevent the Merger from qualifying as a reorganization within the meaning of Section 368(a) of the Code.

(d) Grey Wolf will qualify as a corporation under the Code and applicable Treasury Regulations from the date hereof until the Effective Time of the Merger.

Section 3.11 Employee Benefit Plans.

(a) Section 3.11(a) of the Grey Wolf Disclosure Letter contains a list of all Grey Wolf Benefit Plans. Grey Wolf has provided or made available to Precision true and complete copies of the Grey Wolf Benefit Plans and, if applicable, all amendments thereto, the most recent trust agreements, the Forms 5500 for the prior three years, the most recent Internal Revenue Service (the *IRS*) determination or opinion letters, summary plan descriptions, any summaries of material modifications provided to participants since the most recent summary plan descriptions, material notices to participants, funding statements, annual reports and actuarial reports, if applicable, and all correspondence with any Governmental Authority for each Grey Wolf Benefit Plan.

(b) To the extent applicable, the Grey Wolf Benefit Plans comply in all material respects with the requirements of ERISA and the Code or with the Applicable Laws and regulations of any applicable jurisdiction, and any Grey Wolf Benefit Plan intended to be qualified under Section 401(a) of the Code has received a favorable determination letter from the IRS (or, if applicable, an opinion letter) and such letter has not been revoked; all required amendments since the issuance of such favorable determination letter from the IRS have been made and no amendments have been made which would reasonably be expected to result in the disqualification of any of such Grey Wolf Benefit Plans; the Grey Wolf Benefit Plans have been maintained and operated in compliance in all material respects with their terms; to Grey Wolf s knowledge, there are no breaches of fiduciary duty in connection with the Grey Wolf Benefit Plans for which Grey Wolf could be liable; there are no pending or, to Grey Wolf s knowledge, threatened Claims against or otherwise involving any Grey Wolf Benefit Plan that, individually or in the aggregate, have had or caused or would reasonably be expected to have or cause a Grey Wolf Material Adverse Effect, and no suit, action or other litigation (excluding claims for benefits incurred in the ordinary course of the Grey Wolf Benefit Plan activities) has been brought against or with respect to any such Grey Wolf Benefit Plan for which Grey Wolf could be liable that, individually or in the aggregate, have had or caused or would reasonably be expected to have or cause a Grey Wolf Material Adverse Effect; all material contributions required to be made as of the date hereof to Grey Wolf Benefit Plans have been made or have been properly accrued and are reflected in the Grey Wolf Financial Statements as of the date thereof.

(c) Neither Grey Wolf nor any of the Grey Wolf Subsidiaries or ERISA Affiliates contributes to, or has an obligation to contribute to, and has not within six years prior to the Effective Time contributed to, or had an obligation to contribute to or has any material liability, contingent or otherwise, with respect to, (i) a multiemployer plan within the meaning of Section 3(37) of ERISA, (ii) any plan that is covered by Title IV of ERISA, (iii) any plan subject to Section 412 of the Code or (iv) any plan funded by a voluntary employees benefits association within the meaning of Section 501(c)(9) of the Code.

(d) Except for the Grey Wolf Benefits Plans set forth in Section 3.11(d) of the Grey Wolf Disclosure Letter, no Grey Wolf Benefit Plan maintained by the Grey Wolf Companies provides medical, surgical, hospitalization, death or similar benefits (regardless of whether insured) for employees or former employees of Grey Wolf or any Grey Wolf Subsidiary for periods extending beyond their retirement or other termination of service other than coverage mandated by Applicable Law.

(e) All accrued material obligations of Grey Wolf and the Grey Wolf Subsidiaries, whether arising by operation of Applicable Law, Contract, or past custom, for compensation and benefits, including, but not limited to, bonuses and accrued vacation, and benefits under Grey Wolf Benefit Plans, have been paid or adequate accruals for such obligations are reflected on the Grey Wolf Financial Statements as of the date thereof.

(f) Section 3.11(f) of the Grey Wolf Disclosure Letter sets forth an accurate and complete list of each Grey Wolf Benefit Plan (and the particular circumstances described in this Section 3.11(f) relating to such Grey Wolf Benefit Plan) under which the execution and delivery of this Agreement or the consummation of the transactions contemplated hereby could (either alone or in conjunction with any other event, such as termination of employment), result in, cause the accelerated vesting, funding or delivery of, or increase the amount or value of, any payment or benefit to any employee, officer or director of Grey Wolf or any of the Grey Wolf Subsidiaries.

(g) Section 3.11(g) of the Grey Wolf Disclosure Letter contains a description that is accurate and correct in all material respects of all amounts estimated to be paid or payable (whether in cash, in property, or in the form of benefits, accelerated cash, property, or otherwise) in connection with the transactions contemplated hereby (solely as a result thereof) that were or will be an excess parachute payment within the meaning of Section 280G of the Code.

(h) Each Grey Wolf Benefit Plan which is or reasonably could be determined to be an arrangement subject to Section 409A of the Code has been operated in good faith compliance with Section 409A of the Code since January 1, 2005 and has been, or may be, timely amended with the consent of the participant, if necessary, to comply in good faith with Section 409A of the Code and any applicable guidance, whether proposed or final, issued by the IRS with respect thereto.

(i) No Grey Wolf Benefit Plan is a multiple employer plan within the meaning of Section 413(c) of the Code.

(j) No Grey Wolf Benefit Plan that is not subject to ERISA has any material liabilities thereunder which are not otherwise fully funded, if applicable, or properly accrued and reflected under the Grey Wolf Financial Statements as of the date thereof.

(k) No Grey Wolf Benefit Plan holds any qualifying employer securities or qualifying employer real estate within the meaning of ERISA.

(l) With respect to all Grey Wolf Benefit Plans subject to the Applicable Laws of any jurisdiction outside the U.S. (*International Plans*), (i) to Grey Wolf s knowledge, the International Plans have been maintained in all material respects in accordance with all Applicable Law, (ii) if intended to qualify for special Tax treatment, the International Plans meet the requirements for such treatment in all material respects, (iii) if intended to be funded and/or book-reserved, the International Plans are fully funded and/or book-reserved based upon reasonable actuarial assumptions, and (iv) no liability which would be material to Grey Wolf and the Grey Wolf Subsidiaries, taken as a whole, exists or reasonably could be imposed upon the assets of Grey Wolf or any of the Grey Wolf Subsidiaries by reason of such International Plans, other than to the extent reflected on Grey Wolf s balance sheet as contained in Grey Wolf s Form 10-K for the year ended December 31, 2007.

Section 3.12 Labor Matters.

(a) Except as disclosed in Section 3.12 of the Grey Wolf Disclosure Letter, as of the date of this Agreement, (i) neither Grey Wolf nor any of the Grey Wolf Subsidiaries is a party to, or bound by, any collective bargaining agreement or similar Contract, agreement or understanding with a labor union or similar labor organization and (ii) to Grey Wolf s knowledge, there are no organizational efforts with respect to the formation of a collective bargaining unit presently being made or threatened.

(b) Except for such matters that, individually or in the aggregate, have not had or caused and would not reasonably be expected to have or cause a Grey Wolf Material Adverse Effect, (i) neither Grey Wolf nor any Grey Wolf Subsidiary has received any written complaint of any unfair labor practice or other unlawful employment practice or any written notice of any material violation of any federal, state or local statutes, Applicable Laws, ordinances, rules, regulations, Orders or directives with respect to the employment of individuals by, or the employment practices of, Grey Wolf or any Grey Wolf Subsidiary, or the work conditions, terms and conditions of employment, wages or hours of their respective businesses, (ii) there are no unfair labor practice charges or other employee related complaints against Grey Wolf or any Grey Wolf Subsidiary pending or, to the knowledge of Grey Wolf threatened, before any Governmental Authority by or concerning the employees working in their respective businesses, and (iii) there is no labor dispute, strike, slowdown or work stoppage against Grey Wolf or any of the Grey Wolf Subsidiaries or, to the knowledge of Grey Wolf, pending or threatened against Grey Wolf or any of the Grey Wolf Subsidiaries.

Section 3.13 Environmental Matters. Except for such matters that, individually or in the aggregate, have not had or caused and would not reasonably be expected to have or cause a Grey Wolf Material Adverse Effect:

(a) Grey Wolf and each Grey Wolf Subsidiary has been and is in compliance with all applicable Environmental, Health and Safety Laws and possesses and is in compliance with any permits or licenses required under Environmental, Health and Safety Laws. To the knowledge of Grey Wolf, there are no past or present facts, conditions or circumstances that interfere with or preclude, or could interfere with or preclude if known to a Governmental Authority, the conduct of any of their respective businesses as now conducted or which interfere with continued compliance with applicable Environmental, Health and Safety Laws.

(b) No proceedings or investigations brought by any Governmental Authority or other Person are pending or, to the knowledge of Grey Wolf, threatened against Grey Wolf or the Grey Wolf Subsidiaries that allege the violation of, or seek to impose liability pursuant to any Environmental, Health and Safety Laws, or seek to revoke or modify any permit or license issued to Grey Wolf or a Grey Wolf Subsidiary, and, to the knowledge of Grey Wolf, there are no past or present facts, conditions or circumstances at, on or arising out of, or otherwise associated with, any current (or former) businesses, assets or properties of Grey Wolf or any Grey Wolf Subsidiary, including, but not limited to, any on-site or off-site disposal, release or spill of any Hazardous Materials, which constitute a material violation of, or liability pursuant to, Environmental, Health and Safety Laws or are reasonably likely to give rise to (i) costs, expenses, liabilities or obligations for any investigation, cleanup, remediation, disposal or corrective action under any Environmental, Health and Safety Laws, (ii) claims arising for personal injury, property damage or damage to natural resources, (iii) fines, penalties or injunctive relief, or (iv) an action to revoke or modify any permit or license issued to Grey Wolf or a Grey Wolf Subsidiary.

(c) Neither Grey Wolf nor any of the Grey Wolf Subsidiaries has (i) received any written notice of noncompliance with, violation of, or liability or potential liability under any Environmental, Health and Safety Laws or (ii) entered into or become subject to any consent decree, Order or agreement with any Governmental Authority or other Persons pursuant to any Environmental, Health and Safety Laws or relating to the investigation, cleanup, remediation or disposal of, or the taking of corrective action in relation to, any Hazardous Materials.

Section 3.14 Intellectual Property. Except for such matters that, individually or in the aggregate, have not had or caused and would not reasonably be expected to have or cause a Grey Wolf Material Adverse Effect, (a) the products, services and operations of Grey Wolf and the Grey Wolf Subsidiaries do not infringe upon, violate or misappropriate the Intellectual Property of any Third Party, (b) Grey Wolf and the Grey Wolf Subsidiaries own or possess valid licenses or other valid rights to use the Intellectual Property that Grey Wolf and the Grey Wolf Subsidiaries use, exercise or exploit in, or that may be necessary or desirable for, their businesses as currently being conducted, free and clear of all Liens (other than Permitted Liens), and (c) to the knowledge of Grey Wolf, there is no infringement of any Intellectual Property owned by or licensed by or to Grey Wolf or any of the Grey Wolf Subsidiaries. To Grey Wolf s knowledge, there is no unauthorized use, disclosure, infringement or misappropriation of any Intellectual Property of Grey Wolf or any Grey Wolf Subsidiary by any Person, including, without limitation, any employee or independent contractor (present or former) of Grey Wolf or any Grey Wolf Subsidiary, that, individually or in the aggregate, has had or caused or would reasonably be expected to have or cause a Grey Wolf Material Adverse Effect.

Section 3.15 Insurance. Except for such matters that, individually or in the aggregate, have not had or caused and would not reasonably be expected to have or cause a Grey Wolf Material Adverse Effect:

(a) Grey Wolf and the Grey Wolf Subsidiaries maintain and will maintain through the Closing Date the insurance coverages summarized in its Annual Report on Form 10-K for the year ended December 31, 2007, except for certain changes in such coverages since December 31, 2007 as set forth in Section 3.15(a) of the Grey Wolf Disclosure Letter. In addition, there is no material default with respect to any provision contained in any such policy or binder, and none of the Grey Wolf Companies has failed to give any notice or present any claim under any such policy or binder in a timely fashion.

(b) To the knowledge of Grey Wolf, no event relating specifically to Grey Wolf or the Grey Wolf Subsidiaries (as opposed to events affecting the drilling service industry in general) has occurred that is reasonably likely, after the date of this Agreement, to result in an upward adjustment in premiums under any insurance policies they maintain. Neither Grey Wolf nor any of the Grey Wolf Subsidiaries have received notice from any insurer or agent of such insurer that substantial capital improvements or other expenditures will have to be made in order to continue such insurance policies. Excluding insurance policies that have expired and been replaced in the ordinary course of business, no excess liability or protection and indemnity insurance policy has been cancelled by the insurer within one year prior to the date hereof, and to Grey Wolf s knowledge, no threat in writing has been made to cancel (excluding cancellation upon expiration or failure to renew) any current insurance policy of Grey Wolf or any Grey Wolf Subsidiary.

Section 3.16 No Brokers. Neither Grey Wolf nor any of the Grey Wolf Subsidiaries has entered into any Contract with any Person that may result in the obligation of Grey Wolf, Precision or any of their respective Subsidiaries to pay any finder s fees, brokerage or other like payments in connection with the negotiations leading to this Agreement or the consummation of the transactions contemplated hereby, except that Grey Wolf has retained UBS Securities LLC as its financial advisor, the fee and expense reimbursement arrangements with which have been disclosed in writing to Precision prior to the date hereof.

Section 3.17 Opinion of Financial Advisor. The Grey Wolf Board has received the opinion of UBS Securities LLC, dated the date of this Agreement, to the effect that, as of such date and based upon and subject to various assumptions, matters considered and limitations described in the opinion, the Merger Consideration to be received by holders of Grey Wolf Common Stock, taken in the aggregate, is fair, from a financial point of view, to such holders.

Section 3.18 Precision Trust Unit Ownership. Neither Grey Wolf nor any of the Grey Wolf Subsidiaries owns any Precision Trust Units or any other securities convertible into or otherwise exercisable to acquire Precision Trust Units.

Section 3.19 Vote Required; Board of Director Approval. Under Texas law and the rules of the AMEX, the only vote of the holders of any class or series of Grey Wolf Equity Interests necessary to approve the Grey Wolf Proposal is the affirmative vote in favor of the Merger by the holders of a majority of the issued and outstanding shares of Grey Wolf Common Stock (the *Required Grey Wolf Vote*). As of or prior to the date of this Agreement, the Grey Wolf Board has, by resolutions duly and unanimously adopted at a meeting of all directors on the Grey Wolf Board, which meeting was duly called and held, (a) determined that the Merger is advisable and in the best interests of Grey Wolf and Grey Wolf s shareholders, (b) approved the Merger and this Agreement and (c) recommended that the shareholders of Grey Wolf approve this Agreement and directed that the Grey Wolf Proposal be submitted to the shareholders of Grey Wolf at the Meeting.

Section 3.20 Ownership and Condition of Assets.

(a) As of the date hereof, Grey Wolf or a Grey Wolf Subsidiary has good and valid title to the assets of the Grey Wolf Companies including the drilling rigs listed in Section 3.20(a) of the Grey Wolf Disclosure Letter, other than defects or irregularities of title that do not materially impair the ownership or operation of such assets and in each case free and clear of all Liens, except for Permitted Liens, Liens securing the Grey Wolf Credit Agreement or Liens that have not had or caused and would not reasonably be expected to have or cause a Grey Wolf Material Adverse Effect.

(b) The assets of the Grey Wolf Companies are in good operating condition except for: (i) normal maintenance and repair requirements and normal wear and tear, (ii) warm-stacked rigs or cold-stacked rigs identified as such as of the date of this Agreement in Section 3.20(b) of the Grey Wolf Disclosure Letter, and (iii) as would not, when taken together with the matters described in the immediately preceding clauses (i) and (ii), have a Grey Wolf Material Adverse Effect.

Section 3.21 Undisclosed Liabilities. Neither Grey Wolf nor any of the Grey Wolf Subsidiaries has any liabilities or obligations of any nature, regardless of whether fixed, accrued, contingent or otherwise, except liabilities and obligations that (a) are fully reflected or reserved against in the Grey Wolf Financial Statements included in the Grey Wolf Reports or described in the Grey Wolf Reports filed prior to the date hereof, (b) liabilities and obligations arising under this Agreement and the transaction contemplated by this Agreement, (c) liabilities or obligations incurred in the ordinary course of business consistent with past practices since December 31, 2007, and (d) liabilities and obligations that, individually or in the aggregate, have not had or caused and would not reasonably be expected to have or cause a Grey Wolf Material Adverse Effect.

Section 3.22 Material Contracts.

(a) Section 3.22(a) of the Grey Wolf Disclosure Letter contains a list of all of the following Contracts or agreements (other than those set forth on an exhibit index in the Grey Wolf Reports filed prior to the date of this Agreement) to which Grey Wolf or any Grey Wolf Subsidiary is a party or by which any of them is bound as of the date of this Agreement (other than this Agreement or any Related Document): (i) any non-competition agreement or non-solicitation agreement or non-hire agreement that purports to limit the manner in which, or the localities in which, all or any portion of their respective businesses are conducted or would purport to bind Grey Wolf, Precision or any of their Affiliates; (ii) any hedging agreements by which any of the assets of Grey Wolf or any Grey Wolf Subsidiary are bound, in an aggregate amount in excess of $1 million; (iii) any Contract granting any Person registration or other purchase or sale rights with respect to any Equity Interest in Grey Wolf or any Grey Wolf Subsidiary; (iv) any voting agreement relating to any Equity Interest of Grey Wolf or any Grey Wolf Subsidiary; (v) any Contract outside the ordinary course to which Grey Wolf or any Grey Wolf Subsidiary is a party that entitles the other party or parties thereto to receive the benefits thereof without incurring the obligation to pay for same within sixty days after services are provided; (vi) any Contract outside the ordinary course between Grey Wolf or any Grey Wolf Subsidiary and any current or former Affiliate of Grey Wolf; (vii) any drilling rig construction or conversion Contract with respect to which the drilling rig has not been delivered and paid for; (viii) any drilling Contracts of one year or greater in remaining duration; (ix) any Contract or agreement for the borrowing of money with a borrowing capacity or outstanding Indebtedness of $2 million or more; or (x) any material contract (as such term is defined in Item 601(b)(10) of Regulation S-K of the SEC) (all Contracts or agreements of the types described in clauses (i) through (x), regardless of whether listed in Section 3.22(a) of the Grey Wolf Disclosure Letter and regardless of whether in effect as of

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Prepaid reinsurance premiums

(115,112

)

(100,984

)

Loss reserves recoverable

21,832

6,447

Paid losses recoverable

43,054

30,438

Income taxes recoverable

—

(2,132

)

Accrued investment income

2,366

1,532

Other assets
13,558

8,020

Reserve for losses and loss expenses
(105,842
)

(138,633
)
Unearned premiums
449,238

487,467

Reinsurance balances payable
57,765

51,300

Deferred income taxes
3,551

1,250

Accounts payable and accrued expenses
(95,997
)

(40,113
)
Net cash (used in) provided by operating activities
(44,427
)

80,083

Cash flows provided by (used in) investing activities

Proceeds on sales of investments
1,086,527

1,410,509

Proceeds on maturities of investments
124,716

125,841

Purchases of fixed maturities
(884,461
)

(2,140,447
)
(Purchases) sales of short-term investments, net
(107,411
)

744,518

Sales of other investments
3,539

31,121

Increase in securities lending collateral
(1,485
)

(1,689
)
Redemption of investment in operating affiliates
43,366

50,222

Purchase of investment in investment affiliate
—

(1,341

)
Net cash provided by investing activities
264,791

218,734

Cash flows provided by (used in) financing activities

Net (repayment of) proceeds on issuance of notes payable to operating affiliates
(30,600
)

175,637

Issuance of common shares, net
2,030

3,121

Purchases of common shares under share repurchase program
(197,339
)

(69,691
)
Dividends paid
(29,330
)

(262,232
)
Increase in securities lending payable
1,485

1,689

(Redemption of) investment in third party redeemable noncontrolling interest
(10,496
)

36,290

Net cash (used in) financing activities
(264,250
)

(115,186
)

Effect of foreign currency rate changes on cash and cash equivalents
4,890

(33,786
)

Net (decrease) increase in cash
(38,996
)

149,845

Cash and cash equivalents - beginning of period
$
1,056,346

$
1,219,379

Cash and cash equivalents - end of period
$
1,017,350

$
1,369,224

Taxes paid during the period	$ 175	$ 693
Interest paid during the period	$ 19,174	$ 17,819

The accompanying notes are an integral part of these consolidated financial statements (unaudited).

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Validus Holdings, Ltd.
Notes to Consolidated Financial Statements (unaudited)
(Expressed in thousands of U.S. dollars, except share and per share information)

1. Basis of preparation and consolidation

These unaudited Consolidated Financial Statements include Validus Holdings, Ltd. and its wholly and majority owned subsidiaries (together the "Company") and have been prepared in accordance with accounting principles generally accepted in the United States of America ("U.S. GAAP") for interim financial information and with the instructions to Form 10-Q and Article 10 in Regulation S-X. Accordingly, they do not include all of the information and footnotes required by U.S. GAAP for complete financial statements. In addition, the year-end balance sheet data was derived from audited financial statements but does not include all disclosures required by U.S. GAAP. This Quarterly Report on Form 10-Q should be read in conjunction with the financial statements and related notes included in the Company's Annual Report on Form 10-K for the year ended December 31, 2013, as filed with the U.S. Securities and Exchange Commission (the "SEC").

In the opinion of management, these unaudited consolidated financial statements reflect all adjustments (including normal recurring adjustments) considered necessary for a fair presentation of the Company's financial position and results of operations as at the end of and for the periods presented. To facilitate comparison of information, certain amounts in prior periods have been reclassified to conform to current period presentation. The consolidated statement of cash flows for the three months ended March 31, 2013 includes a reclassification of $19,400 from cash flows used in financing activities to cash flows provided by operating activities to revise the presentation of subscriptions received in advance from third party investors. For the three months ended March 31, 2013, $10,077 within finance expenses has been reclassified into income attributable to operating affiliate investors to conform to current period presentation. All significant intercompany accounts and transactions have been eliminated. The results of operations for any interim period are not necessarily indicative of the results for a full year.

The preparation of these financial statements in conformity with U.S. GAAP requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. While management believes that the amounts included in the Consolidated Financial Statements reflect its best estimates and assumptions, actual results could differ materially from those estimates. The Company's principal estimates include:

•reserve for losses and loss expenses;
•premium estimates for business written on a line slip or proportional basis;
•the valuation of goodwill and intangible assets;
•reinsurance recoverable balances including the provision for uncollectible amounts; and
•investment valuation of financial assets.

The term "ASC" used in these notes refers to Accounting Standard Codification issued by the U.S. Financial Accounting Standards Board ("FASB").

2. Recent accounting pronouncements

Adoption of New Accounting Standards

Parent's Accounting for the Cumulative Translation Adjustment upon Derecognition of Certain Subsidiaries or Groups of Assets within a Foreign Entity or of an Investment in a Foreign Entity

In March 2013, the FASB issued Accounting Standard Update No. 2013-05, "Parent's Accounting for the Cumulative Translation Adjustment upon Derecognition of Certain Subsidiaries or Groups of Assets within a Foreign Entity or of an Investment in a Foreign Entity" (ASU 2013-05). The objective of this Update is to resolve the diversity in practice about whether Subtopic 810-10, Consolidation-Overall, or Subtopic 830-30, Foreign Currency Matters-Translation of Financial Statements, applies to the release of the cumulative translation adjustment into net income when a parent either sells a part or all of its investment in a foreign entity or no longer holds a controlling financial interest in a subsidiary within a foreign entity. The amendments became effective for the Company on January 1, 2014. Adoption of this guidance did not have a material impact on the Company's Consolidated Financial Statements.

Financial Services - Investment Companies - Amendments to the Scope, Measurement, and Disclosure Requirements

In June 2013, the FASB issued Accounting Standard Update No. 2013-08, "Financial Services - Investment Companies - Amendments to the Scope, Measurement, and Disclosure Requirements" (ASU 2013-08). The amendments in this Update change the assessment of whether an entity is an investment company by developing a new two-tiered approach for that assessment, which

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requires an entity to possess certain fundamental characteristics while allowing judgment in assessing other typical characteristics. The new approach requires an entity to assess all of the characteristics of an investment company and consider its purpose and determine whether it is an investment company. The amendments became effective for the Company on January 1, 2014. The Company performed an assessment and has concluded that the AlphaCat ILS funds meet the characteristics outlined in this Update and therefore will continue to be treated as investment companies.

Presentation of an Unrecognized Tax Benefit When a Net Operating Loss Carryforward, a Similar Tax Loss, or a Tax Credit Carryforward Exists

In July 2013, the FASB issued Accounting Standard Update No. 2013-11 “Presentation of an Unrecognized Tax Benefit When a Net Operating Loss Carryforward, a Similar Tax Loss, or a Tax Credit Carryforward Exists” (ASU 2013-11). This Update applies to all entities that have unrecognized tax benefits when a net operating loss carryforward, a similar tax loss, or a tax credit carryforward exists at the reporting date. An unrecognized tax benefit should be presented in the financial statements as a reduction to a deferred tax asset for a net operating loss carryforward, a similar tax loss, or a tax credit carryforward. To the extent a net operating loss carryforward is not available to settle any additional income taxes that would result from the disallowance of a tax position at the reporting date, the unrecognized tax benefit should be presented in the financial statements as a liability and should not be combined with deferred tax assets. The amendments became effective for the Company on January 1, 2014. Adoption of this guidance did not have a material impact on the Company’s Consolidated Financial Statements.

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Validus Holdings, Ltd.
Notes to Consolidated Financial Statements (unaudited)
(Expressed in thousands of U.S. dollars, except share and per share information)

3. Investments
(a) Fixed maturity, short-term and other investments
The Company's investments in fixed maturities, short-term investments and other investments are classified as trading and carried at fair value, with related changes in net unrealized gains or losses included in earnings.
The amortized cost (or cost), gross unrealized gains and (losses) and estimated fair value of investments at March 31, 2014 were as follows:

	Amortized Cost or Cost	Gross Unrealized Gains	Gross Unrealized Losses	Estimated Fair Value
U.S. government and government agency	$ 1,122,846	$2,241	$(4,232)	$1,120,855
Non-U.S. government and government agency	438,415	5,138	(1,224)	442,329
U.S. states, municipalities and political subdivisions	43,960	626	(122)	44,464
Agency residential mortgage-backed securities	293,013	8,201	(1,653)	299,561
Non-agency residential mortgage-backed securities	16,721	254	(645)	16,330
U.S. corporate	1,331,550	9,315	(3,455)	1,337,410
Non-U.S. corporate	699,404	6,460	(1,973)	703,891
Bank loans	640,672	4,678	(1,649)	643,701
Catastrophe bonds	30,500	1,747	—	32,247
Asset-backed securities	623,631	1,408	(540)	624,499
Commercial mortgage-backed securities	22,312	7	(6)	22,313
Total fixed maturities	5,263,024	40,075	(15,499)	5,287,600
Total short-term investments	831,679	121	—	831,800
Other investments				
Fund of hedge funds	2,977	138	(921)	2,194
Hedge funds (a)	581,369	110,058	(84,965)	606,462
Private equity investments	12,068	2,562	(668)	13,962
Investment funds	30,311	188	—	30,499
Mutual funds	6,199	3,658	—	9,857
Total other investments	632,924	116,604	(86,554)	662,974
Total investments including noncontrolling interests	$ 6,727,627	$156,800	$(102,053)	$6,782,374
Noncontrolling interest (a)	$ (512,121)	$(95,750)	$76,468	$(531,403)
Redeemable noncontrolling interest (b)	$ (1,976)	$—	$—	$(1,976)
Total investments excluding noncontrolling interests	$ 6,213,530	$61,050	$(25,585)	$6,248,995

(a) Included in the hedge funds balance are investments held by PaCRe in which the Company has an equity interest of 10%. The remaining 90% interest is held by third party investors and included in the Consolidated Balance Sheets as noncontrolling interest.
(b) Included in the total investments balance are investments held by one AlphaCat ILS fund which is consolidated by the Company but in which the Company has an equity interest of less than 100%. The remaining interests are held by third party investors and included in the Consolidated Balance Sheets as redeemable noncontrolling interest.

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The amortized cost (or cost), gross unrealized gains and (losses) and estimated fair value of investments at December 31, 2013 were as follows:

	Amortized Cost or Cost	Gross Unrealized Gains	Gross Unrealized Losses	Estimated Fair Value
U.S. government and government agency	$ 1,368,826	$ 2,589	$ (6,736)	$ 1,364,679
Non-U.S. government and government agency	454,578	6,511	(2,021)	459,068
U.S. states, municipalities and political subdivisions	42,978	459	(317)	43,120
Agency residential mortgage-backed securities	305,450	8,310	(2,261)	311,499
Non-agency residential mortgage-backed securities	16,530	143	(914)	15,759
U.S. corporate	1,328,960	9,208	(5,684)	1,332,484
Non-U.S. corporate	711,581	5,917	(3,173)	714,325
Bank loans	712,859	5,659	(1,402)	717,116
Catastrophe bonds	72,000	2,551	—	74,551
Asset-backed securities	509,091	1,409	(843)	509,657
Total fixed maturities	5,522,853	42,756	(23,351)	5,542,258
Total short-term investments	751,734	45	(1)	751,778
Other investments				
Fund of hedge funds	3,141	83	(921)	2,303
Hedge funds (a)	584,518	71,641	(95,076)	561,083
Private equity investments	12,333	1,410	(258)	13,485
Investment funds	31,537	92	—	31,629
Mutual funds	6,199	3,617	—	9,816
Total other investments	637,728	76,843	(96,255)	618,316
Total investments including noncontrolling interests	$ 6,912,315	$ 119,644	$ (119,607)	$ 6,912,352
Noncontrolling interest (a)	(512,121)	(62,850)	85,569	(489,402)
Redeemable noncontrolling interest (b)	$ (18,365)	$ —	$ —	$ (18,365)
Total investments excluding noncontrolling interests	$ 6,381,829	$ 56,794	$ (34,038)	$ 6,404,585

(a) Included in the hedge funds balance are investments held by PaCRe in which the Company has an equity interest of 10%. The remaining 90% interest is held by third party investors and included in the Consolidated Balance Sheets as noncontrolling interest.

