

Consolidated Financial Statements of

**Imagine Group Holdings Limited**

December 31, 2006



# Imagine Group Holdings Limited

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## **STATEMENT OF THE DIRECTORS' RESPONSIBILITIES**

The Directors are responsible for preparing the annual report and the consolidated financial statements. The Bermudian Companies Act 1981 permits the Group and its subsidiaries (together, "the Group"), to prepare consolidated financial statements which comprise the consolidated balance sheet, the consolidated statement of income, the consolidated statement of changes in equity, the consolidated statement of cash flows and the related notes in accordance with International Financial Reporting Standards ("IFRS").

International Accounting Standard 1 requires that the consolidated financial statements present fairly for each financial year the Group's financial position, financial performance and cash flows. This requires the faithful representation of the effect of transactions, other events and conditions in accordance with the definitions and recognition criteria for assets, liabilities, income and expenses set out in the International Accounting Standards Board's "Framework for the Preparation and Presentation of Financial Statements". In virtually all circumstances, a fair presentation will be achieved by compliance with all applicable International Financial Reporting Standards. Directors are required to:

- Properly select and apply accounting policies, including whether to prepare financial statements on a going concern basis;
- Present information, including accounting policies, in a manner that provides relevant, reliable, comparable and understandable information; and
- Provide additional disclosures when compliance with the specific requirements in IFRS is insufficient to enable users to understand the impact of particular transactions, other events and conditions on the Group's financial position and financial performance.

The Directors are responsible for keeping proper accounting records which disclose with reasonable accuracy at any time the financial position of the Company, for safeguarding the assets and for taking reasonable steps for the prevention and detection of fraud and other irregularities.



## Report of KPMG Audit Plc to Imagine Group Holdings Limited

We have audited the consolidated financial statements of Imagine Group Holdings Limited for the year ended 31 December 2006 which comprise the consolidated balance sheet, the consolidated statement of income, the consolidated statement of changes in equity the consolidated statement of cash flows, and the related notes. These consolidated financial statements have been prepared on the basis set out in the accounting policies set out therein.

This report is made solely to the Group in accordance with the terms of our engagement. Our audit work has been undertaken so that we might state to the Group those matters we are required to state to it in our auditors' report and for no other purpose. To the fullest extent permitted by law, we do not accept or assume responsibility to anyone other than the Group for our audit work, for this report, or for the opinions we have formed.

### Respective responsibilities of directors and KPMG Audit Plc

The directors' responsibilities for preparing the consolidated financial statements in accordance with International Financial Reporting Standards (IFRSs) are set out in the Statement of Directors' Responsibilities on page 1.

Our responsibility is to audit the consolidated financial statements in accordance with International Standards on Auditing (UK and Ireland).

We report to you our opinion as to whether the consolidated financial statements give a true and fair view. We also report to you if the Group has not kept proper accounting records or if we have not received all the information and explanations we require for our audit.

### Basis of audit opinion

We conducted our audit in accordance with International Standards on Auditing (UK and Ireland) issued by the Auditing Practices Board. An audit includes examination, on a test basis, of evidence relevant to the amounts and disclosures in the consolidated financial statements. It also includes an assessment of the significant estimates and judgments made by the directors in the preparation of the consolidated financial statements, and of whether the accounting policies are appropriate to the Group's circumstances, consistently applied and adequately disclosed.

We planned and performed our audit so as to obtain all the information and explanations which we considered necessary in order to provide us with sufficient evidence to give reasonable assurance that the consolidated financial statements are free from material misstatement, whether caused by fraud or other irregularity or error. In forming our opinion we also evaluated the overall adequacy of the presentation of information in the consolidated financial statements.

### Opinion

In our opinion the consolidated financial statements give a true and fair view, in accordance with IFRS, of the state of the Group's affairs as at 31 December 2006 and of its profit for the year then ended.

*KPMG Audit Plc*

KPMG Audit Plc  
Chartered Accountant  
London, UK  
May 2, 2007



# IMAGINE GROUP HOLDINGS LIMITED

## Consolidated Statement of Income

For the year ended December 31, 2006 with comparative figures for 2005

(Expressed in Thousands of United States Dollars)