(b) Included in the total investments balance are investments held by two AlphaCat ILS funds which are consolidated by the Company but in which the Company has an equity interest of less than 100%. The remaining interests are held by third party investors and included in the Consolidated Balance Sheets as redeemable noncontrolling interest.

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The following table sets forth certain information regarding the investment ratings of the Company's fixed maturities portfolio as at March 31, 2014 and December 31, 2013. Investment ratings are the lower of Moody's or Standard & Poor's rating for each investment security, presented in Standard & Poor's equivalent rating. For investments where Moody's and Standard & Poor's ratings are not available, Fitch ratings are used and presented in Standard & Poor's equivalent rating.

	March 31, 2014		December 31, 2013	
	Estimated Fair Value	% of Total	Estimated Fair Value	% of Total
AAA	$906,648	17.1 %	$788,490	14.2 %
AA	2,124,629	40.2 %	2,378,491	42.9 %
A	1,178,357	22.3 %	1,174,562	21.2 %
BBB	397,563	7.5 %	420,559	7.6 %
Total investment-grade fixed maturities	4,607,197	87.1 %	4,762,102	85.9 %
BB	336,265	6.4 %	350,678	6.3 %
B	321,128	6.1 %	390,430	7.0 %
CCC	4,247	0.1 %	4,659	0.1 %
CC	2,602	— %	2,731	0.1 %
D/NR	16,161	0.3 %	31,658	0.6 %
Total non-investment grade fixed maturities	680,403	12.9 %	780,156	14.1 %
Total fixed maturities	$5,287,600	100.0 %	$5,542,258	100.0 %

The amortized cost and estimated fair value amounts for fixed maturities held at March 31, 2014 and December 31, 2013 are shown below by contractual maturity. Actual maturity may differ from contractual maturity because certain borrowers may have the right to call or prepay certain obligations with or without call or prepayment penalties.

	March 31, 2014		December 31, 2013	
	Amortized Cost	Estimated Fair Value	Amortized Cost	Estimated Fair Value
Due in one year or less	$625,774	$629,800	$688,855	$692,768
Due after one year through five years	3,311,970	3,325,578	3,603,459	3,613,847
Due after five years through ten years	366,524	366,409	396,389	395,633
Due after ten years	3,079	3,110	3,079	3,095
	4,307,347	4,324,897	4,691,782	4,705,343
Asset-backed and mortgage-backed securities	955,677	962,703	831,071	836,915
Total fixed maturities	$5,263,024	$5,287,600	$5,522,853	$5,542,258

(b) Net investment income

Net investment income was derived from the following sources:

	Three Months Ended	
	March 31, 2014	March 31, 2013
Fixed maturities and short-term investments	$23,297	$27,531
Cash and cash equivalents	1,957	533
Securities lending income	2	—
Total gross investment income	25,256	28,064
Investment expenses	(1,894)	(2,415)
Total net investment income	$23,362	$25,649

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(c) Net realized gains and change in net unrealized gains (losses) on investments

The following represents an analysis of net realized gains and the change in net unrealized gains (losses) on investments:

	Three Months Ended	
	March 31, 2014	March 31, 2013
Fixed maturities, short-term and other investments and cash equivalents		
Gross realized gains	$5,296	$10,720
Gross realized (losses)	(1,556)	(8,999)
Net realized gains on investments	3,740	1,721
Change in net unrealized gains (losses) on investments (a)	55,693	(7,237)
Total net realized gains and change in net unrealized gains (losses) on investments including noncontrolling interest	59,433	(5,516)
Noncontrolling interest (a)	(42,002)	4,651
Total net realized gains and change in net unrealized gains (losses) on investments excluding noncontrolling interest	$17,431	$(865)

(a) Includes change in net unrealized (gains) losses on investments held by PaCRe in which the Company has an equity interest of 10%. The remaining 90% interest is held by third party investors and is included in the Consolidated Statements of Comprehensive Income as net (income) loss attributable to noncontrolling interest.

(d) Pledged investments

The following tables outline investments pledged as collateral under the Company's credit facilities. For further details on the credit facilities, please refer to Note 12: "Debt and financing arrangements."

	March 31, 2014		
Description	Commitment	Issued and Outstanding	Investments and cash pledged as collateral
$400,000 syndicated unsecured letter of credit facility	$400,000	$—	$—
$525,000 syndicated secured letter of credit facility	525,000	309,422	499,905
$200,000 secured bi-lateral letter of credit facility	200,000	18,676	35,225
Talbot FAL facility	25,000	25,000	30,897
PaCRe senior secured letter of credit facility	10,000	294	—
AlphaCat Re secured letter of credit facility	30,000	24,800	30,022
IPC bi-lateral facility	40,000	19,817	96,960
$375,000 Flagstone bi-lateral facility	375,000	292,532	453,943
	$1,605,000	$690,541	$1,146,952

	December 31, 2013		
Description	Commitment	Issued and Outstanding	Investments and cash pledged as collateral
$400,000 syndicated unsecured letter of credit facility	$400,000	$—	$—
$525,000 syndicated secured letter of credit facility	525,000	358,567	507,620
$200,000 secured bi-lateral letter of credit facility	200,000	16,726	130,256
Talbot FAL facility	25,000	25,000	30,801
PaCRe senior secured letter of credit facility	10,000	294	—
AlphaCat Re secured letter of credit facility	24,800	24,800	24,806
IPC bi-lateral facility	40,000	20,177	98,465
$375,000 Flagstone bi-lateral facility	375,000	305,686	454,458

	$1,599,800	$751,250	$1,246,406

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In addition, $2,889,470 of cash and cash equivalents and investments were pledged during the normal course of business as at March 31, 2014 (December 31, 2013: $2,947,475). Of those, $2,884,472 were held in trust (December 31, 2013: $2,942,508). Pledged assets are generally for the benefit of the Company's cedants and policyholders, to support AlphaCat's fully collateralized reinsurance transactions and to facilitate the accreditation of Talbot as an alien insurer/reinsurer by certain regulators. See Note 14 (b) for detail on Talbot's FAL facility.

4. Fair value measurements

(a) Classification within the fair value hierarchy

Fair value is defined as the price to sell an asset or transfer a liability in an orderly transaction between market participants. Under U.S. GAAP, a company must determine the appropriate level in the fair value hierarchy for each fair value measurement. The fair value hierarchy prioritizes the inputs, which refer broadly to assumptions market participants would use in pricing an asset or liability, into three levels. It gives the highest priority to unadjusted quoted prices in active markets for identical assets or liabilities and the lowest priority to unobservable inputs. The level in the fair value hierarchy within which a fair value measurement in its entirety falls is determined based on the lowest level input that is significant to the fair value measurement in its entirety.

The three levels of the fair value hierarchy are described below:

Level 1 - Fair values are measured based on unadjusted quoted prices in active markets for identical assets or liabilities that we have the ability to access.

Level 2 - Fair values are measured based on quoted prices in active markets for similar assets or liabilities, quoted prices for identical assets or liabilities in inactive markets, or for which significant inputs are observable (e.g., interest rates, yield curves, prepayment speeds, default rates, loss severities, etc.) or can be corroborated by observable market data.

Level 3 - Fair values are measured based on inputs that are unobservable and significant to the overall fair value measurement. The unobservable inputs reflect our own judgments about assumptions where there is little, if any, market activity for that asset or liability that market participants might use.

The availability of observable inputs can vary from financial instrument to financial instrument and is affected by a wide variety of factors including, for example, the type of financial instrument, whether the financial instrument is new and not yet established in the marketplace, and other characteristics particular to the instrument. To the extent that valuation is based on models or inputs that are less observable or unobservable in the market, the determination of fair value requires significantly more judgment.

Accordingly, the degree of judgment exercised by management in determining fair value is greatest for instruments categorized in Level 3. In periods of market dislocation, the observability of prices and inputs may be reduced for many instruments. This may lead us to change the selection of our valuation technique (for example, from market to cash flow approach) or may cause us to use multiple valuation techniques to estimate the fair value of a financial instrument. These circumstances could cause an instrument to be reclassified between levels within the fair value hierarchy.

There have been no material changes in the Company's valuation techniques during the period, or periods, represented by these Consolidated Financial Statements. The following methods and assumptions were used in estimating the fair value of each class of financial instrument recorded in the Consolidated Balance Sheets.

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At March 31, 2014, the Company's investments were allocated between Levels 1, 2 and 3 as follows:

	Level 1	Level 2	Level 3	Total
U.S. government and government agency	$—	$1,120,855	$—	$1,120,855
Non-U.S. government and government agency	—	442,329	—	442,329
U.S. states, municipalities and political subdivisions	—	44,464	—	44,464
Agency residential mortgage-backed securities	—	299,561	—	299,561
Non-agency residential mortgage-backed securities	—	16,330	—	16,330
U.S. corporate	—	1,337,410	—	1,337,410
Non-U.S. corporate	—	703,891	—	703,891
Bank loans	—	643,701	—	643,701
Catastrophe bonds	—	25,544	6,703	32,247
Asset-backed securities	—	624,499	—	624,499
Commercial mortgage-backed securities	—	22,313	—	22,313
Total fixed maturities	—	5,280,897	6,703	5,287,600
Total short-term investments	817,937	13,863	—	831,800
Other investments				
Fund of hedge funds	—	—	2,194	2,194
Hedge funds (a)	—	—	606,462	606,462
Private equity investments	—	—	13,962	13,962
Investment fund	—	30,499	—	30,499
Mutual funds	—	9,857	—	9,857
Total other investments	—	40,356	622,618	662,974
Total investments including noncontrolling interests	$817,937	$5,335,116	$629,321	$6,782,374
Noncontrolling interest (a)	$—	$—	$(531,403)	$(531,403)
Redeemable noncontrolling interest (b)	$(1,976)	$—	$—	$(1,976)
Total investments excluding noncontrolling interests	$815,961	$5,335,116	$97,918	$6,248,995

(a) Included in the hedge funds balance are investments held by PaCRe in which the Company has an equity interest of 10%. The remaining 90% interest is held by third party investors and included in the Consolidated Balance Sheets as noncontrolling interest.

(b) Included in the total investments balance are investments held by one AlphaCat ILS fund which is consolidated by the Company but in which the Company has an equity interest of less than 100%. The remaining interests are held by third party investors and included in the Consolidated Balance Sheets as redeemable noncontrolling interest.

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At December 31, 2013, the Company’s investments were allocated between Levels 1, 2 and 3 as follows:

	Level 1	Level 2	Level 3	Total
U.S. government and government agency	$—	$1,364,679	$—	$1,364,679
Non-U.S. government and government agency	—	459,068	—	459,068
U.S. states, municipalities and political subdivisions	—	43,120	—	43,120
Agency residential mortgage-backed securities	—	311,499	—	311,499
Non-agency residential mortgage-backed securities	—	15,759	—	15,759
U.S. corporate	—	1,332,484	—	1,332,484
Non-U.S. corporate	—	714,325	—	714,325
Bank loans	—	717,116	—	717,116
Catastrophe bonds	—	74,551	—	74,551
Asset-backed securities	—	509,657	—	509,657
Total fixed maturities	—	5,542,258	—	5,542,258
Total short-term investments	747,215	4,563	—	751,778
Other investments				
Fund of hedge funds	—	—	2,303	2,303
Hedge funds (a)	—	—	561,083	561,083
Private equity investments	—	—	13,485	13,485
Investment fund	—	31,629	—	31,629
Mutual funds	—	9,816	—	9,816
Total other investments	—	41,445	576,871	618,316
Total investments including noncontrolling interests	$747,215	$5,588,266	$576,871	$6,912,352
Noncontrolling interest (a)	$—	$—	$(489,402)	$(489,402)
Redeemable noncontrolling interest (b)	$(18,365)	$—	$—	$(18,365)
Total investments excluding noncontrolling interests	$728,850	$5,588,266	$87,469	$6,404,585

(a) Included in the hedge funds balance are investments held by PaCRe in which the Company has an equity interest of 10%. The remaining 90% interest is held by third party investors and included in the Consolidated Balance Sheets as noncontrolling interest.

(b) Included in the total investments balance are investments held by two AlphaCat ILS funds which are consolidated by the Company but in which the Company has an equity interest of less than 100%. The remaining interests are held by third party investors and included in the Consolidated Balance Sheets as redeemable noncontrolling interest.

At March 31, 2014, Level 3 investments excluding the noncontrolling interest totaled $97,918 (December 31, 2013: $87,469), representing 1.6% (December 31, 2013: 1.4%) of total investments, excluding noncontrolling interest, measured at fair value on a recurring basis.

(b) Level 1 assets measured at fair value

Short term investments

Short term investments categorized as Level 1 consist primarily of highly liquid securities, all with maturities less than one year from the date of purchase. The fair value of the Company's portfolio of short term investments are generally determined using amortized cost which approximates fair value. The Company has determined that certain of its short-term investments, held in highly liquid money market-type funds, should be included in Level 1 as their fair values are based on quoted market prices in active markets.

(c) Level 2 assets measured at fair value

Fixed maturity investments

Fixed maturity investments included in Level 2 include U.S. government and government agency, non-U.S. government and government agency, U.S. states, municipalities and political subdivisions, agency residential mortgage-backed securities, non-agency residential mortgage-backed securities, U.S. corporate, non-U.S. corporate, bank loans, catastrophe bonds, asset-backed securities and commercial mortgage-backed securities.

In general, valuation of the Company's fixed maturity investment portfolios is provided by pricing services, such as index providers and pricing vendors, as well as broker quotations. The pricing vendors provide valuations for a high volume of liquid securities that are actively traded. For securities that do not trade on an exchange, the pricing services generally utilize market data and other observable inputs in matrix pricing models to determine month end prices. Prices are generally verified using third party data. Securities which are priced by an index provider are generally included in the index.

In general, broker-dealers value securities through their trading desks based on observable inputs. The methodologies include mapping securities based on trade data, bids or offers, observed spreads, and performance on newly issued securities. Broker-dealers also determine valuations by observing secondary trading of similar securities. Prices obtained from broker quotations are considered non-binding, however they are based on observable inputs and by observing secondary trading of similar securities obtained from active, non-distressed markets.

The Company considers these Level 2 inputs as they are corroborated with other market observable inputs. The techniques generally used to determine the fair value of the Company's fixed maturity investments are detailed below by asset class.

U.S. government and government agency

U.S. government and government agency securities consist primarily of debt securities issued by the U.S. Treasury and mortgage pass-through agencies such as the Federal National Mortgage Association, the Federal Home Loan Mortgage Corporation and the Government National Mortgage Association. Fixed maturity investments included in U.S. government and government agency securities are primarily priced by pricing services. When evaluating these securities, the pricing services gather information from market sources and integrate other observations from markets and sector news. Evaluations are updated by obtaining broker dealer quotes and other market information including actual trade volumes, when available. The fair value of each security is individually computed using analytical models which incorporate option adjusted spreads and other daily interest rate data.

Non-U.S. government and government agency

Non-U.S. government and government agency securities consist of debt securities issued by non-U.S. governments and their agencies along with supranational organizations (also known as sovereign debt securities). Securities held in these sectors are primarily priced by pricing services who employ proprietary discounted cash flow models to value the securities. Key quantitative inputs for these models are daily observed benchmark curves for treasury, swap and high issuance credits. The pricing services then apply a credit spread for each security which is developed by in-depth and real time market analysis. For securities in which trade volume is low, the pricing services utilize data from more frequently traded securities with similar attributes. These models may also be supplemented by daily market and credit research for international markets.

U.S. states, municipalities and political subdivisions

The Company's U.S. states, municipalities and political subdivisions portfolio contains debt securities issued by U.S. domiciled state and municipal entities. These securities are generally priced by independent pricing services using the techniques described for U.S. government and government agency securities described above.

Agency residential mortgage-backed securities

The Company's agency residential mortgage-backed investments are primarily priced by pricing services using a mortgage pool specific model which utilizes daily inputs from the active to be announced ("TBA") market which is very liquid, as well as the U.S. treasury market. The model also utilizes additional information, such as the weighted average maturity, weighted average coupon and other available pool level data which is provided by the sponsoring agency. Valuations are also corroborated with daily active market quotes.

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Non-agency residential mortgage-backed securities
The Company's non-agency mortgage-backed investments include non-agency prime residential mortgage-backed fixed maturity investments. The Company has no fixed maturity investments classified as sub-prime held in its fixed maturity investments portfolio. Securities held in these sectors are primarily priced by pricing services using an option adjusted spread model or other relevant models, which principally utilize inputs including benchmark yields, available trade information or broker quotes, and issuer spreads. The pricing services also review collateral prepayment speeds, loss severity and delinquencies among other collateral performance indicators for the securities valuation, when applicable.
U.S. corporate
Corporate debt securities consist primarily of investment-grade debt of a wide variety of U.S. corporate issuers and industries. The Company's corporate fixed maturity investments are primarily priced by pricing services. When evaluating these securities, the pricing services gather information from market sources regarding the issuer of the security and obtain credit data, as well as other observations, from markets and sector news. Evaluations are updated by obtaining broker dealer quotes and other market information including actual trade volumes, when available. The pricing services also consider the specific terms and conditions of the securities, including any specific features which may influence risk. In certain instances, securities are individually evaluated using a spread which is added to the U.S. treasury curve or a security specific swap curve as appropriate.
Non-U.S. corporate
Non-U.S. corporate debt securities consist primarily of investment-grade debt of a wide variety of non-U.S. corporate issuers and industries. The Company's non-U.S. corporate fixed maturity investments are primarily priced by pricing services. When evaluating these securities, the pricing services gather information from market sources regarding the issuer of the security and obtain credit data, as well as other observations, from markets and sector news. Evaluations are updated by obtaining broker dealer quotes and other market information including actual trade volumes, when available. The pricing services also consider the specific terms and conditions of the securities, including any specific features which may influence risk.
Bank loans
The Company's bank loan investments consist primarily of below-investment-grade debt of a wide variety of corporate issuers and industries. The Company's bank loans are primarily priced by pricing services. When evaluating these securities, the pricing services gather information from market sources regarding the issuer of the security and obtain credit data, as well as other observations, from markets and sector news. Evaluations are updated by obtaining broker dealer quotes and other market information including actual trade volumes, when available. The pricing services also consider the specific terms and conditions of the securities, including any specific features which may influence risk.
Catastrophe bonds
Catastrophe bonds are based on broker or underwriter bid indications.
Asset-backed securities
Asset backed securities include mostly investment-grade debt securities backed by pools of loans with a variety of underlying collateral, including automobile loan receivables, student loans, credit card receivables, and collateralized loan obligations originated by a variety of financial institutions. Securities held in these sectors are primarily priced by pricing services. The pricing services apply dealer quotes and other available trade information such as bids and offers, prepayment speeds which may be adjusted for the underlying collateral or current price data, the U.S. treasury curve and swap curve as well as cash settlement. The pricing services determine the expected cash flows for each security held in this sector using historical prepayment and default projections for the underlying collateral and current market data. In addition, a spread is applied to the relevant benchmark and used to discount the cash flows noted

above to determine the fair value of the securities held in this sector.
Commercial mortgage-backed securities
Commercial mortgage backed securities are investment-grade debt primarily priced by pricing services. The pricing services apply dealer quotes and other available trade information such as bids and offers, prepayment speeds which may be adjusted for the underlying collateral or current price data, the U.S. treasury curve and swap curve as well as cash settlement. The pricing services determine the expected cash flows for each security held in this sector using historical prepayment and default projections for the underlying collateral and current market data. In addition, a spread is applied to the relevant benchmark and used to discount the cash flows noted above to determine the fair value of the securities held in this sector.

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Short term investments
Short term investments consist primarily of highly liquid securities, all with maturities less than one year from the date of purchase. The fair value of the Company's portfolio of short term investments is generally determined using amortized cost which approximates fair value. The Company has determined that, other than highly liquid money market-type funds, the remaining securities are classified within Level 2 because these securities are typically not actively traded due to their approaching maturity and, as such, their amortized cost approximates fair value.
Investment fund
Investment fund consists of one pooled investment which is invested in fixed income securities with high credit ratings. The investment fund is only open to Lloyd' trust fund participants. The fair value of units in the investment fund is based on the net asset value of the fund as reported by Lloyd's Treasury & Investment Management.
Mutual funds
Mutual funds consist of two investment funds which are invested in various quoted investments. The fair value of units in the mutual funds is based on the net asset value of the fund as reported by the fund manager.
(d) Level 3 assets measured at fair value
Level 3 includes financial instruments that are valued using market approach and income approach valuation techniques. These models incorporate both observable and unobservable inputs. The Company's hedge funds, a fund of hedge funds, private equity investments and certain catastrophe bonds are the only financial instruments in this category as at March 31, 2014. For each respective hedge fund investment, the Company obtains and reviews the valuation methodology used by the fund administrators and investment managers to ensure that the hedge fund investments are following fair value principles consistent with U.S. GAAP in determining the net asset value ("NAV"). Within the hedge fund industry, there is a general lack of transparency necessary to facilitate a detailed independent assessment of the values placed on the securities underlying the NAV provided by the fund manager or fund administrator. To address this, on a quarterly basis, we perform a number of monitoring procedures designed to assist us in the assessment of the quality of the information provided by managers and administrators. These procedures include, but are not limited to, regular review and discussion of each fund's performance with its manager and regular evaluation of fund performance against applicable benchmarks.
Fund of hedge funds
The fund of hedge funds includes a side pocket. While a redemption request has been submitted, the timing of receipt of proceeds on the side pocket is unknown. The fund's administrator provides a monthly reported NAV with a one-month delay in its valuation. As a result, the fund administrator's February 28, 2014 NAV was used as a basis for fair value measurement in the Company's March 31, 2014 balance sheet. The fund manager has provided an estimate of the fund NAV at March 31, 2014 based on the estimated performance provided from the underlying funds. To determine the reasonableness of the estimated NAV, the Company compares the one-month delayed fund administrator's NAV to the fund manager's estimated NAV that incorporates relevant valuation sources on a timely basis. Material variances are recorded in the current reporting period while immaterial variances are recorded in the following reporting period. As this valuation technique incorporates both observable and significant unobservable inputs, the fund of hedge funds is classified as a Level 3 asset.
Hedge funds
The hedge funds were valued at $606,462 at March 31, 2014 (December 31, 2013: $561,083). The hedge funds consist of an investment in four Paulson & Co. managed funds (the "Paulson hedge funds") and one investment fund assumed from the Flagstone Acquisition (the "Flagstone investment fund").
The Paulson hedge funds' administrator provides monthly reported NAVs with a one-month delay in its valuation. As a result, the funds' administrator's February 28, 2014 NAV was used as a partial basis for fair value measurement in the Company's March 31, 2014 balance sheet. The fund manager provides an estimate of the NAV at March 31, 2014

based on estimated performance. The Company adjusts fair value to the fund manager's estimated NAV that incorporates relevant valuation sources on a timely basis. To determine the reasonableness of the estimated NAV, the Company assesses the variance between the fund manager's estimated NAV and the fund administrator's NAV. Material variances are recorded in the current reporting period while immaterial variances are recorded in the following reporting period. Historically, our valuation estimates have not materially differed from the subsequent NAVs.

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The Flagstone investment fund's administrator provides quarterly NAVs with a three-month delay in valuation. As a result, the December 31, 2013 NAV was used as a basis for fair value measurement in the Company's March 31, 2014 balance sheet.

As these valuation techniques incorporate both observable and significant unobservable inputs, both the Paulson hedge funds and the Flagstone investment fund are classified as Level 3 assets. The Paulson hedge funds are subject to quarterly liquidity.

Private equity investments

Private equity investments consist of investments in three private equity funds assumed from the Flagstone Acquisition. The private equity funds' respective fund administrators provide quarterly or semi-annual NAVs with a three-month or six-month delay in valuation as well as audited NAVs as at December 31. As a result, the December 31, 2013 NAV was used as a basis for the fair value measurement in the Company's March 31, 2014 balance sheet. As this valuation technique incorporates both observable and significant unobservable inputs, the private equity investments are classified as Level 3 assets.

The following table presents a reconciliation of the beginning and ending balances for all investments measured at fair value on a recurring basis using Level 3 inputs during the three months ended March 31, 2014 and 2013:

	Three Months Ended	
	March 31, 2014	March 31, 2013
Level 3 investments - Beginning of period	$576,871	$556,234
Purchases	—	459
Sales	(3,589)	(31,334)
Net realized gains	10	40
Net unrealized gains (losses)	49,326	(1,706)
Transfers into Level 3	6,703	—
Level 3 investments - End of period	$629,321	$523,693
Noncontrolling interest (a)	(531,403)	(428,087)
Level 3 investments excluding noncontrolling interest	$97,918	$95,606

(a) Includes Level 3 investments held by PaCRe in which the Company has an equity interest of 10%. The remaining 90% interest is held by third party investors and included in the Consolidated Balance Sheets as noncontrolling interest.

There have not been any transfers between Levels 1 and 2 during the three months ended March 31, 2014 or 2013. During the three months ended March 31, 2014 there was a transfer of investments from Level 2 into Level 3 of the fair value hierarchy. This transfer was due to a reassessment of the extent of unobservable inputs used in establishing the fair value of certain catastrophe bonds. There were no transfers into or out of Level 3 during the three months ended March 31, 2013.

5. Investments in affiliates

The following table presents the Company's investments in affiliates as at March 31, 2014 and December 31, 2013:

	As at March 31, 2014	As at December 31, 2013
Investment affiliate	$39,848	$34,500
Operating affiliates	181,759	106,743
Investments in affiliates	$221,607	$141,243

(a) Investment affiliate

Aquiline Financial Services Fund II L.P.

On December 20, 2011, the Company entered into an Assignment and Assumption Agreement (the "Agreement") with Aquiline Capital Partners LLC, a Delaware limited liability company (the "Assignor") and Aquiline Capital

Partners II GP (Offshore) Ltd., a Cayman Islands company limited by shares (the "General Partner") pursuant to which the Company has assumed 100% of the Assignor's interest in Aquiline Financial Services Fund II L.P. (the "Partnership") representing a total capital commitment of $50,000 (the "Commitment"), as a limited partner in the Partnership (the "Transferred Interest"). The Transferred Interest is governed by the

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terms of an Amended and Restated Exempted Limited Partnership Agreement dated as of July 2, 2010 (the "Limited Partnership Agreement"). Pursuant to the terms of the Limited Partnership Agreement, the Commitment will expire on July 2, 2015.

The Partnership provides quarterly capital account statements with a three-month delay in its valuation. As a result, the Partnership's December 31, 2013 capital account statement was used as the basis for calculating the Company's share of Partnership income for the period.

The following table presents a reconciliation of the beginning and ending investment in the Company's investment affiliate balance for the three months ended March 31, 2014 and 2013:

	Three Months Ended	
	March 31, 2014	March 31, 2013
Investment affiliate, beginning of period	$ 34,500	$ 15,218
Capital contributions	—	1,341
Income from investment affiliate	5,348	1,477
Investment affiliate, end of period	$ 39,848	$ 18,036

The following table presents the Company's investment in the Partnership as at March 31, 2014:

	Investment in investment affiliate			
	Investment at cost	Voting ownership %	Equity Ownership	Carrying Value
Aquiline Financial Services Fund II L.P.	$ 32,110	— %	6.7 %	$ 39,848

The following table presents the Company's investment in the Partnership as at December 31, 2013:

	Investment in investment affiliate			
	Investment at cost	Voting ownership %	Equity Ownership	Carrying Value
Aquiline Financial Services Fund II L.P.	$ 32,110	— %	6.7 %	$ 34,500

(b) Operating affiliates

AlphaCat Re 2011 Ltd.

On May 25, 2011, the Company joined with other investors in capitalizing AlphaCat Re 2011 Ltd. ("AlphaCat Re 2011"), a special purpose reinsurer formed for the purpose of writing collateralized reinsurance and retrocessional reinsurance. AlphaCat Re 2011 was a market facing entity and the Company's investment in AlphaCat Re 2011 has been treated as an equity method investment.

AlphaCat Re 2011 is now considered "off-risk" as the risk periods for all reinsurance contracts written have expired. As a result, partial returns of investment have been made to the investors of AlphaCat Re 2011.The Company's portion of the returns made during the three months ended March 31, 2014 and 2013 are included in the tables below.

AlphaCat Re 2012 Ltd.

On May 29, 2012, the Company joined with other investors in capitalizing AlphaCat Re 2012 Ltd. ("AlphaCat Re 2012"), a special purpose reinsurer formed for the purpose of writing collateralized reinsurance with a particular focus on windstorm risks for Florida domiciled insurance companies. AlphaCat Re 2012 was a market facing entity and the Company's investment in AlphaCat Re 2012 has been treated as an equity method investment.

AlphaCat Re 2012 is now considered "off-risk" as the risk periods for all reinsurance contracts written have expired. As a result, partial returns of investment have been made to the investors of AlphaCat Re 2012.The Company's portion of the returns made during the three months ended March 31, 2014 and 2013 are included in the tables below.

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AlphaCat 2013, Ltd.
On December 17, 2012, the Company joined with other investors in capitalizing AlphaCat 2013, Ltd. ("AlphaCat 2013"), an entity formed for the purpose of investing in collateralized reinsurance and retrocession on a worldwide basis. AlphaCat 2013 deployed its capital through transactions entered into by AlphaCat Reinsurance Ltd. (“AlphaCat Re”) and the Company's investment in AlphaCat 2013 has been treated as an equity method investment.
Partial returns of investment have been made to the investors of AlphaCat 2013.The Company's portion of the returns made during the three months ended March 31, 2014 are included in the tables below.
AlphaCat 2014, Ltd.
On December 20, 2013, the Company joined with other investors in capitalizing AlphaCat 2014, Ltd. (“AlphaCat 2014”), an entity formed for the purpose of investing in collateralized reinsurance and retrocessional contracts for the January 1, 2014 renewal season. AlphaCat 2014 deploys its capital through transactions entered into by AlphaCat Re and the Company's investment in AlphaCat 2014 has been treated as an equity method investment.
AlphaCat ILS funds
The AlphaCat ILS funds invest in instruments with returns linked to property catastrophe reinsurance, retrocession and insurance linked securities ("ILS") contracts. AlphaCat ILS funds all deploy their capital through the AlphaCat Master Fund Ltd. (the “Master Fund”) and AlphaCat Re. All three funds are variable interest entities, with one being consolidated by the Company as the primary beneficiary and one being accounted for as an equity method investment since the Company holds an equity interest of 9.1%. The third fund had been consolidated by the Company as the primary beneficiary from its formation through to December 31, 2013. However, on January 1, 2014 the fund received $35,000 in additional third party subscriptions, resulting in a reduction of the Company’s equity interest below 50%. Since the Company retains significant influence, this fund has been deconsolidated and accounted for as an equity method investment from January 1, 2014. The fair value of the retained interest, based on the fair value of the underlying instruments in Master Fund and AlphaCat Re, amounted to $113,455 at January 1, 2014. The deconsolidation resulted in a gain of $1,372 and is included in the Consolidated Statements of Comprehensive Income as other income. The Company's maximum exposure to any of the funds is the amount of capital invested at any given time.
AlphaCat Master Fund Ltd. and AlphaCat Reinsurance Ltd.
The Company utilizes Master Fund and AlphaCat Re for the purpose of investing in capital market products and writing collateralized reinsurance, respectively, on behalf of certain entities within the AlphaCat operating segment. Master Fund and AlphaCat Re are market facing entities which enter into transactions on behalf of AlphaCat 2013, AlphaCat 2014 and the AlphaCat ILS funds. The Company owns all of the voting equity interest in Master Fund and AlphaCat Re and, as a result, their financial statements are included in the Consolidated Financial Statements of the Company.
The following tables present a reconciliation of the beginning and ending investment in operating affiliates for the three months ended March 31, 2014 and 2013:

	AlphaCat Re 2011	AlphaCat Re 2012	AlphaCat 2013	AlphaCat 2014	AlphaCat ILS funds	Total
As at December 31, 2013	$9,809	$1,313	$51,744	$21,982	$21,895	$106,743
Return of investment	(5,825)	—	(37,541)	—	—	(43,366)
Fair value of retained interest on deconsolidation of AlphaCat ILS fund	—	—	—	—	113,455	113,455
Income (loss) from operating affiliates	193	(36)	1,475	1,611	1,684	4,927
As at March 31, 2014	$4,177	$1,277	$15,678	$23,593	$137,034	$181,759

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	Three Months Ended March 31, 2013				
	AlphaCat Re 2011	AlphaCat Re 2012	AlphaCat 2013	AlphaCat ILS fund	Total
As at December 31, 2012	$62,792	$29,319	$45,000	$20,000	$157,111
Return of investment	(46,436)	(3,786)	—	—	(50,222)
Income from operating affiliates	449	1,825	1,100	149	3,523
As at March 31, 2013	$16,805	$27,358	$46,100	$20,149	$110,412

The following table presents the Company's investments in AlphaCat Re 2011, AlphaCat Re 2012, AlphaCat 2013, AlphaCat 2014 and the AlphaCat ILS funds in the Consolidated Financial Statements as at March 31, 2014:

	Investment in operating affiliates			
	Cost	Voting ownership %	Equity ownership %	Carrying value
AlphaCat Re 2011	$4,178	43.7 %	22.3 %	$4,177
AlphaCat Re 2012	654	49.0 %	37.9 %	1,277
AlphaCat 2013	16,454	40.9 %	19.7 %	15,678
AlphaCat 2014	22,000	42.3 %	19.6 %	23,593
AlphaCat ILS funds (a)	133,455	n/a	n/a	137,034
Total	$176,741			$181,759

(a) Equity ownerships in the two funds were 9.1% and 49.7% respectively as at March 31, 2014.

The following table presents the Company's investments in AlphaCat Re 2011, AlphaCat Re 2012, AlphaCat 2013, AlphaCat 2014 and the AlphaCat ILS fund in the Consolidated Financial Statements as at December 31, 2013:

	Investment in operating affiliates			
	Cost	Voting ownership %	Equity ownership %	Carrying value
AlphaCat Re 2011	$9,882	43.7 %	22.3 %	$9,809
AlphaCat Re 2012	654	49.0 %	37.9 %	1,313
AlphaCat 2013	45,000	40.9 %	19.7 %	51,744
AlphaCat 2014	22,000	42.3 %	19.6 %	21,982
AlphaCat ILS fund	20,000	— %	9.1 %	21,895
Total	$97,536			$106,743

(c) Notes payable and (income) attributable to operating affiliates

Notes are issued during the course of a year by Master Fund and AlphaCat Re to AlphaCat 2013, AlphaCat 2014 and the AlphaCat ILS funds (collectively the “feeder funds”) in order to fund the purchase of capital market products and to write collateralized reinsurance on their behalf. These notes are subsequently redeemed as the underlying transactions are settled. The Company’s investments in the feeder funds, together with investments made by third parties, are provided as consideration for these notes to Master Fund and AlphaCat Re, which are consolidated in the Company’s Consolidated Financial Statements. The effective economic interest in Master Fund and AlphaCat Re that results from these transactions is represented on the Consolidated Balance Sheet as notes payable to operating affiliates. The subsequent income or loss generated by the relevant capital market products or collateralized reinsurance is transferred to the operating affiliates as (income) loss attributable to operating affiliate investors in the Company’s Consolidated Statements of Comprehensive Income. To the extent that the (income) loss attributable to operating affiliate investors has not been returned to investors, it is included in accounts payable and accrued expenses in the

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Notes issued during the three months ended March 31, 2014 amounted to $334,444 (2013: $294,349). The underlying capital market products and collateralized reinsurance typically have at least a twelve month duration. The notes do not have any principal amount, since the final amount payable is dependent on the income or loss as discussed above. They also do not have any stated maturity date, since repayment is dependent on the settlement of the underlying transactions. During the three months ended March 31, 2014 there have been repayments of these notes amounting to $391,115 (2013: $nil).

The following tables present a reconciliation of the beginning and ending notes payable to operating affiliates for the three months ended March 31, 2014 and 2013:

	AlphaCat 2013	AlphaCat 2014	AlphaCat ILS funds	Total
As at December 31, 2013	$223,809	$—	$215,463	$439,272
Notes payable to operating affiliates recognized on deconsolidation of AlphaCat ILS fund	—	—	178,837	178,837
Issuance of notes payable to operating affiliates	—	149,707	184,737	334,444
Redemption of notes payable to operating affiliates	(175,349)	—	(215,766)	(391,115)
Foreign exchange (gain) loss	(297)	109	123	(65)
As at March 31, 2014	$48,163	$149,816	$363,394	$561,373

	AlphaCat 2013	AlphaCat ILS funds	Total
As at December 31, 2012	$—	$—	$—
Issuance of notes payable to operating affiliates	162,506	131,843	294,349
Foreign exchange gain	(1,067)	(2,694)	(3,761)
As at March 31, 2013	$161,439	$129,149	$290,588

The portion of notes payable to operating affiliates that were due to the Company, as an investor in the affiliates, and third party investors as at March 31, 2014 amounted to $141,343 and $420,030, respectively (December 31, 2013: $63,654 and $375,618).

The following table presents the (income) attributable to operating affiliate investors for the three months ended March 31, 2014 and 2013:

	March 31, 2014	March 31, 2013
AlphaCat 2013	$(10,476)	$(8,141)
AlphaCat 2014	(10,789)	—
AlphaCat ILS funds	(10,445)	(1,936)
(Income) attributable to operating affiliate investors	$(31,710)	$(10,077)

The portion of income attributable to operating affiliate investors that was due to the Company, as an investor in the affiliates, and third party investors for the three months ended March 31, 2014 amounted to $6,472 and $25,238, respectively (2013: $1,847 and $8,230).

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6. Noncontrolling interest

On April 2, 2012, the Company joined with other investors in capitalizing PaCRe Ltd. ("PaCRe"), a Class 4 Bermuda reinsurer formed for the purpose of writing high excess property catastrophe reinsurance. The Company has an equity interest of 10% and the remaining 90% interest is held by third party investors. The Company has a majority voting equity interest in PaCRe and as a result, the financial statements of PaCRe are included in the Consolidated Financial Statements of the Company.

The portion of PaCRe's earnings attributable to third party investors is recorded in the Consolidated Statements of Comprehensive Income as net (income) loss attributable to noncontrolling interest. PaCRe's shareholder rights do not include redemption features within the control of the third party shareholders. The third party equity is recorded in the Company's Consolidated Balance Sheets as noncontrolling interest.

The portion of the earnings from the one consolidated AlphaCat ILS fund attributable to third party investors is recorded in the Consolidated Statements of Comprehensive Income as net (income) loss attributable to noncontrolling interest. The AlphaCat ILS funds have rights that enable shareholders, subject to certain limitations, to redeem their shares. The third party equity is therefore recorded in the Company's Consolidated Balance Sheets as redeemable noncontrolling interest. When and if a redemption notice is received, the fair value of the redemption is reclassified to a liability.

The following table presents a reconciliation of the beginning and ending balances of redeemable noncontrolling interest and noncontrolling interest for the three months ended March 31, 2014:

	Three Months Ended March 31, 2014		
	Redeemable noncontrolling interest	Noncontrolling interest	Total
As at December 31, 2013	$86,512	$497,657	$584,169
Income attributable to third parties	232	43,277	43,509
Adjustment to noncontrolling interest as a result of deconsolidation	(78,354)	—	(78,354)
As at March 31, 2014	$8,390	$540,934	$549,324

The following table presents a reconciliation of the beginning and ending balances of redeemable noncontrolling interest and noncontrolling interest for the three months ended March 31, 2013:

	Three Months Ended March 31, 2013		
	Redeemable noncontrolling interest	Noncontrolling interest	Total
As at December 31, 2012	$—	$434,280	$434,280
Issuance of shares	55,690	—	55,690
Income (loss) attributable to third parties	587	(3,136)	(2,549)
As at March 31, 2013	$56,277	$431,144	$487,421

7. Derivative instruments

The Company enters into derivative instruments for risk management purposes, specifically to hedge unmatched foreign currency exposures and interest rate exposures. As at March 31, 2014, the Company held foreign currency forward contracts to mitigate the risk of fluctuations in the U.S. dollar against a number of foreign currencies. As at March 31, 2014, the Company held two interest rate swaps to fix the payment of interest on the Company's 2006 and 2007 Junior Subordinated Deferrable Debentures, as well as three interest rate swaps and one cross-currency interest rate swap to fix the payment of interest and mitigate the foreign exchange rate impact on Flagstone's 2006 and 2007 Junior Subordinated Deferrable Debentures.

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The following table summarizes information on the classification and amount of the fair value of derivatives designated as hedging instruments on the consolidated balance sheets at March 31, 2014 and December 31, 2013:

	As at March 31, 2014			As at December 31, 2013		
Derivatives designated as hedging instruments:	Net notional exposure	Asset Derivative at Fair Value (a)	Liability Derivative at Fair Value (a)	Net notional exposure	Asset Derivative at Fair Value (a)	Liability Derivative at Fair Value (a)
Foreign currency forward contracts	$151,853	$3,839	$477	$163,576	$1,167	$2,313
Interest rate swap contracts	$552,263	$—	$867	$552,263	$—	$911

(a) Asset and liability derivatives are classified within other assets and accounts payable and accrued expenses respectively on the Consolidated Balance Sheets.

(a) Classification within the fair value hierarchy

As described in Note 4: "Fair value measurements" under U.S. GAAP, a company must determine the appropriate level in the fair value hierarchy for each fair value measurement. The assumptions used within the valuation of the Company's derivative instruments are observable in the marketplace, can be derived from observable data or are supported by observable levels at which other similar transactions are executed in the marketplace. Accordingly, these derivatives were classified within Level 2 of the fair value hierarchy.

(b) Derivative instruments designated as a fair value hedge

The Company designates its foreign currency derivative instruments as fair value hedges and formally and contemporaneously documents all relationships between the derivative instruments and hedged items and links the derivative instruments to specific assets and liabilities. The Company assesses the effectiveness of the hedges, both at inception and on an on-going basis and determines whether the hedges are highly effective in offsetting changes in fair value of the linked hedged items.

The following table provides the total impact on earnings, recognized in income within foreign exchange gains (losses), relating to the derivative instruments formally designated as fair value hedges along with the impact of the related hedged items for the three months ended March 31, 2014 and 2013:

Foreign currency forward contracts	Three Months Ended March 31, 2014	Three Months Ended March 31, 2013
Amount of gain (loss) recognized in income on derivative	$3,303	$1,261
Amount of gain (loss) on hedged item recognized in income attributable to risk being hedged	$(3,303)	$(1,261)
Amount of gain (loss) recognized in income on derivative (ineffective portion)	$—	$—

(c) Derivative instruments designated as a cash flow hedge

The Company designates its interest rate derivative instruments as cash flow hedges and formally and contemporaneously documents all relationships between the hedging instruments and hedged items and links the derivative instruments to specific assets and liabilities. The Company assesses the effectiveness of the hedges, both at inception and on an on-going basis and determines whether the hedges are highly effective in offsetting changes in fair value of the linked hedged items. The Company currently applies the long haul method when assessing the hedge's effectiveness.

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The following table provides the total impact on other comprehensive income (loss) and earnings relating to the derivative instruments formally designated as cash flow hedges along with the impact of the related hedged items for the three months ended March 31, 2014 and 2013:

Interest rate swap contracts	Three Months Ended March 31, 2014	Three Months Ended March 31, 2013
Amount of effective portion recognized in other comprehensive income	$3,208	$1,608
Amount of effective portion subsequently reclassified to earnings	$(3,208)	$(1,608)
Amount of ineffective portion excluded from effectiveness testing	$—	$—

The above balances relate to interest payments and have therefore been classified as finance expenses in the Consolidated Statements of Comprehensive Income.

(d) Balance sheet offsetting

There was no balance sheet offsetting activity as at March 31, 2014 or December 31, 2013.

The Company currently provides cash collateral as security for interest rate swap contracts. The Company does not provide cash collateral or financial instruments as security for foreign currency forward contracts. Our derivative instruments are generally traded under International Swaps and Derivatives Association master netting agreements, which establish terms that apply to all transactions. On a periodic basis, the amounts receivable from or payable to the counterparties are settled in cash.

The Company has not elected to settle multiple transactions with an individual counterparty on a net basis.

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8. Reserve for losses and loss expenses

Reserves for losses and loss expenses are based in part upon the estimation of case reserves from broker, insured and ceding company reported data. The Company also uses statistical and actuarial methods to estimate ultimate expected losses and loss expenses, from which incurred but not reported losses can be calculated. The period of time from the occurrence of a loss to the reporting of a loss to the Company and to the settlement of the Company's liability may be several months or years. During this period, additional facts and trends may be revealed. As these factors become apparent, reserves will be adjusted, sometimes requiring an increase or decrease in the overall reserves of the Company, and at other times requiring a reallocation of incurred but not reported reserves to specific case reserves. These estimates are reviewed and adjusted regularly, and such adjustments, if any, are reflected in earnings in the period in which they become known. While management believes that it has made a reasonable estimate of ultimate losses, there can be no assurances that ultimate losses and loss expenses will not exceed this estimate.

The following table represents an analysis of paid and unpaid losses and loss expenses incurred and a reconciliation of the beginning and ending unpaid losses and loss expenses for the three months ended March 31, 2014 and 2013:

	Three Months Ended	
	March 31, 2014	March 31, 2013
Reserve for losses and loss expenses, beginning of period	$3,030,399	$3,517,573
Losses and loss expenses recoverable	(370,154)	(439,967)
Net reserves for losses and loss expenses, beginning of period	2,660,245	3,077,606
Increase (decrease) in net losses and loss expenses incurred in respect of losses occurring in:		
Current year	202,086	210,569
Prior years	(39,415)	(65,798)
Total incurred losses and loss expenses	162,671	144,771
Less net losses and loss expenses paid in respect of losses occurring in:		
Current year	(7,967)	(4,838)
Prior years	(250,115)	(255,274)
Total net paid losses	(258,082)	(260,112)
Foreign exchange loss (gain)	11,818	(33,826)
Net reserve for losses and loss expenses, end of period	2,576,652	2,928,439
Losses and loss expenses recoverable	348,407	429,252
Reserve for losses and loss expenses, end of period	$2,925,059	$3,357,691

Incurred losses and loss expenses comprise:

	Three Months Ended	
	March 31, 2014	March 31, 2013
Gross losses and loss expenses	$181,975	$162,411
Reinsurance recoverable	(19,304)	(17,640)
Net incurred losses and loss expenses	$162,671	$144,771

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9. Reinsurance

The Company enters into reinsurance and retrocession agreements in order to mitigate its accumulation of loss, reduce its liability on individual risks, enable it to underwrite policies with higher limits and increase its aggregate capacity. The cession of insurance and reinsurance does not legally discharge the Company from its primary liability for the full amount of the policies, and the Company is required to pay the loss and bear collection risk if the reinsurer fails to meet its obligations under the reinsurance or retrocession agreement. Amounts recoverable from reinsurers are estimated in a manner consistent with the underlying liabilities.

Credit risk

The Company evaluates the financial condition of its reinsurers and monitors concentration of credit risk arising from its exposure to individual reinsurers. The reinsurance program is generally placed with reinsurers whose rating, at the time of placement, was A- or better as rated by Standard & Poor's or the equivalent with other rating agencies. Exposure to a single reinsurer is also controlled with restrictions dependent on rating. At March 31, 2014, 98.5% (December 31, 2013: 96.7%) of reinsurance recoverables (which includes loss reserves recoverable and recoverables on paid losses and $183,858 of total IBNR recoverable (December 31, 2013: $196,840)) were fully collateralized or from reinsurers rated A- or better.

Reinsurance recoverables by reinsurer as at March 31, 2014 and December 31, 2013 are as follows:

	March 31, 2014			December 31, 2013		
	Reinsurance Recoverable	% of Total		Reinsurance Recoverable	% of Total	
Top 10 reinsurers	$291,958	75.7	%	$340,253	75.6	%
Other reinsurers' balances > $1 million	85,348	22.2	%	100,784	22.4	%
Other reinsurers' balances < $1 million	8,133	2.1	%	9,197	2.0	%
Total	$385,439	100.0	%	$450,234	100.0	%

	March 31, 2014			
Top 10 Reinsurers	Rating	Reinsurance Recoverable	% of Total	
Lloyd's Syndicates	A+	$66,563	17.3	%
Everest Re	A+	49,838	12.9	%
Fully Collateralized	NR	39,120	10.1	%
Hannover Re	AA-	36,377	9.4	%
Third Point Reinsurance Ltd	A-	34,081	8.8	%
Swiss Re	AA-	17,108	4.5	%
Transatlantic Re	A+	13,449	3.5	%
XL Re	A+	12,608	3.3	%
Munich Re	AA-	12,333	3.2	%
Merrimack Mutual Fire Insurance	A+	10,481	2.7	%
Total		$291,958	75.7	%

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	December 31, 2013			
Top 10 Reinsurers	Rating	Reinsurance Recoverable	% of Total	
Lloyd's Syndicates	A+	$73,398	16.3	%
National Indemnity	AA+	51,037	11.3	%
Everest Re	A+	48,055	10.7	%
Hannover Re	AA-	41,483	9.2	%
Fully Collateralized	NR	36,683	8.1	%
Third Point Reinsurance Ltd	A-	30,428	6.8	%
Swiss Re	AA-	20,022	4.5	%
Transatlantic Re	A+	14,114	3.1	%
XL Re	A+	12,673	2.8	%
Munich Re	AA-	12,360	2.8	%
Total		$340,253	75.6	%

NR: Not rated

At March 31, 2014 and December 31, 2013, the provision for uncollectible reinsurance relating to reinsurance recoverables was $5,427 and $5,794, respectively. To estimate the provision for uncollectible reinsurance, the reinsurance recoverable is first allocated to applicable reinsurers. This determination is based on a process rather than an estimate, although an element of judgment is applied, especially in relation to ceded IBNR. The Company then uses default factors to determine the portion of a reinsurer’s balance deemed to be uncollectible. Default factors require considerable judgment and are determined in part using the current rating, or rating equivalent, of each reinsurer as well as other key considerations and assumptions.

10. Share capital

(a) Authorized and issued

The Company’s authorized share capital is 571,428,571 common shares with a par value of $0.175 per share. The holders of common shares are entitled to receive dividends. Holders of common shares are allocated one vote per share, provided that, if the controlled shares of any shareholder or group of related shareholders constitute more than 9.09 percent of the outstanding common shares of the Company, their voting power will be reduced to 9.09 percent.

The Company may from time to time repurchase its securities, including common shares, Junior Subordinated Deferrable Debentures and Senior Notes. On February 5, 2014, the Board of Directors of the Company approved an increase in the Company's common share purchase authorization to $500,000. This amount is in addition to the $1,774,436 of common shares repurchased by the Company through February 5, 2014 under its previously authorized share repurchase programs.

The Company has repurchased 62,171,982 common shares for an aggregate purchase price of $1,917,688 from the inception of its share repurchase program to March 31, 2014. The Company had $356,748 remaining under its authorized share repurchase program as of March 31, 2014.

The Company expects the purchases under its share repurchase program to be made from time to time in the open market or in privately negotiated transactions. The timing, form and amount of the share repurchases under the program will depend on a variety of factors, including market conditions, the Company’s capital position relative to internal and rating agency targets, legal requirements and other factors. The repurchase program may be modified, extended or terminated by the Board of Directors at any time.

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The following table is a summary of the common shares issued and outstanding:

	Common Shares
Common shares issued, December 31, 2013	154,488,497
Restricted share awards vested, net of shares withheld	18,219
Options exercised	90,019
Direct issuance of common stock	359
Common shares issued, March 31, 2014	154,597,094
Treasury shares, March 31, 2014	(63,810,857)
Common shares outstanding, March 31, 2014	90,786,237
	Common Shares
Common shares issued, December 31, 2012	152,698,191
Restricted share awards vested, net of shares withheld	130,637
Restricted share units vested, net of shares withheld	3,796
Options exercised	128,020
Direct issuance of common stock	183
Deferred share units vested, net of shares withheld	2,935
Common shares issued, March 31, 2013	152,963,762
Treasury shares, March 31, 2013	(46,681,321)
Common shares outstanding, March 31, 2013	106,282,441

(b) Warrants

During the three months ended March 31, 2014 and 2013, no warrants were exercised. Holders of the outstanding warrants are entitled to exercise the warrants in whole or in part at any time until the expiration date. The total outstanding warrants at March 31, 2014 were 5,174,114 (December 31, 2013: 5,296,056). No further warrants are anticipated to be issued.

(c) Deferred share units

Under the terms of the Company’s Director Stock Compensation Plan, non-management directors may elect to receive their director fees in deferred share units rather than cash. The number of share units distributed in case of election under the plan is equal to the amount of the annual retainer fee otherwise payable to the director on such payment date divided by 100% of the fair market value of a share on such payment date. Additional deferred share units are issued in lieu of dividends that accrue on these deferred share units. There were no outstanding deferred share units at March 31, 2014 (December 31, 2013: $nil).

As of February 16, 2013, John Hendrickson became an employee director. As a result, his 5,039 deferred share units vested and 2,935 common shares were issued to him, net of shares withheld for taxes.

(d) Dividends

On February 5, 2014, the Company announced a quarterly cash dividend of $0.30 (2013: $0.30) per common share and $0.30 per common share equivalent for which each outstanding warrant is exercisable. This dividend was paid on March 31, 2014 to holders of record on March 14, 2014.

On February 6, 2013 the Company announced a special dividend in the amount of $2.00 per common share and $2.00 per common share equivalent for which each outstanding warrant is exercisable (the "2013 Special Dividend"). The 2013 Special Dividend was paid on February 26, 2013 to shareholders and warrant holders of record as of February 19, 2013.

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11. Stock plans
(a) Long Term Incentive Plan and Short Term Incentive Plan
The Company's Amended and Restated 2005 Long Term Incentive Plan ("LTIP") provides for grants to employees of options, stock appreciation rights ("SARs"), restricted shares, restricted share units, performance shares, dividend equivalents or other share-based awards. In addition, the Company may issue restricted share awards or restricted share units in connection with awards issued under its annual Short Term Incentive Plan ("STIP"). The total number of shares reserved for issuance under the LTIP and STIP are 13,126,896 shares of which 1,987,700 shares are remaining. The LTIP and STIP are administered by the Compensation Committee of the Board of Directors. No SARs have been granted to date. Grant prices are established at the fair market value of the Company's common shares at the date of grant.
i. Options
Options may be exercised for voting common shares upon vesting. Options have a life of 10 years and vest either pro rata or at the end of the required service period from the date of grant. Fair value of the option awards at the date of grant is determined using the Black-Scholes option-pricing model.
Expected volatility is based on stock price volatility of comparable publicly-traded companies. The Company used the simplified method consistent with U.S. GAAP authoritative guidance on stock compensation expenses to estimate expected lives for options granted during the period as historical exercise data was not available and the options met the requirement as set out in the guidance.
The Company has not granted any stock options since September 4, 2009.
There were no share compensation expenses in respect of options recorded for the three months ended March 31, 2014 and 2013.
A modification event was triggered as a result of the 2013 Special Dividend. In accordance with the terms of the LTIP under which the options were issued, an adjustment was required to protect the holders of such stock options from changes in the value of the stock options following the declaration of the 2013 Special Dividend. The modification of the options included a decrease in the exercise price of each stock option and an increase in the number of shares underlying each stock option. The fair value of the options before and after the modification was unchanged.
Activity with respect to options for the three months ended March 31, 2014 was as follows:

	Options	Weighted Average Grant Date Fair Value	Weighted Average Grant Date Exercise Price
Options outstanding, December 31, 2013	1,572,713	$6.66	$18.88
Options exercised	(90,019)	4.25	25.46
Options outstanding, March 31, 2014	1,482,694	$6.81	$18.48

Activity with respect to options for the three months ended March 31, 2013 was as follows:

	Options	Weighted Average Grant Date Fair Value	Weighted Average Grant Date Exercise Price
Options outstanding, December 31, 2012	1,823,947	$6.52	$20.69
Options regranted (modified)	1,833,414	6.76	19.02
Options exercised	(128,020)	3.40	28.98
Options cancelled (modified)	(1,733,139)	6.76	20.12
Options outstanding, March 31, 2013	1,796,202	$6.75	$18.95

At March 31, 2014 and 2013, there were no unrecognized share compensation expenses in respect of options.

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ii. Restricted share awards

Restricted shares granted under the LTIP and STIP vest either pro rata or at the end of the required service period and contain certain restrictions during the vesting period, relating to, among other things, forfeiture in the event of termination of employment and transferability. Share compensation expenses of $7,001 were recorded for the three months ended March 31, 2014 (2013: $4,061). The expenses represent the proportionate accrual of the fair value of each grant based on the remaining vesting period.

Activity with respect to unvested restricted share awards for the three months ended March 31, 2014 was as follows:

	Restricted Share Awards	Weighted Average Grant Date Fair Value
Restricted share awards outstanding, December 31, 2013	2,684,745	$33.74
Restricted share awards granted	17,533	36.81
Restricted share awards vested	(27,353)	29.31
Restricted share awards forfeited	(23,094)	34.57
Restricted share awards outstanding, March 31, 2014	2,651,831	$33.80

Activity with respect to unvested restricted share awards for the three months ended March 31, 2013 was as follows:

	Restricted Share Awards	Weighted Average Grant Date Fair Value
Restricted share awards outstanding, December 31, 2012	2,170,547	$29.24
Restricted share awards granted	22,005	35.63
Restricted share awards vested	(148,304)	25.97
Restricted share awards forfeited	(93,993)	28.42
Restricted share awards outstanding, March 31, 2013	1,950,255	$29.60

At March 31, 2014, there were $62,370 (December 31, 2013: $69,219) of total unrecognized share compensation expenses in respect of restricted share awards that are expected to be recognized over a weighted-average period of 3.0 years (December 31, 2013: 3.2 years).

iii. Restricted share units

Restricted share units under the LTIP and STIP vest either ratably or at the end of the required service period and contain certain restrictions during the vesting period, relating to, among other things, forfeiture in the event of termination of employment and transferability. Share compensation expenses of $166 were recorded for the three months ended March 31, 2014 (2013: $121). The expenses represent the proportionate accrual of the fair value of each grant based on the remaining vesting period.