	<u>Notes</u>	<u>2006</u>	<u>2005</u>
<b>Revenues:</b>			
Gross written premiums		\$ 717,740	\$ 594,451
Ceded premiums		<u>(61,907)</u>	<u>(72,901)</u>
Net written premiums		655,833	521,550
Change in unearned premiums		<u>(54,754)</u>	<u>(32,888)</u>
Net earned premiums		<u>601,079</u>	<u>488,662</u>
Net investment income	19 & 24	111,830	57,669
Net foreign exchange gains		1,213	3,182
Fee income on investment contracts		7,016	25,109
Other income		<u>4,915</u>	<u>1,500</u>
<b>Total revenues</b>		<u>726,053</u>	<u>576,122</u>
<b>Expenses:</b>			
Claims and claims adjustment expenses incurred	14	484,767	453,447
Policy acquisition costs	12	84,919	66,457
Operating expenses	20, 24 & 26	63,435	62,303
Loss on disposal of subsidiary	7	17,093	-
Impairment charge on disposal group held for sale	7	<u>-</u>	<u>5,000</u>
<b>Total expenses</b>		<u>650,214</u>	<u>587,207</u>
<b>Operating income (loss) before financing costs</b>		75,839	(11,085)
Finance costs	24	<u>9,106</u>	<u>3,765</u>
<b>Income (loss) before corporation taxes</b>		66,733	(14,850)
Corporation tax (expense) recovery	21	<u>(8,046)</u>	<u>17,420</u>
<b>Net income for the year</b>		\$ <u>58,687</u>	\$ <u>2,570</u>
<b>Attributable to:</b>			
Equity holders of the parent		\$ 58,514	\$ 2,393
Minority interest		<u>173</u>	<u>177</u>
Net income for the year		\$ <u>58,687</u>	\$ <u>2,570</u>
Basic earnings per share	23	\$ <u>1.19</u>	\$ <u>0.05</u>
Diluted earnings per share	23	\$ <u>1.18</u>	\$ <u>0.05</u>

See accompanying notes to consolidated financial statements

## IMAGINE GROUP HOLDINGS LIMITED

Consolidated Statement of Changes in Equity

For the year ended December 31, 2006 with comparative figures for 2005

(Expressed in Thousands of United States Dollars)

	<u>Share Capital</u>	<u>Retained Earnings</u>	<u>Unrealized Investment (Losses) Gains</u>	<u>Cash Flow Hedging</u>	<u>Cumulative Translation Adjustment</u>	<u>Total Shareholders' Equity</u>	<u>Minority Interest</u>	<u>Total Equity</u>
At January 1, 2005	\$ 478,415	\$ 46,447	\$ (115)	\$ -	\$ 1,285	\$ 526,032	\$ 845	\$ 526,877
Fair value gains - available for sale investments	-	-	1,828	-	-	1,828	-	1,828
Foreign currency translation differences	-	-	-	-	(3,665)	(3,665)	-	(3,665)
Other	-	-	-	-	-	-	(1)	(1)
Total income and expense for the year recognized directly in equity	-	-	1,828	-	(3,665)	(1,837)	(1)	(1,838)
Net income for the year	-	2,393	-	-	-	2,393	177	2,570
Total recognized income and expense for the year	-	2,393	1,828	-	(3,665)	556	176	732
At December 31, 2005	478,415	48,840	1,713	-	(2,380)	526,588	1,021	527,609
Fair value losses - available for sale investments	-	-	(5,116)	-	-	(5,116)	-	(5,116)
Cash flow hedging	-	-	-	(7)	-	(7)	-	(7)
Foreign currency translation differences	-	-	-	-	(6,644)	(6,644)	-	(6,644)
Acquisition of minority interest	-	-	-	-	-	-	(1,194)	(1,194)
Total income and expense for the year recognized directly in equity	-	-	(5,116)	(7)	(6,644)	(11,767)	(1,194)	(12,961)
Net income for the year	-	58,514	-	-	-	58,514	173	58,687
Total recognized income and expense for the year	-	58,514	(5,116)	(7)	(6,644)	46,747	(1,021)	45,726
At December 31, 2006	\$ 478,415	\$ 107,354	\$ (3,403)	\$ (7)	\$ (9,024)	\$ 573,335	\$ -	\$ 573,335

# IMAGINE GROUP HOLDINGS LIMITED

## Consolidated Statement of Cash Flows

For the year ended December 31, 2006 with comparative figures for 2005

(Expressed in Thousands of United States Dollars)