Activity with respect to unvested restricted share units for the three months ended March 31, 2014 was as follows:

	Restricted Share Units	Weighted Average Grant Date Fair Value
Restricted share units outstanding, December 31, 2013	66,518	$33.74
Restricted share units issued in lieu of cash dividends	495	33.74
Restricted share units outstanding, March 31, 2014	67,013	$33.74

Activity with respect to unvested restricted share units for the three months ended March 31, 2013 was as follows:

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	Restricted Share Units	Weighted Average Grant Date Fair Value
Restricted share units outstanding, December 31, 2012	47,238	$29.61
Restricted share units vested	(5,468)	25.27
Restricted share units issued in lieu of cash dividends	3,020	29.69
Restricted share units outstanding, March 31, 2013	44,790	$30.15

At March 31, 2014, there were $1,519 (December 31, 2013: $1,678) of total unrecognized share compensation expenses in respect of restricted share units that are expected to be recognized over a weighted-average period of 3.2 years (December 31, 2013: 3.4 years).

iv. Performance share awards

The performance share awards contain a performance based component. The performance component relates to the compounded growth in the Dividend Adjusted Diluted Book Value per Share ("DBVPS") over a three year period relative to the Company's peer group. For performance share awards granted during the period, the grant date Diluted Book Value per Share is based on the DBVPS at the end of the most recent financial reporting year. The Dividend Adjusted Performance Period End DBVPS will be the DBVPS three years after the grant date DBVPS. The fair value estimate earns over the requisite attribution period and the estimate will be reassessed at the end of each performance period which will reflect any adjustments in the consolidated statements of comprehensive income in the period in which they are determined.

Share compensation expenses of $(20) were recorded for the three months ended March 31, 2014 (2013: $(1,864)). The negative expense is due to a reversal of expenses on unvested performance share awards based on a review of current and projected performance criteria.

Activity with respect to unvested performance share awards for the three months ended March 31, 2014 was as follows:

	Performance Share Awards	Weighted Average Grant Date Fair Value
Performance share awards outstanding, December 31, 2013	101,820	$33.56
Performance share awards conversion adjustment	(15,344)	31.38
Performance share awards outstanding, March 31, 2014	86,476	$33.95

Activity with respect to unvested performance share awards for the three months ended March 31, 2013 was as follows:

	Performance Share Awards	Weighted Average Grant Date Fair Value
Performance share awards outstanding, December 31, 2012	220,845	$31.81
Performance share awards forfeited	(128,667)	32.41
Performance share awards outstanding, March 31, 2013	92,178	$30.99

At March 31, 2014, there were $1,207 (December 31, 2013: $1,642) of total unrecognized share compensation expenses in respect of performance share awards that are expected to be recognized over a weighted-average period of 1.9 years (December 31, 2013: 2.0 years).

(b) Total share compensation expenses

The breakdown of share compensation expenses by award type was as follows:

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	Three Months Ended	
	March 31, 2014	March 31, 2013
Restricted share awards	$7,001	$4,061
Restricted share units	166	121
Performance share awards	(20)	(1,864)
Total	$7,147	$2,318

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12. Debt and financing arrangements
(a) Financing structure
The financing structure at March 31, 2014 was:

	Commitment	Issued and outstanding (a)	Drawn
2006 Junior Subordinated Deferrable Debentures	$150,000	$150,000	$150,000
2007 Junior Subordinated Deferrable Debentures	200,000	139,800	139,800
Flagstone 2006 Junior Subordinated Deferrable Debentures	137,904	137,904	137,904
Flagstone 2007 Junior Subordinated Deferrable Debentures	113,750	113,750	113,750
Total debentures payable	601,654	541,454	541,454
2010 Senior Notes due 2040	250,000	250,000	247,225
Total debentures and senior notes payable	851,654	791,454	788,679
$400,000 syndicated unsecured letter of credit facility	400,000	—	—
$525,000 syndicated secured letter of credit facility	525,000	309,422	—
$200,000 secured bi-lateral letter of credit facility	200,000	18,676	—
Talbot FAL facility	25,000	25,000	—
PaCRe senior secured letter of credit facility	10,000	294	—
AlphaCat Re secured letter of credit facility	30,000	24,800	—
IPC bi-lateral facility	40,000	19,817	—
$375,000 Flagstone bi-lateral facility	375,000	292,532	—
Total credit and other facilities	1,605,000	690,541	—
Total debt and financing arrangements	$2,456,654	$1,481,995	$788,679

The financing structure at December 31, 2013 was:

	Commitment	Issued and outstanding (a)	Drawn
2006 Junior Subordinated Deferrable Debentures	$150,000	$150,000	$150,000
2007 Junior Subordinated Deferrable Debentures	200,000	139,800	139,800
Flagstone 2006 Junior Subordinated Deferrable Debentures	137,866	137,866	137,866
Flagstone 2007 Junior Subordinated Deferrable Debentures	113,750	113,750	113,750
Total debentures payable	601,616	541,416	541,416
2010 Senior Notes due 2040	250,000	250,000	247,198
Total debentures and senior notes payable	851,616	791,416	788,614
$400,000 syndicated unsecured letter of credit facility	400,000	—	—
$525,000 syndicated secured letter of credit facility	525,000	358,567	—
$200,000 secured bi-lateral letter of credit facility	200,000	16,726	—
Talbot FAL facility	25,000	25,000	—
PaCRe senior secured letter of credit facility	10,000	294	—
AlphaCat Re secured letter of credit facility	24,800	24,800	—
IPC bi-lateral facility	40,000	20,177	—
$375,000 Flagstone bi-lateral facility	375,000	305,686	—
Total credit and other facilities	1,599,800	751,250	—
Total debt and financing arrangements	$2,451,416	$1,542,666	$788,614

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

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(b) Senior notes and junior subordinated deferrable debentures

The following table summarizes the key terms of the Company's senior notes and junior subordinated deferrable debentures as at the issuance date for each placement.

Description	Issuance date	Commitment	Maturity date	Fixed/Spread			Interest payments due
2006 Junior Subordinated Deferrable Debentures	June 15, 2006	$ 150,000	June 15, 2036	9.069	%	(b)	Quarterly
Flagstone 2006 Junior Subordinated Deferrable Debentures	August 23, 2006	$ 137,904	September 15, 2036	3.540	%	(a)	Quarterly
2007 Junior Subordinated Deferrable Debentures	June 21, 2007	$ 200,000	June 15, 2037	8.480	%	(b)	Quarterly
Flagstone 2007 Junior Subordinated Deferrable Debentures	June 8, 2007	$ 88,750	July 30, 2037	3.000	%	(a)	Quarterly
Flagstone 2007 Junior Subordinated Deferrable Debentures	September 20, 2007	$ 25,000	September 15, 2037	3.100	%	(a)	Quarterly
2010 Senior Notes due 2040	January 26, 2010	$ 250,000	January 26, 2040	8.875	%	(b)	Semi-annually in arrears

(a) Variable interest rate is the three-month LIBOR, reset quarterly, plus spread as noted in the table.
(b) Fixed interest rate.

The following table summarizes the key terms of the Company's senior notes and junior subordinated deferrable debentures as at March 31, 2014:

Description	Issuance date	Commitment	Maturity date	Fixed/Spread			Interest payments due
2006 Junior Subordinated Deferrable Debentures	June 15, 2006	$ 150,000	June 15, 2036	5.831	%	(b)	Quarterly
Flagstone 2006 Junior Subordinated Deferrable Debentures	August 23, 2006	$ 137,904	September 15, 2036	6.463	%	(b)	Quarterly
2007 Junior Subordinated Deferrable Debentures	June 21, 2007	$ 200,000	June 15, 2037	5.180	%	(b)	Quarterly
Flagstone 2007 Junior Subordinated Deferrable Debentures	June 8, 2007	$ 88,750	July 30, 2037	5.900	%	(b)	Quarterly
Flagstone 2007 Junior Subordinated Deferrable Debentures	September 20, 2007	$ 25,000	September 15, 2037	5.983	%	(b)	Quarterly
2010 Senior Notes due 2040	January 26, 2010	$ 250,000	January 26, 2040	8.875	%	(a)	Semi-annually in arrears

(a) Fixed interest rate.
(b) Interest rate has been fixed as a result of interest rate swap contracts entered into by the Company.

Senior Notes

The Senior Notes due 2040 (the "2010 Senior Notes") were part of a registered public offering. The 2010 Senior Notes mature on January 26, 2040. The Company may redeem the notes, in whole at any time, or in part from time to time, at our option on not less than 30 nor more than 60 days' notice, at a make-whole redemption price as described in "Description of the Notes - Optional Redemption" in the 2010 Senior Notes prospectus supplement. In addition, the Company may redeem the notes, in whole, but not in part, at any time upon the occurrence of certain tax events as described in "Description of the Notes - Redemption for Tax Purposes' in the prospectus supplement.

Debt issuance costs were deferred as an asset and are amortized over the life of the 2010 Senior Notes. There were no redemptions made during the three months ended March 31, 2014 and 2013.

The 2010 Senior Notes are unsecured and unsubordinated obligations of the Company and rank equally in right of payment with all of the Company's existing and future unsecured and unsubordinated indebtedness. The 2010 Senior Notes will be effectively junior to all of the Company's future secured debt, to the extent of the value of the collateral securing such debt, and will rank senior to all our existing and future subordinated debt. The 2010 Senior Notes are structurally subordinated to all obligations of the Company's subsidiaries.

Future payments of principal of $250,000 on the 2010 Senior Notes are all expected to be after 2018.

Junior subordinated deferrable debentures

The Company participated in private placements of junior subordinated deferrable interest debentures due 2036 and 2037 (respectively, the "2006 Junior Subordinated Deferrable Debentures" and "2007 Junior Subordinated Deferrable Debentures").

Debt issuance costs for the 2006 and 2007 Junior Subordinated Deferrable Debentures were deferred as an asset and were amortized to income over the five year optional redemption periods. They are redeemable at the Company's option at par. There were no redemptions made during the three months ended March 31, 2014 and 2013.

As part of the acquisition of Flagstone, the Company assumed junior subordinated deferrable debentures due 2036 and 2037 (respectively, the "Flagstone 2006 Junior Subordinated Deferrable Debentures" and "Flagstone 2007 Junior Subordinated Deferrable Debentures"). These debentures are redeemable quarterly at par. There were no redemptions made during the three months ended March 31, 2014 and 2013.

Future payments of principal of $541,454 on the debentures discussed above are all expected to be after 2018.

(c) Credit facilities

i. $400,000 syndicated unsecured letter of credit facility and $525,000 syndicated secured letter of credit facility

On March 9, 2012, the Company entered into a $400,000 four-year unsecured credit facility with Deutsche Bank Securities Inc., as syndication agent, JPMorgan Chase Bank, N.A. as administrative agent, Lloyds Securities Inc. and Suntrust Bank, as co-documentation agents and the lenders party thereto, which provides for letter of credit and revolving credit availability for the Company (the "Four Year Unsecured Facility") (the full $400,000 of which is available for letters of credit and/or revolving loans). The Four Year Unsecured Facility was provided by a syndicate of commercial banks. Letters of credit under the Four Year Unsecured Facility are available to support obligations in connection with the insurance business of the Company and its subsidiaries. Loans under the Four Year Unsecured Facility are available for the general corporate and working capital purposes of the Company. The Company may request that existing lenders under the Four Year Unsecured Facility or prospective additional lenders agree to make available additional commitments from time to time so long as the aggregate commitments under the Four Year Unsecured Facility do not exceed $500,000.

Also on March 9, 2012, the Company entered into a $525,000 four-year secured credit facility, with the same parties, which provides for letter of credit availability for the Company (the "Four Year Secured Facility" and together with the Four Year Unsecured Facility, the "Credit Facilities"). The Four Year Secured Facility was also provided by a syndicate of commercial banks. Letters of credit under the Four Year Secured Facility will be available to support obligations in connection with the insurance business of the Company. The Company may request that existing lenders under the Four Year Secured Facility or prospective additional lenders agree to make available additional commitments from time to time so long as the aggregate commitments under the Four Year Secured Facility do not exceed $700,000. The obligations of the Company under the Four Year Secured Facility are secured by cash and securities deposited into cash collateral accounts from time to time with The Bank of New York Mellon.

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As of March 31, 2014, there were $309,422 in outstanding letters of credit under the Four Year Secured Facility (December 31, 2013: $358,567) and $nil outstanding under the Four Year Unsecured Facility.

The Credit Facilities contain covenants that include, among other things (i) the requirement that the Company initially maintain a minimum level of consolidated net worth of at least $2,600,000 and, commencing with the end of the fiscal quarter ending March 31, 2012, to be increased quarterly by an amount equal to 50.0% of the Company's consolidated net income (if positive) for such quarter plus 50.0% of the aggregate increases in the consolidated shareholders' equity of the Company during such fiscal quarter by reason of the issuance and sale of common equity interests of the Company, including upon any conversion of debt securities of the Company into such equity interests, (ii) the requirement that the Company maintain at all times a consolidated total debt to consolidated total capital ratio not greater than 0.35:1.00, and (iii) the requirement that Validus Reinsurance, Ltd. and any other material insurance subsidiaries maintain a financial strength rating by A.M. Best of not less than "B++" (Fair). In addition, the Credit Facilities contain customary negative covenants applicable to the Company, including limitations on the ability to pay dividends and other payments in respect of equity interests at any time that the Company is otherwise in default with respect to certain provisions under the respective Credit Facilities, limitations on the ability to incur liens, sell assets, merge or consolidate with others, enter into transactions with affiliates, and limitations on the ability of its subsidiaries to incur indebtedness. The Credit Facilities also contain customary affirmative covenants, representations and warranties and events of default for credit facilities of its type. As of March 31, 2014, and throughout the reporting periods presented, the Company was in compliance with all covenants and restrictions under the Credit Facilities.

On March 9, 2012, upon entering into the Credit Facilities, the Company terminated its (a) three-year bi-lateral $60,000 unsecured revolving credit facility, dated March 12, 2010, (b) $340,000 three-year unsecured credit facility, dated March 12, 2010 and (c) $500,000 five-year secured credit facility, dated March 12, 2007. No early termination penalties were incurred.

ii. $25,000 Talbot FAL facility

Talbot holds a standby Letter of Credit facility (the "Talbot FAL facility") to provide Funds at Lloyd's to support the 2010, 2011, 2012, 2013, 2014 and 2015 underwriting years of account. As of March 31, 2014 the Company had $25,000 (December 31, 2013: $25,000) in outstanding letters of credit under the Talbot FAL facility.

The Talbot FAL facility contains affirmative covenants that include requirements for consolidated net worth and debt to capital ratios in line with those in place for the Credit Facilities and discussed above. The Talbot FAL facility also contains restrictions on our ability to incur debt at our subsidiaries, incur liens, sell assets and merge or consolidate with others. Other than in respect of existing and future preferred and hybrid securities, the payment of dividends and other payments in respect of equity interests are not permitted at any time that we are in default with respect to certain provisions under the Talbot FAL facility. As of March 31, 2014 and throughout the reporting periods presented, the Company was in compliance with all covenants and restrictions under the Talbot FAL facility.

iii. $40,000 IPC bi-lateral facility

The Company assumed an existing evergreen letter of credit facility through the acquisition of IPC (the "IPC bi-lateral facility"). As of March 31, 2014, there were $19,817 outstanding letters of credit issued under the IPC bi-lateral facility (December 31, 2013: $20,177). As of March 31, 2014 and throughout the reporting periods presented, the Company was in compliance with all covenants and restrictions under the IPC bi-lateral facility.

iv. $200,000 secured bi-lateral letter of credit facility

The Company holds an uncommitted secured bi-lateral letter of credit facility with Citibank Europe plc (the "Secured bi-lateral letter of credit facility"). As of March 31, 2014, $18,676 (December 31, 2013: $16,726) of letters of credit were outstanding under the Secured bi-lateral letter of credit facility. The Secured bi-lateral letter of credit facility has no fixed termination date and as of March 31, 2014, the Company is in compliance with all terms and covenants thereof.

v. $10,000 PaCRe senior secured letter of credit facility

On May 11, 2012, PaCRe (as "Borrower") and its subsidiary, PaCRe Investments, Ltd. (as "Guarantor") entered into a secured evergreen credit and letter of credit facility with JPMorgan Chase Bank, N.A. This facility provides for revolving borrowings by the Borrower and for letters of credit issued by the Borrower to be used to support its reinsurance obligations in aggregate amount of $10,000. As of March 31, 2014, $294 (December 31, 2013: $294) of letters of credit were outstanding under this facility. As of March 31, 2014, and throughout the reporting periods presented, PaCRe was in compliance with all covenants and restrictions thereof.

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vi. $30,000 AlphaCat Re secured letter of credit facility

On January 2, 2013 AlphaCat Reinsurance Ltd. (as "Borrower") entered into a secured evergreen letter of credit facility with Comerica Bank. This facility provides for letters of credit issued by the Borrower to be used to support its reinsurance obligations in the aggregate amount of $24,800. During the period ended March 31, 2014 the size of the facility was increased to $30,000 from $24,800. As of March 31, 2014, $24,800 (December 31, 2013: $24,800) of letters of credit were outstanding under this facility. As of March 31, 2014, and throughout the reporting periods presented, AlphaCat Reinsurance Ltd., was in compliance with all covenants and restrictions thereof.

vii. $375,000 Flagstone bi-lateral facility

As part of the Flagstone Acquisition, the Company assumed an evergreen Letters of Credit Master Agreement between Citibank Europe Plc and Flagstone Reassurance Suisse, S.A. (the “Flagstone Bi-Lateral Facility”). At March 31, 2014, the Flagstone Bi-Lateral Facility had $292,532 (December 31, 2013: $305,686) letters of credit issued and outstanding. As of March 31, 2014, and throughout the reporting periods presented, the Company was in compliance with all covenants and restrictions under the Flagstone Bi-Lateral Facility.

(d) Finance expenses

Finance expenses consist of interest on our junior subordinated deferrable debentures, senior notes, the amortization of debt offering costs, fees relating to our credit facilities, bank charges and the costs of FAL as follows:

	Three Months Ended	
	March 31, 2014	March 31, 2013
2006 Junior Subordinated Deferrable Debentures	$2,187	$2,187
2007 Junior Subordinated Deferrable Debentures	1,809	1,809
Flagstone 2006 Junior Subordinated Deferrable Debentures	2,223	1,472
Flagstone 2007 Junior Subordinated Deferrable Debentures	1,750	1,072
2010 Senior Notes due 2040	5,597	5,597
Credit facilities	1,559	954
Bank charges	113	133
AlphaCat ILS funds fees (a)	677	1,114
Talbot FAL Facility	(15)	31
Total finance expenses	$15,900	$14,369

(a) Includes finance expenses incurred by AlphaCat Managers, Ltd. in relation to the AlphaCat ILS funds and fund-raising for AlphaCat 2014 and AlphaCat 2013 respectively.

13. Accumulated other comprehensive (loss)

The changes in accumulated other comprehensive income ("AOCI"), by component for the three months ended March 31, 2014 and 2013 is as follows:

	Three Months Ended March 31, 2014	Three Months Ended March 31, 2013
Beginning balance, December 31	$(617)	$(2,953)
Current period foreign currency translation adjustments	462	(9,785)
Ending balance, March 31	$(155)	$(12,738)

Validus Holdings, Ltd.
Notes to Consolidated Financial Statements (unaudited)
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14. Commitments and contingencies

(a) Concentrations of credit risk

The Company’s investments are managed following prudent standards of diversification. The Company attempts to limit its credit exposure by purchasing high quality fixed income investments to maintain an average portfolio, excluding bank loans, credit quality of AA- or higher, with mortgage and commercial mortgage-backed issues having an aggregate weighted average credit quality of AAA. In addition, the Company limits its exposure to any single issuer to 3% of its investment portfolio or less, excluding government and agency securities. With the exception of the Company's bank loan portfolio, which represents 9.5% of the Company's total investments as at March 31, 2014, the minimum credit rating of any security purchased is Baa3/BBB-. In the case where currently held investments are downgraded below Baa3/BBB-, the Company tolerates a holding of up to 2% of its investment portfolio in aggregate market value, or 10% with written authorization. Excluding bank loans, 1.0% of the portfolio had a split rating below Baa3/BBB- as at March 31, 2014. The Company did not have an aggregate exposure to any single issuer of more than 0.9% of its investment portfolio, other than with respect to government and agency securities as at March 31, 2014.

(b) Funds at Lloyd's

The amounts provided under the Talbot FAL Facility would become a liability of the Company in the event of Syndicate 1183 declaring a loss at a level which would call on this arrangement.

Talbot operates in Lloyd’s through a corporate member, Talbot 2002 Underwriting Capital Ltd (“T02”), which is the sole participant in Syndicate 1183. Lloyd’s sets T02’s required capital annually based on Syndicate 1183’s business plan, rating environment and reserving environment together with input arising from Lloyd’s discussions with, inter alia, regulatory and rating agencies. Such capital, called Funds at Lloyd’s (“FAL”), comprises: cash, investments and undrawn letters of credit provided by various banks.

The amounts of cash, investments and letters of credit provided for each year of account as follows:

	2014 Underwriting Year	2013 Underwriting Year
Talbot FAL facility	$25,000	$25,000
Group funds	450,000	403,700
Total	$475,000	$428,700

The amounts which are provided as FAL are not available for distribution to the Company for the payment of dividends. Talbot’s corporate member may also be required to maintain funds under the control of Lloyd’s in excess of its capital requirement and such funds also may not be available for distribution to the Company for the payment of dividends. See Note 3 (d) for Talbot's investments pledged as collateral.

(c) Lloyd's Central Fund

Whenever a member of Lloyd's is unable to pay its debts to policyholders, such debts may be payable by the Lloyd's Central Fund. If Lloyd's determines that the Central Fund needs to be increased, it has the power to assess premium levies on current Lloyd's members up to 3% of a member's underwriting capacity in any one year. The Company does not believe that any assessment is likely in the foreseeable future and has not provided any allowance for such an assessment. However, based on the Company's 2014 estimated premium income at Lloyd's of £625,000, at the March 31, 2014 exchange rate of £1 equals $1.6658 and assuming the maximum 3% assessment, the Company would be assessed approximately $31,234.

(d) Aquiline Commitment

As discussed in Note 5 "Investments in affiliates," the Company entered into an Assignment and Assumption Agreement with Aquiline Capital Partners LLC, pursuant to which it assumed a total capital commitment of $50,000 which will expire on July 2, 2015. The Company's remaining commitment at March 31, 2014 was $17,890

(December 31, 2013: $17,890).

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Validus Holdings, Ltd.
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15. Related party transactions

The transactions listed below are classified as related party transactions as each counter party has either a direct or indirect shareholding in the Company.

Aquiline Capital Partners, LLC and its related companies ("Aquiline"), which own 3,446,643 shares in the Company, hold warrants to purchase 2,756,088 shares, and have two employees on the Company's Board of Directors who do not receive compensation from the Company and are shareholders of Group Ark Insurance Holdings Ltd. ("Group Ark"). Christopher E. Watson, a director of the Company, serves as a director of Group Ark. Pursuant to reinsurance agreements with a subsidiary of Group Ark, the Company recognized gross premiums written during the three months ended March 31, 2014 of $1,373 (2013: $1,795), with $181 included in premiums receivable at March 31, 2014 (December 31, 2013: $242). The Company also recognized reinsurance premiums ceded during the three months ended March 31, 2014 of $5 (2013: $4). The Company recorded $2,688 of loss reserves recoverable at March 31, 2014 (December 31, 2013: $3,698). Earned premium adjustments of $1,441 (2013: $719) were recorded during the three months ended March 31, 2014.

On November 24, 2009, the Company entered into an Investment Management Agreement with Conning, Inc. ("Conning") to manage a portion of the Company's investment portfolio. Aquiline acquired Conning on June 16, 2009. Jeffrey W. Greenberg, a director of the Company, serves as a director of Conning Holdings Corp., the parent company of Conning. Investment management fees earned by Conning for the three months ended March 31, 2014 were $56 (2013: $191) with $170 included in accounts payable and accrued expenses at March 31, 2014 (December 31, 2013: $283).

On December 20, 2011, the Company entered into an Assignment and Assumption Agreement (the "Agreement") with Aquiline Capital Partners LLC, a Delaware limited liability company (the "Assignor") and Aquiline Capital Partners II GP (Offshore) Ltd., a Cayman Islands company limited by shares (the "General Partner") pursuant to which the Company has assumed 100% of the Assignor's interest in Aquiline Financial Services Fund II L.P. (the "Partnership") representing a total capital commitment of $50,000 (the "Commitment"), as a limited partner in the Partnership (the "Transferred Interest"). Messrs. Greenberg and Watson, directors of the Company, serve as managing principal and senior principal, respectively, of Aquiline Capital Partners LLC. For the three months ended March 31, 2014, the Company incurred $nil (2013: $120) in partnership fees and made $nil (2013: $1,341) capital contributions. There were no amounts included in accounts payable and accrued expenses at March 31, 2014 (December 31, 2013: $nil).

Certain shareholders of the Company and their affiliates, as well as employers of entities associated with directors or officers have purchased insurance and/or reinsurance from the Company in the ordinary course of business. The Company believes these transactions were settled for arms length consideration.

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16. Earnings per share

The following table sets forth the computation of basic and earnings per diluted share for the three months ended March 31, 2014 and 2013:

	Three Months Ended	
	March 31, 2014	March 31, 2013
Basic earnings per share		
Net income	$205,897	$220,694
(Income) loss attributable to noncontrolling interest	(43,509)	2,549
Net income available to Validus	162,388	223,243
Less: Dividends and distributions declared on outstanding warrants	(1,552)	(14,464)
Income available to common shareholders	$160,836	$208,779
Weighted average number of common shares outstanding	93,451,999	107,386,438
Basic earnings per share available to common shareholders	$1.72	$1.94
Earnings per diluted share		
Net income	$205,897	$220,694
(Income) loss attributable to noncontrolling interest	(43,509)	2,549
Net income available to Validus	162,388	223,243
Less: Dividends and distributions declared on outstanding warrants	—	(14,464)
Income available to common shareholders	$162,388	$208,779
Weighted average number of common shares outstanding	93,451,999	107,386,438
Share equivalents:		
Warrants	2,716,010	—
Stock options	750,369	1,631,556
Unvested restricted shares	881,141	1,035,005
Weighted average number of diluted common shares outstanding	97,799,519	110,052,999
Earnings per diluted share available to common shareholders	$1.66	$1.90

Share equivalents that would result in the issuance of common shares of 12,498 (2013: 104,405) were outstanding for the three months ended March 31, 2014, but were not included in the computation of earnings per diluted share because the effect would be antidilutive.

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Validus Holdings, Ltd.
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17. Segment information

The Company conducts its operations worldwide through three operating segments, which have been determined under U.S. GAAP segment reporting to be Validus Re, AlphaCat and Talbot. The Company’s operating segments are strategic business units that offer different products and services. They are managed and have capital allocated separately because each segment requires different strategies.

Validus Re Segment

The Validus Re segment is focused on short-tail lines of reinsurance. The primary lines in which the segment conducts business are property, marine and specialty which includes agriculture, aerospace and aviation, financial lines of business, nuclear, terrorism, life, accident & health, workers’ compensation, crisis management, contingency, motor, technical lines, composite and trade credit.

AlphaCat Segment

The AlphaCat segment manages strategic relationships that leverage the Company’s underwriting and investment expertise and earns management, performance and underwriting fees primarily from the Company’s operating affiliates, AlphaCat Re 2011, AlphaCat Re 2012, AlphaCat 2013 and AlphaCat 2014, as well as PaCRe and the AlphaCat ILS funds.

Talbot Segment

The Talbot segment focuses on a wide range of marine and energy, war, political violence, commercial property, financial institutions, contingency, bloodstock, accident & health and aviation classes of business on an insurance or facultative reinsurance basis and principally property, aerospace and marine classes of business on a treaty reinsurance basis.

Corporate and eliminations

The Company has a corporate function ("corporate"), which includes the activities of the parent company, and which carries out certain functions for the group. Corporate includes ‘non-core’ underwriting expenses, predominantly general and administrative and stock compensation expenses. Corporate also denotes the activities of certain key executives such as the Chief Executive Officer and Chief Financial Officer. For internal reporting purposes, corporate is reflected separately, however corporate is not considered an operating segment under these circumstances. Other reconciling items include, but are not limited to, the elimination of inter segment revenues and expenses and unusual items that are not allocated to segments.

Validus Holdings, Ltd.
Notes to Consolidated Financial Statements (unaudited)
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The following tables summarize the results of our operating segments and "Corporate":

Three Months Ended March 31, 2014	Validus Re Segment	AlphaCat Segment	Talbot Segment	Corporate & Eliminations	Total
Underwriting income					
Gross premiums written	$678,986	$84,347	$290,695	$(42,037)	$1,011,991
Reinsurance premiums ceded	(142,640)	(3,700)	(90,605)	42,037	(194,908)
Net premiums written	536,346	80,647	200,090	—	817,083
Change in unearned premiums	(297,960)	(49,964)	13,798	—	(334,126)
Net premiums earned	238,386	30,683	213,888	—	482,957
Underwriting deductions					
Losses and loss expenses	68,155	(7,860)	102,376	—	162,671
Policy acquisition costs	39,245	2,980	44,928	(1,504)	85,649
General and administrative expenses	18,195	4,128	35,149	16,973	74,445
Share compensation expenses	2,208	(10)	2,582	2,367	7,147
Total underwriting deductions	127,803	(762)	185,035	17,836	329,912
Underwriting income (loss)	$110,583	$31,445	$28,853	$(17,836)	$153,045
Net investment income	18,765	880	4,686	(969)	23,362
Other income	6,770	9,497	17	(2,454)	13,830
Finance expenses	(3,839)	(683)	(26)	(11,352)	(15,900)
Operating income (loss) before taxes, income from operating affiliates and (income) attributable to operating affiliate investors	132,279	41,139	33,530	(32,611)	174,337
Tax benefit (expense)	578	—	130	(668)	40
Income from operating affiliates	—	4,927	—	—	4,927
(Income) attributable to operating affiliate investors	—	(31,710)	—	—	(31,710)
Net operating income (loss)	$132,857	$14,356	$33,660	$(33,279)	$147,594
Net realized gains on investments	2,446	1,225	69	—	3,740
Change in net unrealized gains (losses) on investments	11,898	45,872	2,577	(4,654)	55,693
Income from investment affiliate	5,348	—	—	—	5,348
Foreign exchange (losses) gains	(6,176)	38	(150)	(190)	(6,478)
Net income (loss)	$146,373	$61,491	$36,156	$(38,123)	$205,897
Net (income) attributable to noncontrolling interest	—	(43,509)	—	—	(43,509)
Net income (loss) available (attributable) to Validus	$146,373	$17,982	$36,156	$(38,123)	$162,388

Selected ratios (a):					
Net premiums written / Gross premiums written	79.0 %	95.6 %	68.8 %		80.7 %
Losses and loss expenses	28.6 %	(25.6)%	47.9 %		33.7 %
Policy acquisition costs	16.5 %	9.7 %	21.0 %		17.7 %
General and administrative expenses (b)	8.5 %	13.4 %	17.6 %		16.9 %
Expense ratio	25.0 %	23.1 %	38.6 %		34.6 %
Combined ratio	53.6 %	(2.5)%	86.5 %		68.3 %
Total assets	$5,603,777	$1,582,014	$2,975,510	$94,788	$10,256,089

(a) Ratios are based on net premiums earned.
(b) The general and administrative expense ratio includes share compensation expenses.

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Validus Holdings, Ltd.
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Three Months Ended March 31, 2013	Validus Re Segment	AlphaCat Segment	Talbot Segment	Corporate & Eliminations	Total
Underwriting income					
Gross premiums written	$747,963	$96,516	$293,530	$(33,249)	$1,104,760
Reinsurance premiums ceded	(125,728)	—	(94,737)	33,249	(187,216)
Net premiums written	622,235	96,516	198,793	—	917,544
Change in unearned premiums	(319,101)	(68,899)	1,517	—	(386,483)
Net premiums earned	303,134	27,617	200,310	—	531,061
Underwriting deductions					
Losses and loss expenses	73,402	—	71,369	—	144,771
Policy acquisition costs	51,744	2,638	40,526	(1,297)	93,611
General and administrative expenses	29,441	4,037	30,912	15,889	80,279
Share compensation expenses	1,413	77	1,405	(577)	2,318
Total underwriting deductions	156,000	6,752	144,212	14,015	320,979
Underwriting income (loss)	$147,134	$20,865	$56,098	$(14,015)	$210,082
Net investment income	23,193	881	4,718	(3,143)	25,649
Other income	13,490	6,633	—	(17,438)	2,685
Finance expenses	(3,252)	(1,248)	(74)	(9,795)	(14,369)
Operating income (loss) before taxes, income from operating affiliates and (income) attributable to operating affiliate investors	180,565	27,131	60,742	(44,391)	224,047
Tax expense (benefit)	1,757	—	(1,054)	(385)	318
Income from operating affiliates	—	3,523	—	—	3,523
(Income) attributable to operating affiliate investors	—	(10,077)	—	—	(10,077)
Net operating income (loss)	$182,322	$20,577	$59,688	$(44,776)	$217,811
Net realized gains on investments	1,593	—	128	—	1,721
Change in net unrealized (losses) on investments	(2,193)	(4,788)	(256)	—	(7,237)
Income from investment affiliate	1,477	—	—	—	1,477
Foreign exchange gains (losses)	11,162	(1,187)	(3,918)	865	6,922
Net income (loss)	$194,361	$14,602	$55,642	$(43,911)	$220,694
Net loss attributable to noncontrolling interest	—	2,549	—	—	2,549
Net income (loss) available (attributable) to Validus	$194,361	$17,151	$55,642	$(43,911)	$223,243

Selected ratios (a):

Net premiums written / Gross premiums written	83.2 %	100.0 %	67.7 %		83.1 %
Losses and loss expenses	24.2 %	0.0 %	35.6 %		27.3 %
Policy acquisition costs	17.1 %	9.6 %	20.2 %		17.6 %
General and administrative expenses (b)	10.2 %	14.9 %	16.1 %		15.6 %
Expense ratio	27.3 %	24.5 %	36.3 %		33.2 %
Combined ratio	51.5 %	24.5 %	71.9 %		60.5 %
Total assets	$6,299,481	$1,189,190	$3,043,312	$32,417	$10,564,400

(a) Ratios are based on net premiums earned.
(b) The general and administrative expense ratio includes share compensation expenses.

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The Company’s exposures are generally diversified across geographic zones. The following tables set forth the gross premiums written allocated to the territory of coverage exposure for the periods indicated:

	Three Months Ended March 31, 2014					
	Gross Premiums Written					
	Validus Re	AlphaCat	Talbot	Eliminations	Total	%
United States	$191,868	$8,698	$26,311	$(5,665)	$221,212	21.9 %
Worldwide excluding United States (a)	61,534	7,678	37,182	(4,740)	101,654	9.9 %
Australia and New Zealand	12,816	1,019	2,880	(281)	16,434	1.6 %
Europe	37,896	1,301	18,791	(2,817)	55,171	5.5 %
Latin America and Caribbean	6,934	—	31,239	(3,052)	35,121	3.5 %
Japan	159	—	538	(53)	644	0.1 %
Canada	2,899	216	3,145	(523)	5,737	0.6 %
Rest of the world (b)	53,850	—	18,404	(1,798)	70,456	7.0 %
Sub-total, non United States	176,088	10,214	112,179	(13,264)	285,217	28.2 %
Worldwide including United States (a)	105,191	65,435	23,653	(6,646)	187,633	18.5 %
Other location non-specific (c)	205,839	—	128,552	(16,462)	317,929	31.4 %
Total	$678,986	$84,347	$290,695	$(42,037)	$1,011,991	100.0 %

	Three Months Ended March 31, 2013					
	Gross Premiums Written					
	Validus Re	AlphaCat	Talbot	Eliminations	Total	%
United States	$236,496	$17,489	$20,541	$(6,864)	$267,662	24.2 %
Worldwide excluding United States (a)	50,308	14,689	39,458	(4,508)	99,947	9.0 %
Australia and New Zealand	25,026	2,183	3,005	(230)	29,984	2.7 %
Europe	40,870	1,964	18,311	(2,848)	58,297	5.3 %
Latin America and Caribbean	8,418	—	42,000	(3,218)	47,200	4.3 %
Japan	737	—	654	(50)	1,341	0.1 %
Canada	2,642	318	2,706	(525)	5,141	0.5 %
Rest of the world (b)	19,079	—	18,314	(1,403)	35,990	3.3 %
Sub-total, non United States	147,080	19,154	124,448	(12,782)	277,900	25.2 %
Worldwide including United States (a)	100,540	59,873	19,156	(3,689)	175,880	15.9 %
Other location non-specific (c)	263,847	—	129,385	(9,914)	383,318	34.7 %
Total	$747,963	$96,516	$293,530	$(33,249)	$1,104,760	100.0 %

(a) Represents risks in two or more geographic zones.
(b) Represents risks in one geographic zone.
(c) The other locations non-specific category refers to business for which an analysis of exposure by geographic zone is not applicable, such as marine and aerospace risks, since these exposures can span multiple geographic areas and, in some instances, are not fixed locations.

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18. Subsequent events

(a) Quarterly Dividend

On April 30, 2014, the Company announced a quarterly cash dividend of $0.30 per each common share and $0.30 per common share equivalent for which each outstanding warrant is exercisable, payable on June 30, 2014 to holders of record on June 13, 2014.

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

The following is a discussion and analysis of the Company's consolidated results of operations for the three months ended March 31, 2014 and 2013 and the Company's consolidated financial condition, liquidity and capital resources at March 31, 2014 and December 31, 2013. This discussion and analysis should be read in conjunction with the unaudited consolidated financial statements and notes thereto included in this filing and the audited consolidated financial statements and related notes for the fiscal year ended December 31, 2013, the discussions of critical accounting policies and the qualitative and quantitative disclosure about market risk contained in the Company's Annual Report on Form 10-K for the fiscal year ended December 31, 2013.

For a variety of reasons, the Company's historical financial results may not accurately indicate future performance. See "Cautionary Note Regarding Forward-Looking Statements." The Risk Factors set forth in Part I Item 1A of the Company's Annual Report on Form 10-K for the fiscal year ended December 31, 2013 present a discussion of important factors that could cause actual results to differ materially from the results described in or implied by the forward-looking statements contained herein.

Executive Overview

The Company conducts its operations worldwide through three operating segments which have been determined under U.S. GAAP segment reporting to be Validus Re, AlphaCat and Talbot. Validus Re is a Bermuda-based reinsurance segment focused on short tail lines of reinsurance. AlphaCat is a Bermuda-based investment adviser, managing capital from third parties and the Company in insurance linked securities and other investments in the property catastrophe reinsurance space. Talbot is a specialty insurance segment, primarily operating within the Lloyd's insurance market through Syndicate 1183.

The Company’s strategy is to concentrate primarily on short-tail risks, which has been an area where management believes prices and terms provide an attractive risk-adjusted return and the management team has proven expertise. The Company’s profitability in any given period is based upon premium and investment revenues, less net losses and loss expenses, acquisition expenses and operating expenses. Financial results in the insurance and reinsurance industry are influenced by the frequency and/or severity of claims and losses, including as a result of catastrophic events, changes in interest rates, financial markets and general economic conditions, the supply of insurance and reinsurance capacity and changes in legal, regulatory and judicial environments.

On April 25, 2013, the Company acquired Longhorn Re, Ltd. (renamed Validus Re Americas, Ltd.), a single contract Bermuda-domiciled crop reinsurer.

On December 20, 2013, the Company joined with other investors in capitalizing AlphaCat 2014, a special purpose vehicle formed for the purpose of investing in collateralized reinsurance and retrocessional contracts. The Company has an equity interest and voting rights in AlphaCat 2014 which are below 50%, therefore the investment in AlphaCat 2014 is included as an equity method investment in the Consolidated Financial Statements of the Company.

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Business Outlook and Trends

We underwrite global property insurance and reinsurance and have large aggregate exposures to natural and man-made disasters. The occurrence of claims from catastrophic events results in substantial volatility, and can have material adverse effects on the Company's financial condition and results and its ability to write new business. This volatility affects results for the period in which the loss occurs because U.S. accounting principles do not permit reinsurers to reserve for such catastrophic events until they occur. Catastrophic events of significant magnitude historically have been relatively infrequent, although management believes the property catastrophe reinsurance market has experienced a higher level of worldwide catastrophic losses in terms of both frequency and severity in the period from 1992 to the present. We also expect that increases in the values and concentrations of insured property will increase the severity of such occurrences in the future. The Company seeks to reflect these types of trends when pricing contracts.

Property and other reinsurance premiums have historically risen in the aftermath of significant catastrophic losses. As loss reserves are established, industry surplus is depleted and the industry's capacity to write new business diminishes. At the same time, management believes that there is a heightened awareness of exposure to natural catastrophes on the part of cedants, rating agencies and catastrophe modeling firms, resulting in an increase in the demand for reinsurance protection. The global property and casualty insurance and reinsurance industry has historically been highly cyclical. Since 2007, increased capital provided by new entrants or by the commitment of capital by existing insurers and reinsurers increased the supply of insurance and reinsurance which resulted in a softening of rates on most lines. During 2010 and 2011, there was an increased level of catastrophe activity, principally the Chilean earthquake, Deepwater Horizon, Tohoku and Christchurch earthquake events, but the Company continues to see increased competition and decreased premium rates in most classes of business.

During the January 2013 renewal season, the Validus Re and AlphaCat segments underwrote $655.7 million in gross premiums written, an increase of 12.7% from the prior year period. This increase was driven primarily by an increase in gross premiums written in the specialty lines. This renewal data does not include Talbot's operations as its business is distributed relatively evenly throughout the year. During the mid-year 2013 renewal period, the Validus Re segment experienced rate softening across U.S. and international property lines. The Talbot segment experienced relatively flat rate price movements in the year ended December 31, 2013 with increases being generated by the onshore energy, marine treaty and marine liability accounts offset by decreases generated by aviation accounts and the remainder of the treaty portfolio.

During the January 2014 renewal season, the Validus Re and AlphaCat segments underwrote $575.2 million in gross premiums written, a decrease of 3.2% from the prior period, excluding the impact of the agriculture business in both years. This decrease was primarily driven by a challenging rate environment in our U.S. property catastrophe business, which experienced a reduction in rates of approximately 12.5%.

Financial Measures

The Company believes that the primary financial indicator for evaluating performance and measuring the overall growth in value generated for shareholders is book value per diluted common share. Book value per diluted common share plus accumulated dividends, together with other important financial indicators, is shown below:

	Three Months Ended March 31,		Year Ended December 31,
	2014	2013	2013
Book value per diluted common share plus accumulated dividends	$45.56	$41.57	$43.91
Book value per diluted common share	37.58	34.79	36.23
Underwriting income	153,045	210,082	604,908
Net operating income attributable to Validus	146,090	215,618	578,672

Annualized return on average equity	17.7 %	22.5 %	14.0 %

Book value per diluted common share plus accumulated dividends is considered by management to be the primary indicator of financial performance, as we believe growth in book value on a diluted basis, plus the dividends that have accumulated, ultimately translates into the return that a shareholder will receive. Book value per diluted common share plus accumulated dividends increased by $1.65, or 3.8%, from $43.91 at December 31, 2013 to $45.56 at March 31, 2014. Cash dividends per common share are an integral part of the value created for shareholders. The Company paid quarterly cash dividends of $0.30 per common share and common

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share equivalent in the three months ended March 31, 2014. On April 30, 2014, the Company announced a quarterly cash dividend of $0.30 per common share and $0.30 per common share equivalent for which each outstanding warrant is exercisable, payable on June 30, 2014 to holders of record on June 13, 2014. Book value per diluted common share plus accumulated dividends is calculated based on total shareholders' equity plus the assumed proceeds from the exercise of outstanding options and warrants, divided by the sum of common shares, unvested restricted shares and options and warrants outstanding (assuming their exercise), plus accumulated dividends. Book value per diluted common share plus accumulated dividends is a non-GAAP financial measure, as described in more detail in the section entitled "Non-GAAP Financial Measures."

Book value per diluted common share is considered by management to be a measure of our returns to common shareholders, as we believe growth in book value on a diluted basis ultimately translates into growth in stock price. Book value per diluted common share after dividends paid, increased by $1.35, or 3.7%, from $36.23 at December 31, 2013 to $37.58 at March 31, 2014. The increase was as a result of the net income available to Validus for the three months ended March 31, 2014. Book value per diluted common share is a non-GAAP financial measure, as described in more detail in the section entitled "Non-GAAP Financial Measures."

Underwriting income measures the performance of the Company's core underwriting function, excluding revenues and expenses such as net investment income (loss), other income, finance expenses, net realized and change in net unrealized gains (losses) on investments, foreign exchange gains (losses) and non-recurring items. The Company believes the reporting of underwriting income enhances the understanding of our results by highlighting the underlying profitability of the Company's core insurance and reinsurance operations. Underwriting income is a non-GAAP financial measure, as described in more detail in the section entitled "Non-GAAP Financial Measures."

Net operating income available to Validus is defined as net income excluding net realized and change in net unrealized gains (losses) on investments, income (loss) from investment affiliate, foreign exchange gains (losses), non-recurring items and income (loss) (attributable) to noncontrolling interest. This measure focuses on the underlying fundamentals of our operations without the influence of gains (losses) from the sale of investments, translation of non-U.S. dollar currencies and non-recurring items. Net operating income is a non-GAAP financial measure, as described in more detail in the section entitled "Non-GAAP Financial Measures."

Annualized return on average equity represents the return generated on common shareholders' capital during the period. Return on average equity is calculated by dividing the net income available to Validus for the period by the average shareholders' equity available to Validus during the period. Average shareholders' equity is the average of the beginning, ending and intervening quarter end shareholders' equity balances. The Company's objective is to generate superior returns on capital that appropriately reward shareholders for the risks assumed. The decrease in annualized return on average equity for the three months ended March 31, 2014 was driven primarily by a decrease in net income available to Validus. Net income available to Validus for the three months ended March 31, 2014 decreased by $60.9 million or 27.3% compared to the three months ended March 31, 2013.

First Quarter 2014 Summarized Consolidated Results of Operations

- Gross premiums written for the three months ended March 31, 2014 were $1,012.0 million compared to $1,104.8 million for the three months ended March 31, 2013, a decrease of $92.8 million, or 8.4%.
- Net premiums earned for the three months ended March 31, 2014 were $483.0 million compared to $531.1 million for the three months ended March 31, 2013, a decrease of $48.1 million, or 9.1%.
- Underwriting income for the three months ended March 31, 2014 was $153.0 million compared to $210.1 million for the three months ended March 31, 2013, a decrease of $57.0 million, or 27.1%.
- Combined ratio for the three months ended March 31, 2014 of 68.3% which included $39.4 million of favorable loss reserve development on prior accident years, benefiting the loss ratio by 8.2 percentage points compared to a combined ratio for the three months ended March 31, 2013 of 60.5% which included $65.8 million of favorable loss reserve development on prior accident years, benefiting the loss ratio by 12.4 percentage points.

- Loss ratio for the three months ended March 31, 2014 of 33.7% compared to 27.3% for the three months ended March 31, 2013.
- Loss ratios by line of business are as follows:

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	Three Months Ended March 31, 2014	Three Months Ended March 31, 2013	Percentage Point Change
Property	14.3 %	5.4 %	8.9 %
Marine	40.1 %	34.7 %	5.4 %
Specialty	55.2 %	61.1 %	(5.9)%
All lines	33.7 %	27.3 %	6.4 %

- Net investment income for the three months ended March 31, 2014 was $23.4 million compared to $25.6 million for the three months ended March 31, 2013, a decrease of $2.3 million, or 8.9%.
- Net operating income available to Validus for the three months ended March 31, 2014 was $146.1 million compared to $215.6 million for the three months ended March 31, 2013, a decrease of $69.5 million, or 32.2%.
- Net income available to Validus for the three months ended March 31, 2014 was $162.4 million, or $1.66 per diluted common share compared to $223.2 million or $1.90 per diluted common share for the three months ended March 31, 2013.
- Losses and loss expenses from notable loss events for the three months ended March 31, 2014 and March 31, 2013 were $nil.
- Investment yield for the three months ended March 31, 2014 was 1.29% compared to 1.38% for the three months ended March 31, 2013.
- Annualized return on average equity and annualized net operating return on average equity for the three months ended March 31, 2014 were 17.7% and 15.9%, respectively, compared to 22.5% and 21.8% for the three months ended March 31, 2013.
- Total investments and cash as at March 31, 2014 was $7.8 billion compared to $8.0 billion at December 31, 2013.

Overview of the Results of Operations for the Three Months Ended March 31, 2014 compared to the Three Months Ended March 31, 2013.

The change in net operating income available to Validus for the three months ended March 31, 2014 compared to the three months ended March 31, 2013 is described in the following table:

(Dollars in thousands)	Increase (decrease) to net operating income available to Validus over the three months ended March 31 2014 compared to 2013
Net premiums earned	$ (48,104)
Notable losses (a)	—
Incurred current year losses, excluding notable losses	8,483
Prior period loss development	(26,383)
Other underwriting deductions (b)	8,967
Underwriting income (c)	(57,037)
(Income) attributable to operating affiliate investors	(21,633)
Other operating expenses and income, net (d)	8,453
Net operating income (c)	(70,217)
Net operating (income) loss attributable to noncontrolling interest	689
Net operating income available to Validus (c)	$ (69,528)

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(a) There were no notable loss events for the three months ended March 31, 2014 and 2013, respectively.

(b) Other underwriting deductions consist of policy acquisition costs, general & administrative expenses and share compensation expenses.

(c) Non-GAAP Financial Measures. In presenting the Company's results, management has included and discussed underwriting income and operating income that is not calculated under standards or rules that comprise U.S. GAAP. Such measures are referred to as non-GAAP. Non-GAAP measures may be defined or calculated differently by other companies. These measures should not be viewed as a substitute for those determined in accordance with U.S. GAAP. Further discussion of these measures is presented in the section entitled "Non-GAAP Financial Measures."

(d) Other operating expenses and income, net, consists of net investment income, other income, finance expenses, taxes and income (loss) from operating affiliates.

Net operating income available to Validus for the three months ended March 31, 2014 was $146.1 million compared to $215.6 million for the three months ended March 31, 2013, a decrease of $69.5 million or 32.2%. The primary factors driving the decrease in net operating income were:

- Decrease in underwriting income of $57.0 million primarily due to:

- A decrease in net premiums earned of $48.1 million, primarily due to a reduction in gross premiums written; and

- A decrease in favorable prior period loss development of $26.4 million, offset by;

- A favorable movement in policy acquisition costs of $8.0 million.

Also contributing to the decrease was an unfavorable movement in income attributable to operating affiliate investors of $21.6 million, offset by an increase in other income of $11.1 million.

Segment Reporting

Management has determined that the Company operates in three reportable segments - Validus Re, AlphaCat and Talbot.

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First Quarter 2014 Results of Operations - Validus Re Segment

The following table presents results of operations for the three months ended March 31, 2014 and 2013, respectively:

	Three Months Ended March 31,	
(Dollars in thousands)	2014	2013
Underwriting income		
Gross premiums written	$678,986	$747,963
Reinsurance premiums ceded	(142,640)	(125,728)
Net premiums written	536,346	622,235
Change in unearned premiums	(297,960)	(319,101)
Net premiums earned	238,386	303,134
Underwriting deductions		
Losses and loss expenses	68,155	73,402
Policy acquisition costs	39,245	51,744
General and administrative expenses	18,195	29,441
Share compensation expenses	2,208	1,413
Total underwriting deductions	127,803	156,000
Underwriting income (a)	110,583	147,134
Net investment income	18,765	23,193
Other income	6,770	13,490
Finance expenses	(3,839)	(3,252)
Operating income before taxes	132,279	180,565
Tax benefit	578	1,757
Net operating income (a)	$132,857	$182,322
Selected ratios:		
Net premiums written / Gross premiums written	79.0 %	83.2 %
Losses and loss expenses	28.6 %	24.2 %
Policy acquisition costs	16.5 %	17.1 %
General and administrative expenses (b)	8.5 %	10.2 %
Expense ratio	25.0 %	27.3 %
Combined ratio	53.6 %	51.5 %

a) Non-GAAP Financial Measures: In presenting the Company's results, management has included and discussed underwriting income and net operating income that are not calculated under standards or rules that comprise U.S. GAAP. Such measures are referred to as non-GAAP. Non-GAAP measures may be defined or calculated differently by other companies. These measures should not be viewed as a substitute for those determined in accordance with U.S. GAAP. Further discussion of these measures is presented in the section entitled “Non-GAAP Financial Measures.”

b) The general and administrative expense ratio includes share compensation expenses.

The change in net operating income for the three months ended March 31, 2014 compared to the three months ended March 31, 2013, respectively, is described in the following table:

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(Dollars in thousands)	Increase (decrease) to net operating income over the three months ended March 31 2014 compared to 2013
Net premiums earned	$(64,748)
Notable losses (a)	—
Incurred current year losses, excluding notable losses	24,001
Prior period loss development	(18,754)
Other underwriting deductions (b)	22,950
Underwriting income (d)	(36,551)
Other operating income and expenses, net (c)	(12,914)
Net operating income (d)	$(49,465)

(a) There were no notable loss events for the three months ended March 31, 2014 and 2013, respectively.

(b) Other underwriting deductions consist of policy acquisition costs, general & administrative expenses and share compensation expenses.

(c) Other operating income and expenses, net, consists of net investment income, other income, finance expenses and taxes.

(d) Non-GAAP Financial Measures. In presenting the Company's results, management has included and discussed underwriting and operating income that are not calculated under standards or rules that comprise U.S. GAAP. Such measures are referred to as non-GAAP. Non-GAAP measures may be defined or calculated differently by other companies. These measures should not be viewed as a substitute for those determined in accordance with U.S. GAAP. Further discussion of these measures is presented in the section entitled "Non-GAAP Financial Measures.

Gross Premiums Written

	Gross Premiums Written Three Months Ended March 31,		
(Dollars in thousands)	2014	2013	Change
Property	$270,602	$326,024	$(55,422)
Marine	152,962	161,432	(8,470)
Specialty	255,422	260,507	(5,085)
Total	$678,986	$747,963	$(68,977)

The decrease in gross premiums written in the property lines of $55.4 million was primarily due to a reduction in catastrophe excess of loss treaties of $45.2 million. This was as a result of current market conditions, the impact of a program that was withdrawn and a number of non-renewals due to both unfavorable pricing and the inclusion of terror exposure on some programs without an appropriate premium for the additional risk. The decrease in gross premiums written of $8.5 million in the marine lines was primarily due to non-renewals and some business historically written in marine lines being renewed in specialty lines. The decrease in gross premiums written of $5.1 million in the specialty lines was due to a $37.5 million reduction in agricultural business as a result of reduced participation in a number of quota share agreements, offset by new composite business as well as business written by the new trade credit team, totaling $17.9 million and $15.3 million, respectively.

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(Dollars in thousands)	Business Mix - Ratio of Gross Premiums Written by Line of Business to Total Gross Premiums Written Three Months Ended March 31, 2014 Gross Premiums Written	 Gross Premiums Written (%)	 Three Months Ended March 31, 2013 Gross Premiums Written	 Gross Premiums Written (%)
Property	$270,602	39.9 %	$326,024	43.6 %
Marine	152,962	22.5 %	161,432	21.6 %
Specialty	255,422	37.6 %	260,507	34.8 %
Total	$678,986	100.0 %	$747,963	100.0 %

Reinsurance Premiums Ceded

(Dollars in thousands)	Reinsurance Premiums Ceded Three Months Ended March 31, 2014	 2013	 Change
Property	$121,870	$84,058	$37,812
Marine	13,365	2,972	10,393
Specialty	7,405	38,698	(31,293)
Total	$142,640	$125,728	$16,912

Reinsurance premiums ceded in the property lines increased by $37.8 million, due to significant restructuring of retrocessional coverage purchased, reflecting favorable market conditions and changes in timing of purchases, that resulted in $64.9 million of new aggregate excess of loss and industry loss warranty purchases. This was offset by a $28.1 million decrease in catastrophe bond coverage due to the non-renewal of a contract. The increase in reinsurance premiums in the marine lines of $10.4 million was primarily due to additional quota share coverage purchased as a result of price reductions and broader coverage and terms available in the market. The decrease in reinsurance premiums ceded in the specialty lines of $31.3 million was due primarily to the non-renewal of proportional coverage that was purchased in the first quarter of 2013 and related to the agriculture business.

Net Premiums Written

(Dollars in thousands)	Net Premiums Written Three Months Ended March 31, 2014	 2013	 Change
Property	$148,732	$241,966	$(93,234)
Marine	139,597	158,460	(18,863)
Specialty	248,017	221,809	26,208
Total	$536,346	$622,235	$(85,889)

The decrease in Validus Re net premiums written was driven by factors highlighted above in respect of gross premiums written and reinsurance premiums ceded.

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	Net Retention - Ratio of Net Premiums Written to Gross Premiums Written					
	Three Months Ended March 31, 2014			Three Months Ended March 31, 2013		
(Dollars in thousands)	Net Premiums Written	% of Gross Premiums Written		Net Premiums Written	% of Gross Premiums Written	
Property	$148,732	55.0	%	$241,966	74.2	%
Marine	139,597	91.3	%	158,460	98.2	%
Specialty	248,017	97.1	%	221,809	85.1	%
Total	$536,346	79.0	%	$622,235	83.2	%

The property ratio has decreased by 19.2 percentage points reflecting the restructuring of the property retrocessional coverage and specifically the increase in non-proportional coverage as well as a reduction in gross written premium. The marine ratio has decreased by 6.9 percentage due to an increase in ceded premiums as a result of the factors mentioned above. The specialty ratio has increased by12.0 percentage due to the decrease in reinsurance coverage purchased for the agriculture business.

Net Premiums Earned

	Net Premiums Earned			
	Three Months Ended March 31,			
(Dollars in thousands)	2014	2013	Change	
Property	$123,662	$184,482	$(60,820	)
Marine	42,857	56,601	(13,744	)
Specialty	71,867	62,051	9,816	
Total	$238,386	$303,134	$(64,748	)

The decrease in net premiums earned is consistent with the pattern of net premiums written in the current quarter and the second half of 2013.

Losses and Loss Expenses

	Losses and Loss Expense Ratio - All lines			
	Three Months Ended March 31,			
	2014		2013	
All lines—current period—notable losses	0.0	%	0.0	%
All lines—change in prior accident years	(4.2	)%	(9.5	)%
All lines—current period excluding items above	32.8	%	33.7	%
All lines—loss ratio	28.6	%	24.2	%

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(Dollars in thousands)	Losses and Loss Expenses - All lines Three Months Ended March 31, 2014	2013	Change
All lines—current period—notable losses	—	—	—
All lines—change in prior accident years	(10,028)	(28,782)	18,754
All lines—current period excluding items above	78,183	102,184	(24,001)
All lines - losses and loss expenses	68,155	73,402	(5,247)

Notable Losses
There were no notable loss events for the three months ended March 31, 2014 and 2013, respectively.

Losses and Loss Expenses by Line of Business

	Losses and Loss Expense Ratio - Property Lines Three Months Ended March 31, 2014	2013
Property—current period—notable losses	0.0 %	0.0 %
Property—change in prior accident years	(1.7)%	(17.7)%
Property—current period excluding items above	13.5 %	18.3 %
Property—loss ratio	11.8 %	0.6 %

(Dollars in thousands)	Losses and Loss Expenses - Property Lines Three Months Ended March 31, 2014	2013	Change
Property - current period—notable losses	$—	$—	$—
Property - change in prior accident years	(2,111)	(32,565)	30,454
Property—current period excluding items above	16,696	33,688	(16,992)
Property - losses and loss expenses	$14,585	$1,123	$13,462

Property lines experienced $30.5 million lower favorable loss reserve development, primarily related to unfavorable claims emergence on non-notable loss events and lower favorable development on other attritional losses this quarter.

	Losses and Loss Expense Ratio - Marine Lines Three Months Ended March 31, 2014	2013
Marine—current period—notable losses	0.0 %	0.0 %
Marine—change in prior accident years	(31.5)%	1.5 %
Marine—current period excluding items above	38.8 %	36.8 %
Marine—loss ratio	7.3 %	38.3 %

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	Losses and Loss Expenses - Marine Lines Three Months Ended March 31,		
(Dollars in thousands)	2014	2013	Change
Marine - current period—notable losses	$—	$—	$—
Marine—change in prior accident years	(13,513)	828	(14,341)
Marine—current period excluding items above	16,619	20,824	(4,205)
Marine - losses and loss expenses	$3,106	$21,652	$(18,546)

Marine lines experienced $13.5 million favorable loss reserve development during three months ended March 31, 2014 compared to unfavorable loss reserve development of $0.8 million in 2013 due primarily to favorable emergence on the Gryphon Alpha mooring failure this quarter and unfavorable development on Hurricane Sandy in the prior period.

	Losses and Loss Expense Ratio - Specialty Lines Three Months Ended March 31,	
	2014	2013
Specialty—current period—notable losses	0.0 %	0.0 %
Specialty—change in prior accident years	7.8 %	4.8 %
Specialty—current period excluding items above	62.4 %	76.8 %
Specialty—loss ratio	70.2 %	81.6 %

	Losses and Loss Expenses - Specialty Lines Three Months Ended March 31,		
(Dollars in thousands)	2014	2013	Change
Specialty - current period—notable losses	$—	$—	$—
Specialty—change in prior accident years	5,596	2,955	2,641
Specialty—current period excluding items above	44,868	47,672	(2,804)
Specialty - losses and loss expenses	$50,464	$50,627	$(163)

Specialty lines experienced $2.6 million higher unfavorable loss reserve development, primarily related to an increase in the loss estimate on agriculture losses this quarter. The current period loss ratio was significantly lower due to aerospace losses during the first quarter last year.

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Policy Acquisition Costs

(Dollars in thousands)	Policy Acquisition Costs Three Months Ended March 31, 2014	2013	Change
Property	$21,934	$28,532	$(6,598)
Marine	7,564	11,604	(4,040)
Specialty	9,747	11,608	(1,861)
Total	$39,245	$51,744	$(12,499)

	Acquisition Cost Ratio Three Months Ended March 31, 2014	2013	Change
Property	17.7%	15.5%	2.2%
Marine	17.6%	20.5%	(2.9)%
Specialty	13.6%	18.7%	(5.1)%
Total	16.5%	17.1%	(0.6)%

The acquisition cost ratio for the property lines has increased by 2.2 percentage points primarily due to the impact of the restructured retrocessional coverage discussed above. The acquisition cost ratio for the specialty lines has decreased by 5.1 percentage points due to changes in terms on some of the renewed agricultural policies.

General and Administrative and Share Compensation Expenses

(Dollars in thousands)	Three Months Ended March 31, 2014 Expenses	% of Net Premiums Earned	Three Months Ended March 31, 2013 Expenses	% of Net Premiums Earned
General and administrative expenses	$18,195	7.6%	$29,441	9.7%
Share compensation expenses	$2,208	0.9%	$1,413	0.5%
Total	$20,403	8.5%	$30,854	10.2%

The decrease in general and administrative expenses of $11.2 million or 38.2% was primarily due to the higher costs that were assumed in the prior year following the acquisition of Flagstone.

Selected Underwriting Ratios

The underwriting results of an insurance or reinsurance company are often measured by reference to its combined ratio, which is the sum of the loss and loss expense ratio and the expense ratio. The loss and loss expense ratio is calculated by dividing losses and loss expenses incurred (including estimates for incurred but not reported losses) by net premiums earned. The expense ratio is calculated by dividing acquisition costs combined with general and administrative expenses by net premiums earned. The following table presents the loss and loss expense ratio, policy acquisition cost ratio, general and administrative expense ratio, expense ratio and combined ratio for the three months ended March 31, 2014 and 2013.

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	Three Months Ended March 31, 2014	Three Months Ended March 31, 2013
Loss and loss expense ratio	28.6 %	24.2 %
Policy acquisition cost ratio	16.5 %	17.1 %
General and administrative expense ratio (a)	8.5 %	10.2 %
Expense ratio	25.0 %	27.3 %
Combined ratio	53.6 %	51.5 %

(a) Includes general and administrative expenses and share compensation expenses.

The increase in the combined ratio for the three months ended March 31, 2014 of 2.1 percentage points compared to the three months ended March 31, 2013 is due to the movement in the underlying ratios as discussed above.

Net Investment Income

	Net Investment Income Three Months Ended March 31,		
(Dollars in thousands)	2014	2013	Change
Fixed maturities and short-term investments	$18,212	$21,716	$(3,504)
Other investments	490	3,769	(3,279)
Cash and cash equivalents	1,603	(201)	1,804
Securities lending income	2	—	2
Total gross investment income	20,307	25,284	(4,977)
Investment expenses	(1,542)	(2,091)	549
Total	$18,765	$23,193	$(4,428)

The decrease in net investment income for the three months ended March 31, 2014 was $4.4 million or 19.1% mainly due to a special dividend received on other investments in 2013.

Other Income

	Other Income Three Months Ended March 31,		
(Dollars in thousands)	2014	2013	Change
Other income	$6,770	$13,490	$(6,720)

Other income for the three months ended March 31, 2014 primarily arises from the run off of legacy Flagstone balances.

Finance Expenses

	Finance Expenses Three Months Ended March 31,		
(Dollars in thousands)	2014	2013	Change
Finance expenses	$3,839	$3,252	$587

Finance expenses for the three months ended March 31, 2014 and 2013 were comparable.

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First Quarter 2014 Results of Operations - AlphaCat Segment

The following table presents results of operations for the three months ended March 31, 2014 and 2013, respectively:

	Three Months Ended March 31,	
(Dollars in thousands)	2014	2013
Underwriting income		
Gross premiums written	$84,347	$96,516
Reinsurance premiums ceded	(3,700)	—
Net premiums written	80,647	96,516
Change in unearned premiums	(49,964)	(68,899)
Net premiums earned	30,683	27,617
Underwriting deductions		
Losses and loss expenses	(7,860)	—
Policy acquisition costs	2,980	2,638
General and administrative expenses	4,128	4,037
Share compensation expenses	(10)	77
Total underwriting deductions	(762)	6,752
Underwriting income (a)	31,445	20,865
Net investment income	880	881
Other income	9,497	6,633
Finance expenses	(683)	(1,248)
Operating income before income from operating affiliates and (income) attributable to operating affiliate investors	41,139	27,131
Income from operating affiliates	4,927	3,523
(Income) attributable to operating affiliate investors	(31,710)	(10,077)
Net operating income (a)	14,356	20,577
Net operating (income) attributable to noncontrolling interest	(1,504)	(2,193)
Net operating income available to Validus (a)	$12,852	$18,384
Selected ratios:		
Net premiums written / Gross premiums written	95.6%	100.0%
Losses and loss expenses	(25.6)%	—%
Policy acquisition costs	9.7%	9.6%
General and administrative expenses (b)	13.4%	14.9%
Expense ratio	23.1%	24.5%
Combined ratio	(2.5)%	24.5%

a) Non-GAAP Financial Measures: In presenting the Company's results, management has included and discussed underwriting income and net operating income that are not calculated under standards or rules that comprise U.S. GAAP. Such measures are referred to as non-GAAP. Non-GAAP measures may be defined or calculated differently by other companies. These measures should not be viewed as a substitute for those determined in accordance with U.S. GAAP. Further discussion of these measures is presented in the section entitled "Non-GAAP Financial Measures."

b) The general and administrative expense ratio includes share compensation expenses.

The change in net operating income for the three months ended March 31, 2014 compared to the three months ended March 31, 2013, respectively, is described in the following table:

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(Dollars in thousands)	Increase (decrease) to net operating income available to Validus over the three months ended March 31 2014 compared to 2013
Net premiums earned	3,066
Notable losses (a)	—
Prior period loss development	7,860
Other underwriting deductions (b)	(346)
Underwriting income (d)	10,580
(Income) attributable to operating affiliate investors	(21,633)
Other operating income and expenses, net (c)	4,832
Net operating income (d)	(6,221)
Net operating income attributable to noncontrolling interest	689
Net operating income available to Validus (d)	(5,532)

(a) There were no notable loss events for the three months ended March 31, 2014 and 2013, respectively.

(b) Other underwriting deductions consist of policy acquisition costs, general & administrative expenses and share compensation expenses.

(c) Other operating income and expenses, net, consists of net investment income, other income, finance expenses, taxes and income (loss) from operating affiliates.

(d) Non-GAAP Financial Measures. In presenting the Company's results, management has included and discussed underwriting and operating income that are not calculated under standards or rules that comprise U.S. GAAP. Such measures are referred to as non-GAAP. Non-GAAP measures may be defined or calculated differently by other companies. These measures should not be viewed as a substitute for those determined in accordance with U.S. GAAP. Further discussion of these measures is presented in the section entitled "Non-GAAP Financial Measures.

Gross Premiums Written

	Gross Premiums Written Three Months Ended March 31,		
(Dollars in thousands)	2014	2013	Change
Property	$84,347	$96,516	$(12,169)
Total	$84,347	$96,516	$(12,169)

The decrease in gross premiums written in the property lines of $12.2 million was as a result of having a smaller sidecar in operation during the period compared to the prior period. The capital base of AlphaCat 2014 was $160.0 million compared to $230.0 million in AlphaCat 2013.

Reinsurance Premiums Ceded

AlphaCat reinsurance premiums ceded for the three months ended March 31, 2014 were $3.7 million compared to $nil for the three months ended March 31, 2013. The reinsurance was purchased due to the availability of attractively priced coverage.

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Net Premiums Written

(Dollars in thousands)	Net Premiums Written Three Months Ended March 31, 2014	2013	Change
Property	$80,647	$96,516	$(15,869)
Total	$80,647	$96,516	$(15,869)

The decrease in AlphaCat net premiums written was driven by factors highlighted above in respect of gross premiums written and reinsurance premiums ceded. The ratios of net premiums written to gross premiums written were 95.6% and 100.0% for the three months ended March 31, 2014 and 2013, respectively.

Net Premiums Earned

(Dollars in thousands)	Net Premiums Earned Three Months Ended March 31, 2014	2013	Change
Property	$30,683	$27,617	$3,066
Total	$30,683	$27,617	$3,066

The increase in net premiums earned in property lines is due to significantly higher mid-year renewals in 2013 compared to 2012.

Losses and Loss Expenses

	Losses and Loss Expense Ratio - Property Lines Three Months Ended March 31, 2014	2013
Property - current period - notable losses	— %	— %
Property - change in prior accident years	(25.6)%	— %
Property - current period excluding items above	— %	— %
Property—loss ratio	(25.6)%	— %

(Dollars in thousands)	Losses and Loss Expenses - Property Lines Three Months Ended March 31, 2014	2013	Change
Property - current period—notable losses	—	—	—
Property - change in prior accident years	(7,860)	—	(7,860)
Property - current period excluding items above	—	—	—
Property - losses and loss expenses	(7,860)	—	(7,860)

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Property lines experienced $7.9 million higher favorable loss reserve development compared to three months ended March 31, 2013, due to the partial release of reserves originally established in the third quarter of 2013 on an aggregate excess of loss contract. AlphaCat typically writes high excess and aggregate stop loss contracts, therefore losses can be triggered by a combination of loss events incurred by the cedant.

Policy Acquisition Costs

	Policy Acquisition Costs Three Months Ended March 31,		
(Dollars in thousands)	2014	2013	Change
Property	$2,980	$2,638	$342
Total	$2,980	$2,638	$342

	Acquisition Cost Ratio Three Months Ended March 31,		
	2014	2013	Change
Property	9.7 %	9.6 %	0.1 %
Total	9.7 %	9.6 %	0.1 %

The acquisition cost ratios for the three months ended March 31, 2014 and 2013 were comparable.

General and Administrative and Share Compensation Expenses

	Three Months Ended March 31, 2014		Three Months Ended March 31, 2013	
(Dollars in thousands)	Expenses	% of Net Premiums Earned	Expenses	% of Net Premiums Earned
General and administrative expenses	4,128	13.4 %	4,037	14.6 %
Share compensation expenses	(10)	— %	77	0.3 %
Total	$4,118	13.4 %	$4,114	14.9 %

The general and administrative expenses for the three months ended March 31, 2014 and 2013 were comparable.

Selected Underwriting Ratios

The following table presents the loss and loss expense ratio, policy acquisition cost ratio, general and administrative expense ratio, expense ratio and combined ratio for the three months ended March 31, 2014 and 2013.

	Three Months Ended March 31, 2014	Three Months Ended March 31, 2013
Loss and loss expense ratio	(25.6)%	0.0 %
Policy acquisition cost ratio	9.7 %	9.6 %
General and administrative expense ratio (a)	13.4 %	14.9 %
Expense ratio	23.1 %	24.5 %
Combined ratio	(2.5)%	24.5 %

(a) Includes general and administrative expenses and share compensation expenses.

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The decrease in the combined ratio for the three months ended March 31, 2014 of 27.0 percentage points compared to the three months ended March 31, 2013 is due to the movement in the underlying ratios as discussed above.

Net Investment Income

	Net Investment Income Three Months Ended March 31,		
(Dollars in thousands)	2014	2013	Change
Fixed maturities and short-term investments	$865	$874	$(9)
Cash and cash equivalents	15	7	8
Total net investment income	880	881	(1)

Net investment income for the three months ended March 31, 2014 and 2013 was comparable.

Other Income

	Other Income Three Months Ended March 31,		
(Dollars in thousands)	2014	2013	Change
Other income	$9,497	$6,633	$2,864

The increase in other income of $2.9 million, or 43.2%, is primarily due to the gain on the deconsolidation of one of the AlphaCat ILS funds in the quarter.

Finance Expenses

	Finance Expenses Three Months Ended March 31,		
(Dollars in thousands)	2014	2013	Change
Finance expenses	$683	$1,248	$(565)

Finance expenses for the three months ended March 31, 2014 and 2013 were comparable.

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Income From Operating Affiliates

	Income from Operating Affiliates Three Months Ended March 31,		
(Dollars in thousands)	2014	2013	Change
AlphaCat Re 2011	193	449	(256)
AlphaCat Re 2012	(36)	1,825	(1,861)
AlphaCat 2013	1,475	1,100	375
AlphaCat 2014	1,611	—	1,611
AlphaCat ILS funds	1,684	149	1,535
Total	4,927	3,523	1,404

For details of voting and equity ownership interests of the above entities, refer to Note 5 to the Consolidated Financial Statements in Part I. The increase in income from operating affiliates for the three months ended March 31, 2014 is due to additional income as a result of the deconsolidation of one of the AlphaCat ILS funds.

(Income) Attributable To Operating Affiliate Investors

	(Income) attributable to operating affiliate investors Three Months Ended March 31,		
(Dollars in thousands)	2014	2013	Change
(Income) attributable to operating affiliate investors	$(31,710)	$(10,077)	$(21,633)

Income attributable to operating affiliate investors for the three months ended March 31, 2014 was $31.7 million compared to $10.1 million for the three months ended March 31, 2013 reflecting the improved underwriting performance of the segment and the transfer of economics as a result of the deconsolidation of one of the AlphaCat ILS funds. This represents the transfer of investors' economic interest in the non-consolidated affiliated entities and includes both the Company's and third-party investors' share.

Net Operating (Income) Attributable to Noncontrolling Interest

	Net operating (income) loss attributable to noncontrolling interest Three Months Ended March 31,		
(Dollars in thousands)	2014	2013	Change
Net operating (income) attributable to noncontrolling interest	$(1,504)	$(2,193)	$689

For the three months ended March 31, 2014, the net operating income attributable to noncontrolling interest was $1.5 million, which comprised $1.3 million relating to 90% of the net operating income in PaCRe for the quarter and $0.2 million of net operating income relating to the consolidated AlphaCat ILS fund.

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First Quarter 2014 Results of Operations - Talbot Segment

The following table presents results of operations for the three months ended March 31, 2014 and 2013, respectively:

	Three Months Ended March 31,	
(Dollars in thousands)	2014	2013
Underwriting income		
Gross premiums written	$290,695	$293,530
Reinsurance premiums ceded	(90,605)	(94,737)
Net premiums written	200,090	198,793
Change in unearned premiums	13,798	1,517
Net premiums earned	213,888	200,310
Underwriting deductions		
Losses and loss expenses	102,376	71,369
Policy acquisition costs	44,928	40,526
General and administrative expenses	35,149	30,912
Share compensation expenses	2,582	1,405
Total underwriting deductions	185,035	144,212
Underwriting income (a)	28,853	56,098
Net investment income	4,686	4,718
Other income	17	—
Finance expenses	(26)	(74)
Operating income before taxes	33,530	60,742
Tax (expense) benefit	130	(1,054)
Net operating income (a)	$33,660	$59,688
Selected ratios:		
Net premiums written / Gross premiums written	68.8%	67.7%
Losses and loss expenses	47.9%	35.6%
Policy acquisition costs	21.0%	20.2%
General and administrative expenses (b)	17.6%	16.1%
Expense ratio	38.6%	36.3%
Combined ratio	86.5%	71.9%

a) Non-GAAP Financial Measures: In presenting the Company's results, management has included and discussed underwriting income and net operating income that are not calculated under standards or rules that comprise U.S. GAAP. Such measures are referred to as non-GAAP. Non-GAAP measures may be defined or calculated differently by other companies. These measures should not be viewed as a substitute for those determined in accordance with U.S. GAAP. Further discussion of these measures is presented in the section entitled “Non-GAAP Financial Measures.”

b) The general and administrative expense ratio includes share compensation expenses.

The change in net operating income for the three months ended March 31, 2014 compared to the three months ended March 31, 2013, respectively, is described in the following table:

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(Dollars in thousands)	Increase (decrease) to net operating income over the three months ended March 31 2014 compared to 2013
Net premiums earned	$13,578
Notable losses (a)	—
Incurred current year losses, excluding notable losses	(15,518)
Prior period loss development	(15,489)
Other underwriting deductions (b)	(9,816)
Underwriting income (d)	(27,245)
Other operating income and expenses, net (c)	1,217
Net operating income (d)	$(26,028)

(a) There were no notable loss events for the three months ended March 31, 2014 and 2013, respectively.

(b) Other underwriting deductions consist of policy acquisition costs, general & administrative expenses and share compensation expenses.

(c) Other operating income and expenses, net, consists of net investment income, other income, finance expenses and taxes.

(d) Non-GAAP Financial Measures. In presenting the Company's results, management has included and discussed underwriting and operating income that are not calculated under standards or rules that comprise U.S. GAAP. Such measures are referred to as non-GAAP. Non-GAAP measures may be defined or calculated differently by other companies. These measures should not be viewed as a substitute for those determined in accordance with U.S. GAAP. Further discussion of these measures is presented in the section entitled "Non-GAAP Financial Measures.

Gross Premiums Written

	Gross Premiums Written Three Months Ended March 31,		
(Dollars in thousands)	2014	2013	Change
Property	$78,103	$77,975	$128
Marine	119,571	124,726	(5,155)
Specialty	93,021	90,829	2,192
Total	$290,695	$293,530	$(2,835)

The increase in gross premiums written in the property lines was due to new business and premium adjustments of $11.4 million, offset by $11.3 million of Latin American business now written by Validus Re. This business was previously written by Talbot and ceded to Validus Re. The decrease in gross premiums written in the marine lines of $5.2 million was due primarily to a reduction in marine and energy liability lines of $4.3 million which was as a result of a difference in the timing of premium adjustments.

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(Dollars in thousands)	Business Mix - Ratio of Gross Premiums Written by Line of Business to Total Gross Premiums Written					
	Three Months Ended March 31, 2014			Three Months Ended March 31, 2013		
	Gross Premiums Written	Gross Premiums Written (%)		Gross Premiums Written	Gross Premiums Written (%)	
Property	$78,103	26.9	%	$77,975	26.6	%
Marine	119,571	41.1	%	124,726	42.5	%
Specialty	93,021	32.0	%	90,829	30.9	%
Total	$290,695	100.0	%	$293,530	100.0	%

The changes in mix of business are consistent with the changes in gross premiums written discussed above.

Reinsurance Premiums Ceded

(Dollars in thousands)	Reinsurance Premiums Ceded Three Months Ended March 31,			
	2014	2013	Change	
Property	$43,649	$48,409	$(4,760	)
Marine	18,473	15,356	3,117	
Specialty	28,483	30,972	(2,489	)
Total	$90,605	$94,737	$(4,132	)

The decrease in reinsurance premiums ceded in the property lines of $4.8 million was due primarily to decreases in property treaty lines of $8.8 million due to lower quota share premiums as a result of business being written directly through Validus Re and a reduction of $4.1 million in energy onshore premiums due to downward premium adjustments and changes in program price and structure. These were offset by an increase of $8.7 million in direct property lines primarily due to increases in coverage.

Net Premiums Written

(Dollars in thousands)	Net Premiums Written Three Months Ended March 31,			
	2014	2013	Change	
Property	$34,454	$29,566	$4,888	
Marine	101,098	109,370	(8,272	)
Specialty	64,538	59,857	4,681	
Total	$200,090	$198,793	$1,297	

The increase in Talbot net premiums written was driven by the factors highlighted above in respect of gross premiums written and reinsurance premiums ceded.

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(Dollars in thousands)	Net Retention - Ratio of Net Premiums Written to Gross Premiums Written			
	Three Months Ended March 31, 2014		Three Months Ended March 31, 2013	
	Net Premiums Written	% of Gross Premiums Written	Net Premiums Written	% of Gross Premiums Written
Property	$34,454	44.1 %	$29,566	37.9 %
Marine	101,098	84.6 %	109,370	87.7 %
Specialty	64,538	69.4 %	59,857	65.9 %
Total	$200,090	68.8 %	$198,793	67.7 %

The property ratio has increased by 6.2 percentage points due to the reduction in quota share ceded to Validus Re as this business is now written directly through Validus Re.

Net Premiums Earned

(Dollars in thousands)	Net Premiums Earned		
	Three Months Ended March 31,		
	2014	2013	Change
Property	$50,939	$43,548	$7,391
Marine	89,072	84,978	4,094
Specialty	73,877	71,784	2,093
Total	$213,888	$200,310	$13,578

The increase in property and specialty lines net premiums earned are consistent with the pattern of net premiums written influencing the earned premiums for the three months ended March 31, 2014 compared to the three months ended March 31, 2013. The increase in the marine lines net premiums earned is due to a combination of a decrease in reinstatement premiums in the first quarter of 2013, which would have been fully earned and a reduction in gross premiums written compared to the three months ended March 31, 2013.

Losses and Loss Expenses

	Losses and Loss Expense Ratio - All lines	
	Three Months Ended March 31,	
	2014	2013
All lines—current period—notable losses	— %	— %
All lines—change in prior accident years	(10.0)%	(18.5)%
All lines—current period excluding items above	57.9 %	54.1 %
All lines—loss ratio	47.9 %	35.6 %

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(Dollars in thousands)	Losses and Loss Expenses - All lines Three Months Ended March 31, 2014	2013	Change
All lines—current period—notable losses	—	—	—
All lines—change in prior accident years	(21,527)	(37,016)	15,489
All lines—current period excluding items above	123,903	108,385	15,518
All lines - loss and loss expenses	102,376	71,369	31,007

Notable Losses

There were no notable loss events for the three months ended March 31, 2014 and 2013, respectively.

Losses and Loss Expenses by Line of Business

	Losses and Loss Expense Ratio - Property Lines Three Months Ended March 31, 2014	2013
Property—current period—notable losses	— %	— %
Property—change in prior accident years	(26.8) %	(21.9) %
Property—current period excluding items above	71.2 %	51.3 %
Property—loss ratio	44.4 %	29.4 %

(Dollars in thousands)	Losses and Loss Expenses - Property Lines Three Months Ended March 31, 2014	2013	Change
Property - current period—notable losses	—	—	—
Property - change in prior accident years	(13,667)	(9,528)	(4,139)
Property—current period excluding items above	36,284	22,311	13,973
Property - losses and loss expenses	22,617	12,783	9,834

Property lines experienced $4.1 million higher favorable loss reserve development, primarily related to favorable development on the Tohoku earthquake. The current period loss ratio, excluding the impact of notable losses, was higher by 19.9 percentage points, representing a higher level of attritional claims experienced during the quarter, including a construction fire loss of $9.6 million.

	Losses and Loss Expense Ratio - Marine Lines Three Months Ended March 31, 2014	2013
Marine—current period—notable losses	— %	— %
Marine—change in prior accident years	6.4 %	(21.8) %
Marine—current period excluding items above	49.5 %	54.1 %
Marine—loss ratio	55.9 %	32.3 %

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	Losses and Loss Expenses - Marine Lines		
	Three Months Ended March 31,		
(Dollars in thousands)	2014	2013	Change
Marine - current period—notable losses	—	—	—
Marine—change in prior accident years	5,680	(18,518)	24,198
Marine—current period excluding items above	44,064	45,978	(1,914)
Marine - losses and loss expenses	49,744	27,460	22,284

Marine lines experienced $5.7 million of unfavorable loss reserve development for the three months ended March 31, 2014 compared to $18.5 million of favorable loss reserve development for the three months ended March 31, 2013. The adverse loss reserve development primarily related to higher than expected development on attritional claims during the period, including a single buoy mooring failure of $6.8 million, as well as a higher than expected emergence of events.

	Losses and Loss Expense Ratio - Specialty Lines	
	Three Months Ended March 31,	
	2014	2013
Specialty—current period—notable losses	— %	— %
Specialty—change in prior accident years	(18.3)%	(12.5) %
Specialty—current period excluding items above	58.9 %	55.9 %
Specialty—loss ratio	40.6 %	43.4 %

	Losses and Loss Expenses - Specialty Lines		
	Three Months Ended March 31,		
(Dollars in thousands)	2014	2013	Change
Specialty - current period—notable losses	—	—	—
Specialty—change in prior accident years	(13,540)	(8,970)	(4,570)
Specialty—current period excluding items above	43,555	40,096	3,459
Specialty - losses and loss expenses	30,015	31,126	(1,111)

Specialty lines experienced $4.6 million higher favorable loss reserve development, primarily related to lower than expected development on attritional claims during the period.

Policy Acquisition Costs

	Policy Acquisition Costs		
	Three Months Ended March 31,		
(Dollars in thousands)	2014	2013	Change
Property	$6,271	$5,024	$1,247
Marine	21,990	18,095	3,895
Specialty	16,667	17,407	(740)
Total	$44,928	$40,526	$4,402

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	Acquisition Cost Ratio		
	Three Months Ended March 31,		
	2014	2013	Change
Property	12.3 %	11.5 %	0.8 %
Marine	24.7 %	21.3 %	3.4 %
Specialty	22.6 %	24.2 %	(1.6)%
Total	21.0 %	20.2 %	0.8 %

The increase in the marine acquisition cost ratio was due to profit commission adjustments that reduced the costs for the three months ended March 31, 2013.

General and Administrative and Share Compensation Expenses

	Three Months Ended March 31, 2014		Three Months Ended March 31, 2013	
(Dollars in thousands)	Expenses	% of Net Premiums Earned	Expenses	% of Net Premiums Earned
General and administrative expenses	35,149	16.4 %	30,912	15.4 %
Share compensation expenses	2,582	1.2 %	1,405	0.7 %
Total	$37,731	17.6 %	$32,317	16.1 %

General and administrative expenses have increased by $4.2 million due to salary increases, an increase in overall headcount and a strengthening of the British pound against the U.S. dollar compared to the prior period.

Selected Underwriting Ratios

The following table presents the loss and loss expense ratio, policy acquisition cost ratio, general and administrative expense ratio, expense ratio and combined ratio for the three months ended March 31, 2014 and 2013.

	Three Months Ended March 31, 2014	Three Months Ended March 31, 2013
Loss and loss expense ratio	47.9 %	35.6 %
Policy acquisition cost ratio	21.0 %	20.2 %
General and administrative expense ratio (a)	17.6 %	16.1 %
Expense ratio	38.6 %	36.3 %
Combined ratio	86.5 %	71.9 %

(a) Includes general and administrative expenses and share compensation expenses.

The increase in the combined ratio for the three months ended March 31, 2014 of 14.6 percentage points compared to the three months ended March 31, 2013 is due to the movement in the underlying ratios as discussed above.

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Net Investment Income

	Investment Income		
	Three Months Ended March 31,		
(Dollars in thousands)	2014	2013	Change
Fixed maturities and short-term investments	$4,699	$4,315	$384
Cash and cash equivalents	339	727	(388)
Total gross investment income	5,038	5,042	(4)
Investment expenses	(352)	(324)	(28)
Total	$4,686	$4,718	$(32)

Net investment income for the three months ended March 31, 2014 and 2013 was comparable.

Non-Segment Discussion

Corporate Expenses

Corporate general and administrative expenses for the three months ended March 31, 2014, net of eliminations related to the operating segments, were $17.0 million compared to $15.9 million for the three months ended March 31, 2013, an increase of $1.1 million or 6.8%. General and administrative expenses have increased due to the increase in headcount. Corporate general and administrative expenses are comprised of executive and board expenses, internal and external audit expenses and other costs relating to the Company as a whole.

Corporate share compensation expenses for the three months ended March 31, 2014, net of operating segment eliminations were $2.4 million compared to $(0.6) million for the three months ended March 31, 2013, an increase of $2.9 million.

Corporate finance expenses for the three months ended March 31, 2014 were $11.4 million compared to $9.8 million for the three months ended March 31, 2013, an increase of $1.6 million or 15.9%.

Non-Operating Income and Expenses

The following non-operating income and expense items are discussed on a consolidated basis, since management does not include these items when assessing the results of its operating segments.

Net Realized and Change in Net Unrealized Gains (Losses) on Investments

	Net Realized and Change in Net Unrealized (Losses) Gains on Investments		
	Three Months Ended March 31,		
(Dollars in thousands)	2014	2013	Change
Net realized gains on investments	$3,740	$1,721	$2,019
Change in net unrealized gains (losses) on investments	55,693	(7,237)	62,930
Net realized and change in net unrealized gains (losses) on investments	$59,433	$(5,516)	$64,949

The movement in the change in net realized and unrealized gains (losses) on investments of $64.9 million was due to a favorable movement in net realized and unrealized gains on fixed maturity and short term investments of $14.6 million and a favorable movement in net realized and unrealized gains on other investments of $50.3 million.

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The favorable movement on fixed maturity and short term investments was primarily as a result of a shift in the yield curve and a tightening of corporate bond spreads. The favorable movement on other investments was primarily due to improved performance of the Paulson & Co. hedge fund investments held by PaCRe.

Income From Investment Affiliate

	Income From Investment Affiliate		
	Three Months Ended March 31,		
(Dollars in thousands)	2014	2013	Change
Income from investment affiliate	$5,348	$1,477	$3,871

Income from investment affiliate for the three months ended March 31, 2014 was $3.9 million higher than for the three months ended March 31, 2013. The income from investment affiliate relates to the income earned from the Company's investment in the Aquiline Financial Services Fund II L.P. which is recorded on a three-month lag and therefore reflects the underlying performance of that fund for the previous quarter.

Foreign Exchange (Losses) Gains

Our reporting currency is the U.S. dollar. As a significant portion of our operations are transacted in currencies other than the U.S. dollar, fluctuations in foreign exchange rates may affect period-to-period comparisons. The Company's largest foreign currency fluctuation exposure is due to the following currencies, with the movement in each currency against the U.S. dollar shown in the table below:

U.S. dollar strengthened (weakened) against:	Three Months Ended March 31, 2014	Three Months Ended March 31, 2013
British Pound sterling	(0.6)%	6.9%
Euro	(0.2)%	3.2%
Canadian dollar	4.0%	2.4%
Swiss franc	(0.9)%	4.0%
Australian dollar	(3.9)%	—%
New Zealand dollar	(5.2)%	—%
Singapore dollar	(0.3)%	1.7%
Japanese yen	(1.9)%	8.4%

	Foreign Exchange		
	Three Months Ended March 31,		
(Dollars in thousands)	2014	2013	Change
Foreign exchange (losses) gains	$(6,478)	$6,922	$(13,400)

Foreign exchange losses for the three months ended March 31, 2014 were ($6.5) million compared to gains of $6.9 million for the three months ended March 31, 2013, a decrease of $13.4 million, or 193.6%, due to the impact of a weaker U.S dollar on reserves held in New Zealand dollars.

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The Company currently hedges foreign currency exposure by balancing assets (primarily cash, investments and premium receivables) with liabilities (primarily case reserves and event IBNR) for certain major non-U.S. dollar currencies, or by entering into forward foreign currency contracts. Consequently, the Company aims to have a limited exposure to foreign exchange fluctuations.

Net (Income) Loss Attributable to Noncontrolling Interest

	Net (Income) Loss Attributable to Noncontrolling Interest Three Months Ended March 31,		
(Dollars in thousands)	2014	2013	Change
Net (income) loss attributable to noncontrolling interest	$(43,509)	$2,549	$(46,058)

For the three months ended March 31, 2014, net income attributable to noncontrolling interest was $43.5 million, which was comprised of operating income of $1.5 million, as discussed in the AlphaCat Segment Results of Operations, and a non-operating gain of $42.0 million, primarily on the investment portfolio within PaCRe.

For the three months ended March 31, 2013, net loss attributable to noncontrolling interest was $2.5 million, which was comprised of operating income of $2.2 million, as discussed in the AlphaCat Segment Results of Operations, and a non-operating loss of $4.7 million, primarily on the investment portfolio within PaCRe.

Other Non-GAAP Financial Measures

The operating results of an insurance or reinsurance company are also often measured by reference to its net operating income, which is a non-GAAP financial measure. Net operating income, as set out in the table below, is reconciled to net income (the most directly comparable GAAP financial measure) by the addition or subtraction of certain Consolidated Statement of Comprehensive Income (Loss) line items, as illustrated below.

(Dollars in thousands)	Three Months Ended March 31, 2014	Three Months Ended March 31, 2013
Net operating income	147,594	217,811
Net realized gains on investments	3,740	1,721
Change in net unrealized gains (losses) on investments	55,693	(7,237)
Income from investment affiliate	5,348	1,477
Foreign exchange (losses) gains	(6,478)	6,922
Net income	$205,897	$220,694

Operating income indicates the performance of the Company's core underwriting function, excluding revenues and expenses such as the reconciling items in the table above. The Company believes the reporting of operating income enhances the understanding of our results by highlighting the underlying profitability of the Company's core insurance and reinsurance business. This profitability is influenced significantly by earned premium growth, adequacy of the Company's pricing and loss frequency and severity. Over time it is also influenced by the Company's underwriting discipline, which seeks to manage exposure to loss through favorable risk selection and diversification, its management of claims, its use of reinsurance and its ability to manage its expense ratio, which it accomplishes through its management of acquisition costs and other underwriting expenses.

The Company excludes the U.S. GAAP measures noted above, in particular net realized and unrealized gains and losses on investments, from its calculation of operating income because the amount of these gains and losses is heavily influenced by, and fluctuates in part, according to availability of investment market opportunities. The Company believes these amounts are largely independent of its core underwriting activities and including them distorts the analysis of trends in its operations. In addition to presenting net income determined in accordance with U.S. GAAP, the Company believes that showing operating income provides investors with a valuable measure of profitability and enables investors, analysts, rating agencies and other users of its financial information to more easily analyze the Company's results of operations in a manner similar to how management analyzes the Company's underlying business performance.

Operating income should not be viewed as a substitute for U.S. GAAP net income as there are inherent material limitations associated with the use of operating income as compared to using net income, which is the most directly comparable U.S. GAAP financial measure. The most significant limitation is the ability of users of the financial information to make comparable assessments of operating income with other companies, particularly as operating income may be defined or calculated differently by other companies. Therefore, the Company provides prominence in this filing to the use of the most comparable U.S. GAAP financial measure, net income, which includes the reconciling items in the table above. The Company compensates for these limitations by providing both clear and transparent disclosure of net income and reconciliation of operating income to net income.

The Company also uses underwriting income as a primary measure of underwriting results in its analysis of historical financial information and when performing its budgeting and forecasting processes. Analysts, investors and rating agencies who follow the Company request this non-GAAP financial information on a regular basis. In addition, underwriting income is one of the factors considered by the compensation committee of our Board of Directors in determining the total annual incentive compensation.

In presenting the Company's results, management has also included and discussed certain schedules containing book value per diluted common share and book value per diluted common share plus accumulated dividends that are not calculated under standards or rules that comprise U.S. GAAP. Such measures are referred to as non-GAAP and may be defined or calculated differently by other companies. These measures should not be viewed as a substitute for those determined in accordance with U.S. GAAP.

The following tables present reconciliations of diluted book value per share to book value per share, the most comparable U.S. GAAP financial measure, at March 31, 2014 and December 31, 2013.

	As at March 31, 2014			
(Dollars in thousands, except share and per share amounts)	Equity Amount	Shares	Exercise Price	Book Value Per Share
Book value per common share				
Total shareholders' equity available to Validus	$3,649,064	90,786,237		$ 40.19
Book value per diluted common share				
Total shareholders' equity available to Validus	3,649,064	90,786,237		
Assumed exercise of outstanding warrants	90,950	5,174,114	$ 17.58	
Assumed exercise of outstanding stock options	27,396	1,482,694	$ 18.48	
Unvested restricted shares	—	2,805,320		
Book value per diluted common share	$3,767,410	100,248,365		$ 37.58
Adjustment for accumulated dividends				$ 7.98
Book value per diluted common share plus accumulated dividends				$ 45.56

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(Dollars in thousands, except share and per share amounts)	As at December 31, 2013 Equity Amount	Shares	Exercise Price	Book Value Per Share
Book value per common share				
Total shareholders' equity available to Validus	$3,704,094	96,044,312		$ 38.57
Book value per diluted common share				
Total shareholders' equity available to Validus	3,704,094	96,044,312		
Assumed exercise of outstanding warrants	98,513	5,296,056	$ 18.60	
Assumed exercise of outstanding stock options	29,688	1,572,713	$ 18.88	
Unvested restricted shares	—	2,853,083		
Book value per diluted common share	$3,832,295	105,766,164		$ 36.23
Adjustment for accumulated dividends				$ 7.68
Book value per diluted common share plus accumulated dividends				$ 43.91

Liquidity and Capital Resources

Investments

At March 31, 2014, the Company held investments totaling $6,782.4 million, compared to $6,912.4 million at December 31, 2013, a decrease of $130.0 million, or 1.9%, primarily as a result of share repurchase activity. A significant portion of (re)insurance contracts written by the Company provides short-tail reinsurance coverage for losses resulting mainly from natural and man-made catastrophes, which could result in payment of a substantial amount of losses at short notice. Accordingly, the Company’s investment portfolio is primarily structured to provide liquidity, which means the investment portfolio contains a significant amount of relatively short-term fixed maturity investments, such as government and government agency securities, corporate debt securities, bank loans and mortgage-backed and asset-backed securities. At March 31, 2014, the average duration of the Company’s fixed maturity and short term investment portfolio was 1.61 years (December 31, 2013: 1.60 years). This duration is reviewed regularly based on changes in the duration of our liabilities and in general market conditions.

The Company’s investment portfolio is also structured to preserve capital. With the exception of the Company's bank loan portfolio and catastrophe bonds, the Company’s investment guidelines require that fixed income investments are rated BBB- or higher at the time of purchase. At March 31, 2014, the Company’s total investment portfolio including cash had an average credit quality rating of AA- (December 31, 2013 : AA-) and an effective yield of 1.29% (December 31, 2013 : 1.30%) for the period then ended. The estimated fair value of investment grade fixed maturities was $4,607.2 million, or 87.1% of the fixed maturity portfolio, compared to $4,762.1 million as at December 31, 2013, or 85.9%, a decrease of $154.9 million, or 3.3%. The estimated fair value of non-investment grade fixed maturities, excluding bank loans, as at March 31, 2014 was $36.7 million compared to $63.0 million as at December 31, 2013, a decrease of $26.3 million, or 41.8%.

The Company also has an allocation to other investments, primarily hedge funds. At March 31, 2014, these other investments, excluding noncontrolling interests, totaled $131.6 million, or 1.94%, of our total investments (December 31, 2013 : $128.9 million or 1.9%). For further details related to our investment portfolio, including the extent of investments with fair values measured using unobservable inputs, see Notes 4 and 5 to the Consolidated Financial Statements in Part I, Item 1.

The value of the Company’s fixed maturity portfolio will fluctuate with, among other factors, changes in the interest rate environment and in overall economic conditions. Additionally, the structure of the investment portfolio exposes the Company to other risks, including insolvency or reduced credit quality of corporate debt securities, and prepayment, default and structural risks on asset-backed securities, mortgage-backed securities and bank loans.

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The estimated fair value of investments at March 31, 2014 and December 31, 2013 was as follows:

(Dollars in thousands)	March 31, 2014 Estimated Fair Value	March 31, 2014 % of Total Investments	December 31, 2013 Estimated Fair Value	December 31, 2013 % of Total Investments
U.S. government and government agency	$1,120,855	17.9 %	$1,364,679	21.3 %
Non-U.S. government and government agency	442,329	7.1 %	459,068	7.2 %
U.S. states, municipalities and political subdivision	44,464	0.7 %	43,120	0.7 %
Agency residential mortgage-backed securities	299,561	4.8 %	311,499	4.9 %
Non-agency residential mortgage-backed securities	16,330	0.3 %	15,759	0.2 %
U.S. corporate	1,337,410	21.4 %	1,332,484	20.8 %
Non-U.S. corporate	703,891	11.3 %	714,325	11.2 %
Bank loans	643,701	10.3 %	717,116	11.2 %
Catastrophe bonds	32,247	0.5 %	74,551	1.2 %
Asset-backed securities	624,499	10.0 %	509,657	8.0 %
Commercial mortgage-backed securities	22,313	0.3 %	—	— %
Total fixed maturities	5,287,600	84.6 %	5,542,258	86.5 %
Total short-term investments	831,800	13.3 %	751,778	11.7 %
Total other investments	662,974	10.6 %	618,316	9.7 %
Total investments	6,782,374	108.5 %	6,912,352	107.9 %
Noncontrolling interest (a)	(531,403)	(8.5)%	(489,402)	(7.6)%
Redeemable noncontrolling interest (b)	(1,976)	— %	(18,365)	(0.3)%
Total investments excluding noncontrolling interest	$6,248,995	100.0 %	$6,404,585	100.0 %

(a) Included in the other investments balance are investments held by PaCRe in which the Company has an equity interest of 10%. The remaining 90% interest is held by third party investors.

(b) Included in the short-term investments balance are investments held by the consolidated AlphaCat ILS fund, where the Company has an equity interest of less than 100% and the remaining interest is held by third party investors.

As part of the ongoing risk management process, the Company monitors the aggregation of country or jurisdiction risk exposure. Jurisdiction risk exposure is the risk that events within a jurisdiction, such as currency crises, regulatory changes and other political events, will adversely affect the ability of obligors within the jurisdiction to honor their obligations. The following table provides a breakdown of the fair value of jurisdiction risk exposures outside the United States within the Company's fixed maturity portfolio:

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(Dollars in thousands)	March 31, 2014 Fair Value	% of Total		December 31, 2013 Fair Value	% of Total	
United Kingdom	$135,958	11.9	%	$153,248	13.1	%
Germany	64,880	5.7	%	74,834	6.4	%
Supranational	60,725	5.3	%	59,274	5.1	%
Netherlands	29,408	2.6	%	29,395	2.5	%
France	29,100	2.5	%	24,340	2.1	%
Norway	24,764	2.2	%	24,097	2.1	%
Province of British Columbia	22,332	1.9	%	22,430	1.9	%
Other (individual jurisdictions below $20,000)	75,162	6.5	%	71,450	5.9	%
Total Non-U.S. Government Securities	442,329	38.6	%	459,068	39.1	%
European Corporate Securities	234,984	20.5	%	248,613	21.2	%
United Kingdom Corporate Securities	178,425	15.6	%	165,845	14.1	%
Other Non-U.S. Corporate Securities	290,482	25.3	%	299,867	25.6	%
Total Non-U.S. Fixed Income Portfolio	$1,146,220	100.0	%	$1,173,393	100.0	%

The Company manages its corporate debt securities by limiting its exposure to any single issuer, excluding government and agency securities, to 3% or less of its total investments and cash. At March 31, 2014, the Company did not have an aggregate exposure to any single issuer of more than 1.0%, other than with respect to government and government agency securities. The top ten exposures to fixed income corporate issuers at March 31, 2014 are as follows:

(Dollars in thousands)	March 31, 2014			
Issuer (a)	Fair Value (b)	S&P Rating (c)	% of Total Cash and Investments	
JPMorgan Chase & Co	74,087	A-	0.9	%
Bank of New York Mellon Corp	52,568	A+	0.7	%
BP PLC	47,297	A	0.6	%
Bank of America Corp	46,548	BBB+	0.6	%
General Electric Co	43,353	A+	0.6	%
Anheuser-Busch Inbev SA	43,146	A	0.6	%
Wells Fargo & Company	38,780	A	0.5	%
Apple Inc	34,729	AA+	0.4	%
Goldman Sachs Group Inc	34,052	BBB+	0.4	%
Verizon Communications Inc	33,636	BBB+	0.4	%
Total	448,196		5.7	%

(a) Issuers exclude government-backed government-sponsored enterprises and cash and cash equivalents.

(b) Credit exposures represent only direct exposure to fixed maturities and short-term investments of the parent issuer and its major subsidiaries. These exposures exclude asset and mortgage backed securities that were issued, sponsored or serviced by the parent.

(c) Ratings used are the lower of Standard & Poor's (S&P) and Moody's. When Moody's ratings are used, they are presented in S&P's equivalent rating.

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The tables below show the Company’s investments in affiliates, accounted for under the equity method:

	March 31, 2014						
(Dollars in thousands)	Investment at cost	Voting ownership		Equity ownership		Carrying value
AlphaCat Re 2011	$4,178	43.7	%	22.3	%	$4,177
AlphaCat Re 2012	654	49.0	%	37.9	%	1,277
AlphaCat 2013	16,454	40.9	%	19.7	%	15,678
AlphaCat 2014	22,000	42.3	%	19.6	%	23,593
AlphaCat ILS funds (a)	133,455	n/a		n/a		137,034
Aquiline Financial Services Fund II L.P.	32,110	—	%	6.7	%	39,848
Total	$208,851					$221,607

a) Equity ownerships in the two funds were 9.1% and 49.7%, respectively as at March 31, 2014.

	December 31, 2013					
(Dollars in thousands)	Investment at cost	Voting ownership		Equity ownership		Carrying value
AlphaCat Re 2011	$9,882	43.7	%	22.3	%	$9,809
AlphaCat Re 2012	654	49.0	%	37.9	%	1,313
AlphaCat 2013	45,000	40.9	%	19.7	%	51,744
AlphaCat 2014	22,000	42.3	%	19.6	%	21,982
AlphaCat ILS fund	20,000	—	%	9.1	%	21,895
Aquiline Financial Services Fund II L.P.	32,110	—	%	6.7	%	34,500
Total	$129,646					$141,243

During the first quarter of 2014, the Company received partial returns of investment from AlphaCat Re 2011 and AlphaCat 2013 of $5.8 million and $37.5 million, respectively. The Company expects to receive further returns of investment during the year from AlphaCat Re 2011, AlphaCat Re 2012 and AlphaCat 2013.

Reserves for Losses and Loss Expenses

At March 31, 2014, gross and net reserves for losses and loss expenses were estimated using the methodology as outlined in the Critical Accounting Policies and Estimates section below. The following tables indicate the breakdown of gross and net reserves for losses and loss expenses between lines of business and between case reserves and IBNR.

	As at March 31, 2014		
(Dollars in thousands)	Gross Case Reserves	Gross IBNR	Total Gross Reserve for Losses and Loss Expenses
Property	$757,450	$588,920	$ 1,346,370
Marine	468,031	420,656	888,687
Specialty	242,691	447,311	690,002
Total	$1,468,172	$1,456,887	$ 2,925,059

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(Dollars in thousands)	As at March 31, 2014 Net Case Reserves	Net IBNR	Total Net Reserve for Losses and Loss Expenses
Property	$660,709	$502,879	$ 1,163,588
Marine	427,921	388,064	815,985
Specialty	214,993	382,086	597,079
Total	$1,303,623	$1,273,029	$ 2,576,652

The following table sets forth a reconciliation of gross and net reserves for losses and loss expenses by segment for the three months ended March 31, 2014.

	Three Months Ended March 31, 2014				
(Dollars in thousands)	Validus Re Segment	AlphaCat Segment	Talbot Segment	Eliminations	Total
Gross reserves at period beginning	$1,723,465	$17,612	$1,362,574	$(73,252)	$3,030,399
Losses recoverable	(105,601)	—	(337,805)	73,252	(370,154)
Net reserves at period beginning	1,617,864	17,612	1,024,769	—	2,660,245
Incurred losses- current year	78,183	—	123,903	—	202,086
Change in prior accident years	(10,028)	(7,860)	(21,527)	—	(39,415)
Incurred losses	68,155	(7,860)	102,376	—	162,671
Foreign exchange	11,422	(21)	417	—	11,818
Paid losses	(168,097)	—	(89,985)	—	(258,082)
Net reserves at period end	1,529,344	9,731	1,037,577	—	2,576,652
Losses recoverable	99,563	—	321,400	(72,556)	348,407
Gross reserves at period end	$1,628,907	$9,731	$1,358,977	$(72,556)	$2,925,059

The amount of recorded reserves represents management's best estimate of expected losses and loss expenses on premiums earned. For the three months ended March 31, 2014, favorable loss reserve development on prior accident years was $39.4 million of which $10.0 million related to the Validus Re segment, $7.9 million related to the AlphaCat segment and $21.5 million related to the Talbot segment.

The management of insurance and reinsurance companies use significant judgment in the estimation of reserves for losses and loss expenses. Given the magnitude of some notable loss events and other uncertainties inherent in loss estimation, meaningful uncertainty remains regarding the estimation for these events. The Company's actual ultimate net loss may vary materially from these estimates. Ultimate losses for notable loss events are estimated through detailed review of contracts which are identified by the Company as potentially exposed to the specific notable loss event. However, there can be no assurance that the ultimate loss amount estimated for a specific contract will be accurate, or that all contracts with exposure to a specific notable loss event will be identified in a timely manner. Potential losses in excess of the estimated ultimate loss assigned to a contract on the basis of a specific review, or loss amounts from contracts not specifically included in the detailed review may be reserved for in the reserve for potential development on notable loss events. Any reserve for potential development on notable loss events (or “RDE”) is included as part of the Company's overall reserve as defined and disclosed in the Critical Accounting Policies and Estimates section.

For disclosure purposes, only those notable loss events which had an initial ultimate loss estimate above $30.0 million are disclosed separately and included in the reserves for notable loss roll forward table. To the extent that there are complexity and volatility factors relating to notable loss events in the aggregate, additions to the RDE may be established for a specific accident year. The Company increased the threshold for disclosure for notable losses effective January 1, 2013 from $15.0 million to $30.0 million.

The reserve for notable loss events table below does not disclose 2010 or 2011 notable loss events. Deepwater Horizon and the Christchurch earthquake, both 2010 events, had closing reserves at March 31, 2014, of $79.3 million and $82.5 million, respectively.

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RESERVES FOR NOTABLE LOSS EVENTS - USD (000's)

2012 NOTABLE LOSS EVENTS		December 31, 2012			Year Ended December 31, 2013			Three Months Ended March 31, 2014		
Notable Loss	Initial Estimate (a)	Development (Favorable) / Unfavorable (b)	Allocations of RDE	Closing Estimate (c) 31-Dec-13	Development (Favorable) / Unfavorable (b)	Allocations of RDE	Closing Estimate (c) 31-Dec-13	Development (Favorable) / Unfavorable (b)	Allocations of RDE	Closing Estimate (c) 31-Mar-14
Hurricane Sandy	$361,036	$—	—	$361,036	$(2,009)	—	$359,027	(643)	—	$358,384
Costa Concordia	76,197	(2,061)	—	74,136	39,567	—	113,703	—	—	113,703
Cat 67	22,713	5,377	—	28,090	(8,817)	—	19,273	1	—	19,274
U.S. Drought	22,021	—	—	22,021	4,619	—	26,640	100	—	26,740
Hurricane Isaac	15,209	67	—	15,276	(9,374)	—	5,902	(18)	—	5,884
Total 2012 Notable Loss Events	$497,176	$3,383	$—	$500,559	$23,986	$—	$524,545	$(560)	$—	$523,985

	Year Ended December 31, 2012		Year Ended December 31, 2013		Three Months Ended March 31, 2014	
Notable Loss	Paid Loss (Recovery)	Closing Reserve (d) 31-Dec-12	Paid Loss (Recovery)	Closing Reserve (d) 31-Dec-13	Paid Loss (Recovery)	Closing Reserve (d) 31-Mar-14
Hurricane Sandy	$38,515	$322,521	$134,978	$185,534	$9,337	$175,554
Costa Concordia	13,040	61,096	36,456	64,207	11,370	52,837
Cat 67	13,432	14,658	2,332	3,509	53	3,457
U.S. Drought	12,346	9,675	14,294	—	(2)	102
Hurricane Isaac	313	14,963	3,727	1,862	62	1,782
Total 2012 Notable Loss Events	$77,646	$422,913	$191,787	$255,112	$20,820	$233,732

2013 NOTABLE LOSS EVENTS		Year Ended December 31, 2013			Three Months Ended March 31, 2014		
Notable Loss	Initial Estimate (a)	Development (Favorable) / Unfavorable (b)	Allocations of RDE	Closing Estimate (c) 31-Dec-13	Development (Favorable) / Unfavorable (b)	Allocations of RDE	Closing Estimate (c) 31-Mar-14
European Floods	$77,587	$(16,762)	—	$60,825	$(12,111)	—	$48,714
Total 2013 Notable Loss Events	$77,587	$(16,762)	$—	$60,825	$(12,111)	$—	$48,714

	Year Ended December 31, 2013		Three Months Ended March 31, 2014	
Notable Loss	Paid Loss (Recovery)	Closing Reserve (d) 31-Dec-13	Paid Loss (Recovery)	Closing Reserve (d) 31-Mar-14
European Floods	$8,006	$52,819	$3,339	$37,369
Total 2013 Notable Loss Events	$8,006	$52,819	$3,339	$37,369

(a) Includes paid losses, case reserves and IBNR reserves.
(b) Development other than allocation of RDE.
(c) Excludes impact of movements in foreign exchange rates.

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(d) Closing Reserve for the period equals Closing Estimate for the period less cumulative Paid Losses.

Sources of Liquidity

Holding Company Liquidity

Validus Holdings, Ltd. is a holding company and conducts no operations of its own. The Company relies primarily on cash dividends and other permitted payments from operating subsidiaries within the Validus Re, AlphaCat and Talbot segments to pay dividends, finance expenses and other holding company expenses. There are restrictions on the payment of dividends from most operating subsidiaries, primarily due to regulatory requirements in the jurisdictions in which the operating subsidiaries are domiciled. We believe the dividend/distribution capacity of the Company’s subsidiaries will provide the Company with sufficient liquidity for the foreseeable future. We continue to generate substantial cash from operating activities and remain in a strong financial position, with resources available for reinvestment in existing businesses, strategic acquisitions and managing our capital structure to meet short and long-term objectives.

The following table details the capital resources of the Company's more significant subsidiaries on an unconsolidated basis.

(Dollars in thousands)	Capital at March 31, 2014
Validus Reinsurance, Ltd. (consolidated)	3,915,659
Noncontrolling interest in PacRe, Ltd.	540,934
Redeemable noncontrolling interest in AlphaCat ILS fund	8,390
Talbot Holdings, Ltd. (consolidated)	806,266
Other subsidiaries, net	69,060
Other, net	(353,242)
Total consolidated capitalization	4,987,067
Senior notes payable	(247,225)
Debentures payable	(541,454)
Redeemable noncontrolling interest in AlphaCat ILS fund	(8,390)
Total shareholders' equity	$4,189,998

Sources and Uses of Cash

The Company has written certain (re)insurance business that has loss experience generally characterized as having low frequency and high severity. This results in volatility in both results and operational cash flows. The potential for large claims or a series of claims under one or more reinsurance contracts means that substantial and unpredictable payments may be required within relatively short periods of time. As a result, cash flows from operating activities may fluctuate, perhaps significantly, between individual quarters and years. Management believes the Company’s unused credit facility amounts and highly liquid investment portfolio are sufficient to support any potential operating cash flow deficiencies.

In addition to relying on premiums received and investment income from the investment portfolio, the Company intends to meet these cash flow demands by carrying a substantial amount of short and medium term investments that would mature, or possibly be sold, prior to the settlement of expected liabilities. The Company cannot provide assurance, however, that it will successfully match the structure of its investments with its liabilities due to uncertainty related to the timing and severity of loss events.

There are three main sources of cash flows for the Company: operating activities, investing activities and financing activities. The movement in net cash provided by or used in operating, investing and financing activities and the effect of foreign currency rate changes on cash and cash equivalents for the three months ended March 31, 2014 and 2013 is provided in the following table.

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	Three Months Ended March 31,		
(Dollars in thousands)	2014	2013	Change
Net cash (used in) provided by operating activities	$(44,427)	$80,083	$(124,510)
Net cash provided by investing activities	264,791	218,734	46,057
Net cash (used in) financing activities	(264,250)	(115,186)	(149,064)
Effect of foreign currency rate changes on cash and cash equivalents	4,890	(33,786)	38,676
Net (decrease) increase in cash	$(38,996)	$149,845	$(188,841)

Operating Activities

Cash flow from operating activities is derived primarily from the receipt of premiums less the payment of losses and loss expenses related to underwriting activities.

Net cash used in operating activities during the three months ended March 31, 2014 was $44.4 million compared to net cash provided by operating activities of $80.1 million for three months ended March 31, 2013, an unfavorable movement of $124.5 million. This unfavorable movement is due to payments made to third party investors in affiliates during the quarter with no comparative in the prior period as well as upfront payments in respect of certain retrocessional coverage.

We anticipate that cash flows from operations will continue to be sufficient to cover cash outflows under our contractual commitments as well as most loss scenarios through the foreseeable future. Refer to the “Capital Resources” section below for further information on our anticipated obligations.

Investing Activities

Cash flow from investing activities is derived primarily from the receipt of net proceeds on the Company’s investment portfolio. As at March 31, 2014, the Company’s portfolio was composed of fixed income investments, short-term and other investments amounting to $6,782.4 million or 87.0% of total cash and investments.

Net cash provided by investing activities during the three months ended March 31, 2014 was $264.8 million compared to $218.7 million for the three months ended March 31, 2013, a favorable movement of $46.1 million. This favorable movement was due to a reduction of $1,256.0 million in fixed maturity securities purchases, offset by a net increase of $851.9 million in the purchase of short-term investments and a reduction in proceeds on the sale of investments of $324.0 million.

Financing Activities

Cash flow from financing activities is derived primarily from the issuance and purchase of shares in the Company and its subsidiaries, and the issuance and repayment of notes to operating affiliates.

Net cash used in financing activities during the three months ended March 31, 2014 was $264.3 million compared to $115.2 million during the three months ended March 31, 2013, an unfavorable movement of $149.1 million. This unfavorable movement was driven primarily by a $206.2 million movement in the issuance of notes payable to operating affiliates which is the result of a net repayment of $30.6 million in the current quarter compared to an issuance of $175.6 million in 2013. There was also an increase of $127.6 million in the repurchase of common shares under the share repurchase program and an unfavorable movement of $46.8 million in third party redeemable noncontrolling interest. The unfavorable movement in redeemable noncontrolling interest was as the result of a redemption of $10.5 million during the quarter compared to an investment of $36.3 million in the prior quarter. These movements were offset by a decrease in dividends paid of $232.9 million as a result of the special dividend that was paid in the first quarter of 2013 with no comparative dividend in the current quarter.

Capital Resources

The following table details the Company's capital position as at March 31, 2014 and December 31, 2013.

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Capitalization (Dollars in thousands)	March 31, 2014	December 31, 2013
Senior Notes (a)	$247,225	$247,198
Junior Subordinated Deferrable Debentures (JSDs) (b)	289,800	289,800
Flagstone Junior Subordinated Deferrable Debentures (JSDs) (c)	251,654	251,616
Total debt	788,679	788,614
Redeemable noncontrolling interest	8,390	86,512
Ordinary shares, capital and surplus available to Validus	3,649,219	3,704,711
Accumulated other comprehensive (loss)	(155)	(617)
Noncontrolling interest	540,934	497,657
Total shareholders' equity (d)	4,189,998	4,201,751
Total capitalization (d) (f)	4,987,067	5,076,877
Total capitalization available to Validus (e) (f)	$4,437,743	$4,492,708
Debt to total capitalization	15.8%	15.5%
Debt (excluding JSDs) to total capitalization	5.0%	4.9%

Notes

(a) On January 21, 2010, the Company offered and sold $250.0 million of Senior Notes due 2040 (the “2010 Senior Notes”) in a registered public offering. The 2010 Senior Notes mature on January 26, 2040, and are redeemable at the Company’s option in whole any time or in part from time to time at a make-whole redemption price. The net proceeds of $244.0 million from the sale of the 2010 Senior Notes, after the deduction of commissions paid to the underwriters in the transaction and other expenses, was used by the Company for general corporate purposes, which included the repurchase of our outstanding capital stock and dividends to our shareholders.

(b) $150.0 million of Junior Subordinated Deferrable Debentures (the "2006 Junior Subordinated Deferrable Debentures") were issued on June 15, 2006, mature on June 15, 2036 and have been redeemable at the Company's option at par since June 15, 2011. $200.0 million of Junior Subordinated Deferrable Debentures ("2007 Junior Subordinated Deferrable Debentures") were issued on June 21, 2007, mature on June 15, 2037 and have been redeemable at the Company's option at par since June 15, 2012. During 2008 and 2009, the Company repurchased $60.2 million principal amount of its 2007 Junior Subordinated Deferrable Debentures due 2037 from an unaffiliated financial institution.

(c) As part of the acquisition of Flagstone Reinsurance Holdings, S.A., the Company assumed $137.2 million of junior subordinated deferrable interest debentures due 2036 (the “Flagstone 2006 Junior Subordinated Deferrable Debentures”). The Flagstone 2006 Junior Subordinated Deferrable Debentures mature on September 15, 2036 and have been redeemable at the Company's option at par since September 15, 2011. In addition, the Company assumed $113.7 million of junior subordinated deferrable interest debentures due 2037 (the “Flagstone 2007 Junior Subordinated Deferrable Debentures”). $88.8 million of the Flagstone 2007 Junior Subordinated Deferrable Debentures mature on July 30, 2037 and have been redeemable at the Company's option at par since July 30, 2012. $25.0 million of the Flagstone 2007 Junior Subordinated Deferrable Debentures mature on September 15, 2037 and have been redeemable at the Company's option at par since September 15, 2012.

(d) Total capitalization equals total shareholders' equity plus borrowings drawn under credit facilities, Senior Notes and Junior Subordinated Deferrable Debentures and redeemable noncontrolling interests.

(e) Total capitalization available to Validus equals total capitalization less noncontrolling interests.

(f) The Company does not include notes payable to operating affiliate investors within total capitalization, since these are issued to some of the Company's operating affiliates specifically for the purpose of purchasing capital market products and writing collateralized reinsurance.

Shareholders' Equity

Shareholders' equity available to Validus at March 31, 2014 was $3,649.1 million.

On April 30, 2014, the Company announced a quarterly cash dividend of $0.30 per common share and $0.30 per common share equivalent for which each outstanding warrant is exercisable, which is payable on June 30, 2014 to shareholders and warrant holders of record on June 13, 2014. The timing and amount of any future cash dividends, however, will be at the discretion of the Board and

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will depend upon our results of operations and cash flows, our financial position and capital requirements, general business conditions, legal, tax, regulatory, rating agency and contractual constraints or restrictions and any other factors that the Board deems relevant.

On February 6, 2013, the Company approved a special dividend in the amount of $2.00 per common share and common share equivalent. The dividend was paid on February 26, 2013 to shareholders and warrant holders of record on February 19, 2013. On the same date the Board also approved an increase in the Company's regular quarterly dividend to $0.30 from $0.25 per common share and common share equivalent for which each outstanding warrant is exercisable.

The Company may from time to time repurchase its securities, including common shares, Junior Subordinated Deferrable Debentures and Senior Notes. On February 5 and October 31, 2013, the Board of Directors of the Company approved increases in its common share repurchase authorization to $500.0 million and $500.0 million, respectively. On February 5, 2014, the Board of Directors of the Company approved a further increase to the Company's common share repurchase authorization to $500.0 million. This amount is in addition to the $1,774.4 million of common shares repurchased by the Company through February 5, 2014 under its previously authorized share repurchase programs.

The Company expects the purchases under its share repurchase program to be made from time to time in the open market or in privately negotiated transactions. The timing, form and amount of the share repurchases under the program will depend on a variety of factors, including market conditions, the Company's capital position relative to internal and rating agency targets, legal requirements and other factors. The repurchase program may be modified, extended or terminated by the Board of Directors at any time.

Debt and Financing Arrangements

The following table details the Company's borrowings and credit facilities as at March 31, 2014.

(Dollars in thousands)	Maturity Date / Term	Commitments (a)	In Use/Outstanding
2006 Junior Subordinated Deferrable Debentures	June 15, 2036	$150,000	$150,000
2007 Junior Subordinated Deferrable Debentures	June 15, 2037	200,000	139,800
2010 Senior Notes due 2040	January 26, 2040	250,000	250,000
$400,000 syndicated unsecured letter of credit facility	March 9, 2016	400,000	—
$525,000 syndicated secured letter of credit facility	March 9, 2016	525,000	309,422
$200,000 secured bi-lateral letter of credit facility	Evergreen	200,000	18,676
Talbot FAL Facility (b)	December 31, 2015	25,000	25,000
PaCRe senior secured letter of credit facility	Evergreen	10,000	294
AlphaCat Re secured letter of credit facility	Evergreen	30,000	24,800
IPC Bi-Lateral Facility	Evergreen	40,000	19,817
$375,000 Flagstone bi-lateral facility	Evergreen	375,000	292,532
Flagstone 2006 Junior Subordinated Deferrable Debentures	September 15, 2036	137,904	137,904
Flagstone 2007 Junior Subordinated Deferrable Debentures	September 15, 2037	113,750	113,750
Total		$2,456,654	$1,481,995

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

(b) Talbot operates in Lloyd’s through a corporate member, Talbot 2002 Underwriting Capital Ltd (“T02”), which is the sole participant in Syndicate 1183. Lloyd’s sets T02’s required capital annually based on Syndicate 1183’s business plan, rating environment, reserving environment together with input arising from Lloyd’s discussions with, inter alia, regulatory and rating agencies. Such capital, called Funds at Lloyd’s (“FAL”), comprises: cash, investments and undrawn letters of credit provided by various banks.

Please refer to Note 12 to the Consolidated Financial Statements (Part I, Item 1) for further discussion of the Company’s debt and financing arrangements.

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Ratings

The following table summarizes the financial strength ratings of the Company and its principal reinsurance and insurance subsidiaries from internationally recognized rating agencies as of May 2, 2014:

	A.M. Best (a)	S&P (b)	Moody's (c)	Fitch (d)
Validus Holdings, Ltd.				
Issuer credit rating	bbb	BBB+	Baa2	A-
Senior debt	bbb	BBB+	Baa2	BBB-
Subordinated debt	bbb-	BBB	Baa3	—
Preferred stock	bb+	BBB-	Ba1	—
Outlook on ratings	Stable	Stable	Positive	Stable
Validus Reinsurance, Ltd.				
Financial strength rating	A	A	A3	A
Outlook on ratings	Stable	Stable	Positive	Stable
Talbot				
Financial strength rating applicable to all Lloyds syndicates	A	A+	—	A+
Outlook on ratings	Positive	Positive	—	Positive
Validus Reinsurance (Switzerland), Ltd.				
Financial strength rating	A	A-	—	—
Outlook on ratings	Stable	Stable	—	—

(a) The A.M. Best ratings were most recently affirmed on February 25, 2014 for Validus Holdings, Ltd, Validus Reinsurance, Ltd and Validus Reinsurance (Switzerland), Ltd. The A.M. Best rating for Lloyds was most recently affirmed on July 19, 2013.

(b) The S&P ratings were most recently affirmed on August 30, 2012 for Validus Holdings, Ltd and Validus Reinsurance, Ltd. The S&P rating for Validus Reinsurance (Switzerland), Ltd. was issued on December 11, 2013. The S&P rating for Lloyds was most recently affirmed on August 28, 2012.

(c) The Moody's ratings were most recently affirmed on September 16, 2013 for Validus Holdings, Ltd and Validus Reinsurance, Ltd.

(d) The Fitch ratings were most recently affirmed on February 5, 2014 for Validus Holdings, Ltd. and Validus Reinsurance, Ltd. The Fitch ratings for Lloyds were affirmed on June 25, 2013.

Recent accounting pronouncements

Please refer to Note 2 to the Consolidated Financial Statements (Part I, Item 1) for further discussion of relevant recent accounting pronouncements.

Critical Accounting Policies and Estimates

There are certain accounting policies that the Company considers to be critical due to the judgment and uncertainty inherent in the application of those policies. In calculating financial statement estimates, the use of different assumptions could produce materially different estimates. The Company believes the following critical accounting policies affect significant estimates used in the preparation of our consolidated financial statements:

- Reserve for losses and loss expenses;

- Premium estimates for business written on a line slip or proportional basis;

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- The valuation of goodwill and intangible assets;
- Reinsurance premiums ceded and reinsurance recoverable balances including the provision for uncollectible amounts; and
- Investment valuation of financial assets.

Critical accounting policies and estimates are discussed further in Item 7, Management's Discussion and Analysis of Results of Operations and Financial Condition in the Company's Annual Report on Form 10-K for the year ended December 31, 2013.

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 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 that 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 and reinsurance sectors in particular. Statements that include the words “expect”, “intend”, “plan”, “believe”, “project”, “anticipate”, “will”, “may”, and similar statements of a future or forward-look 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 and, therefore, you should not place undue reliance on any such statement.

We believe that these factors include, but are not limited to, the following:

- unpredictability and severity of catastrophic events;
- our ability to obtain and maintain ratings, which may affect our ability to raise additional equity or debt financings, , as well as other factors described herein;
- adequacy of the Company’s risk management and loss limitation methods;
- cyclicality of demand and pricing in the insurance and reinsurance markets;
- the Company’s ability to implement its business strategy during “soft” as well as “hard” markets;
- adequacy of the Company’s loss reserves;
- continued availability of capital and financing;
- the Company’s ability to identify, hire and retain, on a timely and unimpeded basis and on anticipated economic and other terms, experienced and capable senior management, as well as underwriters, claims professionals and support staff;

- acceptance of our business strategy, security and financial condition by rating agencies and regulators, as well as by brokers and (re)insureds;
- competition, including increased competition, on the basis of pricing, capacity, coverage terms or other factors;
- potential loss of business from one or more major insurance or reinsurance brokers;
- the Company’s ability to implement, successfully and on a timely basis, complex infrastructure, distribution capabilities, systems, procedures and internal controls, and to develop accurate actuarial data to support the business and regulatory and reporting requirements;
- general economic and market conditions (including inflation, volatility in the credit and capital markets, interest rates and foreign currency exchange rates) and conditions specific to the insurance and reinsurance markets in which we operate;
- the integration of businesses we may acquire or new business ventures, including overseas offices, we may start and the risk associated with implementing our business strategies and initiatives with respect to the new business ventures;
- accuracy of those estimates and judgments used in the preparation of our financial statements, including those related to revenue recognition, insurance and other reserves, reinsurance recoverables, investment valuations, intangible assets, bad debts, taxes, contingencies, litigation and any determination to use the deposit method of accounting, which, for a relatively new insurance and reinsurance company like our company, are even more difficult to make than those made in a mature company because of limited historical information;
- the effect on the Company’s investment portfolio of changing financial market conditions including inflation, interest rates, liquidity and other factors;
- acts of terrorism, political unrest, outbreak of war and other hostilities or other non-forecasted and unpredictable events;
- availability and cost of reinsurance and retrocession coverage;
- the failure of reinsurers, retrocessionaires, producers or others to meet their obligations to us;
- the timing of loss payments being faster or the receipt of reinsurance recoverables being slower than anticipated by us;
- changes in domestic or foreign laws or regulations, or their interpretations;
- changes in accounting principles or the application of such principles by regulators;
- statutory or regulatory or rating agency developments, including as to tax policy and reinsurance and other regulatory matters such as the adoption of proposed legislation that would affect Bermuda-headquartered companies and/or Bermuda-based insurers or reinsurers; and
- the other factors set forth under Part I Item 1A "Risk Factors" and under Part II Item 7 "Management's Discussion and Analysis of Financial Condition and Results of Operations" and the other sections of the Company's Annual Report on Form 10-K for the year ended December 31, 2013, as well as the risk and other factors set forth in the Company's other filings with the SEC, as well as management's response to any of the aforementioned factors.

In addition, other general factors could affect our results, including: (a) developments in the world’s financial and capital markets and our access to such markets; (b) changes in regulations or tax laws applicable to us, and (c) the effects of business disruption or economic contraction due to terrorism or other hostilities.

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. Any forward-looking statements made in this report are qualified by these cautionary statements, and there can be no assurance that the actual results or developments anticipated by us will be realized or, even if substantially realized, that they will have the expected consequences to, or effects on, us or our business or operations. We undertake no obligation to update publicly or revise any forward-looking statement, whether as a result of new information, future developments or otherwise.

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ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

We are principally exposed to five types of market risk:

- interest rate risk;
- foreign currency risk;
- credit risk;
- liquidity risk; and
- inflation risk.

Interest Rate Risk: The Company's fixed maturity portfolio is exposed to interest rate risk. Fluctuations in interest rates have a direct impact on the market valuation of these investments. As interest rates rise and credit spreads widen, the market value of the Company's fixed maturity portfolio falls and the Company has the risk that cash outflows will have to be funded by selling assets, which will be trading at depreciated values. As interest rates decline and credit spreads tighten, the market value of the Company's fixed income portfolio increases and the Company has reinvestment risk, as funds reinvested will earn less than is necessary to match anticipated liabilities. We manage interest rate risk by selecting investments with characteristics such as duration, yield, currency and liquidity tailored to the anticipated cash outflow characteristics of the insurance and reinsurance liabilities the Company assumes.

As at March 31, 2014 and 2013, the impact on the Company's fixed maturity and short-term investments from an immediate 100 basis point increase in market interest rates (based on U.S. treasury yield) would have resulted in an estimated decrease in market value of 1.8% and 1.7% or approximately $113.3 million and $109.1 million, respectively. As at March 31, 2014 and 2013, the impact on the Company's fixed maturity portfolio from an immediate 100 basis point decrease in market interest rates would have resulted in an estimated increase in market value of 1.3% and 1.3% or approximately $82.2 million and $82.3 million, respectively.

As at March 31, 2014, the Company held $962.7 million (December 31, 2013: $836.9 million), or 18.2% (December 31, 2013: 15.1%), of the Company's fixed maturity portfolio in asset-backed and mortgage-backed securities. These assets are exposed to prepayment risk, which occurs when holders of underlying loans increase the frequency with which they prepay the outstanding principal before the maturity date and refinance at a lower interest rate cost. The adverse impact of prepayment is more evident in a declining interest rate environment. As a result, the Company will be exposed to reinvestment risk, as cash flows received by the Company will be accelerated and will be reinvested at the prevailing interest rates.

Foreign Currency Risk: Certain of the Company's reinsurance contracts provide that ultimate losses may be payable in foreign currencies depending on the country of original loss. Foreign currency exchange rate risk exists to the extent that there is an increase in the exchange rate of the foreign currency in which losses are ultimately owed. Therefore, we attempt to manage our foreign currency risk by seeking to match our liabilities under insurance and reinsurance policies that are payable in foreign currencies with cash and investments that are denominated in such currencies. As of March 31, 2014, $967.8 million, or 9.4% of our total assets and $903.4 million, or 14.9% of our total liabilities were held in foreign currencies. As of March 31, 2014, approximately $114.1 million, or 1.8% of our total liabilities held in foreign currencies were non-monetary items which do not require revaluation at each reporting date. As of

March 31, 2013, $1,105.9 million, or 10.5% of our total assets and $1,143.9 million, or 18.5% of our total liabilities were held in foreign currencies. As of March 31, 2013, $168.1 million, or 2.7% of our total liabilities held in foreign currencies were non-monetary items which do not require revaluation at each reporting date. When necessary, we may also use derivatives to economically hedge un-matched foreign currency exposures, specifically forward contracts. Foreign currency forward contracts do not eliminate fluctuations in the value of our assets and liabilities denominated in foreign currencies but rather allow us to establish a rate of exchange for a future point in time. For further information on the accounting treatment of our foreign currency derivatives, refer to Note 7 of Part I, Item 1 - Consolidated Financial Statements. To the extent foreign currency exposure is not hedged or otherwise matched, the Company may experience exchange losses, which in turn would adversely affect the results of operations and financial condition.

Credit Risk: We are exposed to credit risk from the possibility that counterparties may default on their obligations to us. The Company’s primary credit risks reside in investment in U.S. corporate bonds and recoverable from reinsurers. We limit our credit exposure by purchasing high quality fixed income investments to maintain an average portfolio credit quality of AA- or higher with

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mortgage and commercial mortgage-backed issues having an aggregate weighted average credit quality of AAA. In addition, we have limited our exposure to any single issuer to 3.0% or less of total investments, excluding treasury and agency securities. With the exception of the bank loan portfolio, the Company's investment guidelines require that investments be rated BBB- or higher at the time of purchase. Where investments are downgraded below BBB-/Baa3, we permit our investment managers to hold up to 2.0% in aggregate market value, or up to 10.0% with written authorization of the Company. At March 31, 2014, 0.8% of the portfolio, excluding bank loans was below BBB-/Baa3 and we did not have an aggregate exposure to any single issuer of more than 0.9% of total investments, other than with respect to government and agency securities.

The amount of the maximum exposure to credit risk is indicated by the carrying value of the Company's financial assets. The Company's primary credit risks reside in investment in U.S. corporate bonds and recoverables from reinsurers. The Company evaluates the financial condition of its reinsurers and monitors concentration of credit risk arising from its exposure to individual reinsurers. The reinsurance program is generally placed with reinsurers whose rating, at the time of placement, was A- or better rated by S & P or the equivalent with other rating agencies. Exposure to a single reinsurer is also controlled with restrictions dependent on rating. At March 31, 2014, 98.5% of reinsurance recoverables (which includes loss reserves recoverable and recoverables on paid losses) were from reinsurers rated A- or above, (December 31, 2013: 96.7%, rated A-) or from reinsurers posting full collateral.

Liquidity risk: Certain of the Company's investments may become illiquid. Disruptions in the credit markets may materially affect the liquidity of the Company's investments, including non-agency residential mortgage-backed securities and bank loans which represent 8.5% (December 31, 2013: 9.2%) of total cash and investments at March 31, 2014. If the Company requires significant amounts of cash on short notice in excess of normal cash requirements (which could include claims on a major catastrophic event) in a period of market illiquidity, the investments may be difficult to sell in a timely manner and may have to be disposed of for less than what may otherwise have been possible under other conditions. At March 31, 2014, the Company had $1,075.3 million of unrestricted, liquid assets, defined as unpledged cash and cash equivalents, short term investments, government and government agency securities. Details of the Company's debt and financing arrangements at March 31, 2014 are provided below.

(Dollars in thousands)	Maturity Date / Term	In Use / Outstanding
2006 Junior Subordinated Deferrable Debentures	June 15, 2036	$150,000
2007 Junior Subordinated Deferrable Debentures	June 15, 2037	139,800
2010 Senior Notes due 2040	January 26, 2040	250,000
$400,000 syndicated unsecured letter of credit facility	March 9, 2016	—
$525,000 syndicated secured letter of credit facility	March 9, 2016	309,422
$200,000 secured bi-lateral letter of credit facility	Evergreen	18,676
Talbot FAL facility	December 31, 2015	25,000
PaCRe senior secured letter of credit facility	Evergreen	294
AlphaCat Re secured letter of credit facility	Evergreen	24,800
IPC Bi-Lateral Facility	Evergreen	19,817
$375,000 Flagstone bi-lateral facility	Evergreen	292,532
Flagstone 2006 Junior Subordinated Deferrable Debentures	September 15, 2036	137,904
Flagstone 2007 Junior Subordinated Deferrable Debentures	September 15, 2037	113,750
Total		$1,481,995

Inflation Risk: We do not believe that inflation has had or will have a material effect on our combined results of operations, except insofar as (a) inflation may affect interest rates, and (b) losses and loss expenses may be affected by inflation.

ITEM 4. CONTROLS AND PROCEDURES

Conclusion Regarding the Effectiveness of Disclosure 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

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Rules 13a-15 and 15d-15 promulgated under the Securities Exchange Act of 1934, as amended, 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 recorded, processed, summarized and reported when required and the information is accumulated and communicated, as appropriate, to allow timely decisions regarding required disclosures.

Changes in Internal Control Over Financial Reporting

There have been no changes in internal control over financial reporting identified in connection with the Company's evaluation required pursuant to Rules 13a-15 and 15d-15 promulgated under the Securities Exchange Act of 1934, as amended, that occurred during the most recent fiscal quarter that have materially affected, or are reasonably likely to materially affect, the Company's internal control over financial reporting.

PART II — OTHER INFORMATION

ITEM 1. LEGAL PROCEEDINGS

During the normal course of business, the Company and its subsidiaries are subject to litigation and arbitration. Legal proceedings such as claims litigation are common in the insurance and reinsurance industry in general. The Company and its subsidiaries may be subject to lawsuits and regulatory actions in the normal course of business that do not arise from or directly relate to claims on reinsurance treaties or contracts or insurance policies.
Litigation typically can include, but is not limited to, allegations of underwriting errors or misconduct, employment claims, regulatory activity, shareholder disputes or disputes arising from business ventures. These events are difficult, if not impossible, to predict with certainty. It is Company policy to dispute all allegations against the Company and/or its subsidiaries that management believes are without merit.
As at March 31, 2014, the Company was not a party to, or involved in any litigation or arbitration that it believes could have a material adverse effect on the financial condition, results of operations or liquidity of the Company.

ITEM 1A. RISK FACTORS

Please refer to the discussion of Risk factors in Part 1 of the Company's Annual Report on Form 10-K for the year ended December 31, 2013.

ITEM 2. UNREGISTERED SALES OF EQUITY SECURITIES AND USE OF PROCEEDS

The Company has repurchased approximately 62.2 million common shares for an aggregate purchase price of $1,917.7 million from the inception of the share repurchase program to April 30, 2014.
The Company expects the purchases under its share repurchase program to be made from time to time in the open market or in privately negotiated transactions. The timing, form and amount of the share repurchases under the program will depend on a variety of factors, including market conditions, the Company's capital position relative to internal and rating agency targets, legal requirements and other factors.
On February 5, 2014, the Board of Directors of the Company approved an increase to the Company's common share repurchase authorization to $500.0 million. This amount is in addition to the $1,774.4 million of common shares

repurchased by the Company through February 5, 2014 under its previously authorized share repurchase programs. The repurchase program may be modified, extended or terminated by the Board of Directors at any time. The remaining amount available under the current share repurchase authorization is $356.7 million as of April 30, 2014.

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Share repurchases include repurchases by the Company of shares, from time to time, from employees in order to facilitate the payment of withholding taxes on restricted shares which have vested. We repurchase these shares at their fair market value, as determined by reference to the closing price of our common shares on the day the restricted shares vested.

	Share Repurchase Activity (Expressed in thousands of U.S. dollars except for share and per share information)				
	As at December 31, 2013				Quarter ended
Effect of share repurchases:	(cumulative)	January	February	March	March 31, 2014
Aggregate purchase price (a)	$1,720,349	$44,689	$101,456	$51,194	$197,339
Shares repurchased	56,805,310	$1,202,160	$2,799,228	$1,365,284	$5,366,672
Average price (a)	$30.29	$37.17	$36.24	$37.50	$36.77
Estimated cumulative net accretive (dilutive) impact on:					
Diluted BV per common share (b)					$2.58
Diluted EPS - Quarter (c)					$0.60

	Share Repurchase Activity (Expressed in thousands of U.S. dollars except for share and per share information)			
Effect of share repurchases:	As at March 31, 2014 (cumulative)	April	As at April 30, 2014	Cumulative to Date Effect
Aggregate purchase price (a)	$ 1,917,688	$ —	$ —	$ 1,917,688
Shares repurchased	62,171,982	—	—	62,171,982
Average price (a)	$ 30.84	$ —	$ —	$ 30.84

(a) Share transactions are on a trade date basis through April 30, 2014 and are inclusive of commissions. Average share price is rounded to two decimal places.

(b) As the average price per share repurchased during the periods from 2009 at the inception of the share repurchase program through to 2013 was lower than the book value per common share, the repurchase of shares increased the ending book value per share.

(c) The estimated impact on earnings per diluted share was calculated by comparing reported results versus i) net income per share plus an estimate of lost net investment income on the cumulative share repurchases divided by ii) weighted average diluted shares outstanding excluding the weighted average impact of cumulative share repurchases. The impact of cumulative share repurchases was accretive to earnings per diluted share.

ITEM 3. DEFAULTS UPON SENIOR SECURITIES

None.

ITEM 4. MINE SAFETY DISCLOSURE

Not applicable.

ITEM 5. OTHER INFORMATION

None.

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ITEM 6. EXHIBITS

Exhibit	Description
Exhibit 31.1*	Certification of Chief Executive Officer pursuant to Section 302 of The Sarbanes-Oxley Act of 2002.
Exhibit 31.2*	Certification of Chief Financial Officer pursuant to Section 302 of The Sarbanes-Oxley Act of 2002.
Exhibit 32*	Certification pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of The Sarbanes-Oxley Act of 2002.
Exhibit 101.1 INS*	XBRL Instance Document
Exhibit 101.SCH*	XBRL Taxonomy Extension Schema Document
Exhibit 101.CAL*	XBRL Taxonomy Extension Calculation Linkbase Document
Exhibit 101.LAB*	XBRL Taxonomy Extension Label Linkbase Document
Exhibit 101.PRE*	XBRL Taxonomy Extension Presentation Linkbase Document
Exhibit 101.DEF*	XBRL Taxonomy Extension Definition Linkbase Document

*Filed herewith

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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 thereunto duly authorized.

		VALIDUS HOLDINGS, LTD. (Registrant)
Date:	May 2, 2014	/s/ Edward J. Noonan Edward J. Noonan Chief Executive Officer
Date:	May 2, 2014	/s/ Jeffrey D. Sangster Jeffrey D. Sangster Executive Vice President and Chief Financial Officer

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