	<u>Notes</u>	<u>2006</u>	<u>2005</u>
<b>Cash Flows from Operating Activities</b>			
Income (loss) before corporation taxes		\$ 66,733	\$ (14,850)
Adjustments for:			
Goodwill impairment		451	-
Loss on disposal of subsidiary	7	17,093	-
Impairment loss on disposal group held for sale	7	-	5,000
Impairment loss on fixed maturities		-	2,954
Investment income		(99,938)	(64,771)
Share-based payment expense		2,000	-
Net unrealized investment gains		(14,578)	(62)
Finance costs		9,106	3,765
Changes in operating assets and liabilities:			
Other assets		(28,932)	(8,936)
Funds held by ceding companies		(1,068)	2,195
Premiums and other reinsurance balances receivable		(61,974)	(33,983)
Deferred policy acquisition costs		1,352	(5,167)
Prepaid reinsurance premiums		5,857	10,572
Investment contract assets		14,135	2,570
Reinsurers' share of claims and claims adjustment expenses		67,791	(57,990)
Claims and claims adjustment expenses		191,909	213,584
Investment contract liabilities		(17,025)	17,578
Unearned premiums		44,692	21,120
Reinsurance balances payable		(13,663)	39,622
Accounts payable and other liabilities		39,348	(52,823)
		223,289	80,378
Net corporation taxes paid		(8,905)	(1,456)
<b>Net cash provided by operating activities</b>		<u>214,384</u>	<u>78,922</u>
<b>Cash Flows from Investing Activities</b>			
Interest received		96,377	60,550
Net cash acquired on acquisition of subsidiaries	6	5,155	23,953
Acquisition of minority interest		(1,959)	-
Disposal of subsidiary, net of cash disposed of	7	(56,470)	-
Net movement of short-term investments		167,806	8,296
Net movement of structured insurance assets		18,637	14,058
Net movement of derivative financial instruments		(1,688)	5,440
Net movement of equities		2,296	(19,816)
Purchase of fixed maturities		(1,231,094)	(1,482,969)
Proceeds on sale of fixed maturities	9	900,189	1,254,152
<b>Net cash used in investing activities</b>		<u>(100,751)</u>	<u>(136,336)</u>
<b>Cash Flows from Financing Activities</b>			
Net proceeds on loans payable		59,827	50,000
<b>Net cash provided by financing activities</b>		<u>59,827</u>	<u>50,000</u>
Net increase (decrease) in cash and cash equivalents		173,460	(7,414)
Cash and cash equivalents at beginning of the year		418,642	426,056
Cash and cash equivalents at end of the year		\$ <u>592,102</u>	\$ <u>418,642</u>
<b>Represented by:</b>			
Cash and cash equivalents		\$ 592,102	\$ 382,150
Cash and short-term investments classified as held for sale	7	-	36,492
		\$ <u>592,102</u>	\$ <u>418,642</u>

See accompanying notes to consolidated financial statements

# IMAGINE GROUP HOLDINGS LIMITED

Notes to Consolidated Financial Statements

December 31, 2006

*(Expressed in Thousands of United States Dollars)*

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## 1. General and background

Imagine Group Holdings Limited (the "Company", "Group" or "IGHL") is a holding company formed under the laws of Bermuda, with its registered office located at 7 Reid Street, Hamilton, Bermuda. The Company was incorporated on December 10, 1998 and its ultimate majority shareholder is Brookfield Asset Management Inc. (NYSE: BAM)

The Group provides specialty insurance and reinsurance products to the global insurance marketplace through its direct and indirect subsidiaries.

These Consolidated Financial Statements were authorized for issue by the directors on May 2, 2007.

## 2. Significant accounting policies

The accompanying Consolidated Financial Statements are presented in United States dollars, rounded to the nearest thousand except in the case of per share items. They are prepared in accordance with International Financial Reporting Standards ("IFRS"). They are prepared on the historical cost basis except for the accounting for investments, structured insurance assets, derivative financial instruments and share-based payment liabilities as detailed in Notes 2(g), (h) and (l).

The accounting policies adopted by the Group are consistent with those of the previous financial year and are as follows:

### a) *Principles of consolidation*

The Consolidated Financial Statements include IGHL and all of its subsidiaries that are controlled by IGHL. Companies acquired are consolidated from the date on which control over the net assets and operations of the acquiree is effectively transferred to the Group. The financial effects of the acquisitions on March 30, December 15 and December 31, 2006, are described in Note 6. All intercompany balances and transactions including unrealized intercompany profits have been eliminated in the preparation of these Consolidated Financial Statements.

### b) *Segmental reporting*

A segment is a distinguishable component of the Group that is engaged in providing related products and services (business segment), or in providing products or services within a particular economic environment (geographical segment), which is subject to risks and rewards that are different from those of other segments. The Group's primary format for segmental reporting is based on business segments and its secondary format is based on geographical segments.

### c) *Classification of insurance and investment contracts*

Contracts under which the Group accepts significant insurance risk from another party (the policyholder or ceding company) by agreeing to compensate the policyholder or ceding company if a specified uncertain future event (the insured event) adversely affects the policyholder or ceding company are classified as insurance contracts.

# IMAGINE GROUP HOLDINGS LIMITED

Notes to Consolidated Financial Statements

December 31, 2006

*(Expressed in Thousands of United States Dollars)*

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## 2. Significant accounting policies (Continued)

### c) *Classification of insurance and investment contracts (Continued)*

Insurance risk is significant if, and only if, an insured event could cause the Group to pay significant additional benefits. Once a contract is classified as an insurance contract it remains classified as an insurance contract until all rights and obligations are extinguished or expire.

Contracts under which the transfer of insurance risk to the Group from the policyholder or ceding company is not significant are classified as investment contracts, as described in Note 2(e). Insurance risk is risk other than financial risk.

Insurance contracts may also transfer financial risk. Financial risk is the risk of a possible future change in one or more of a specified interest rate, security price, commodity price, foreign exchange rate, index of prices or rates, credit rating or credit index or other variable, provided in the case of a non-financial variable that the variable is not specific to a party to the contract.

### d) *Insurance contracts*

#### *(i) Premiums and acquisition costs*

Gross written premiums reflect business written during the year and are recognized as earned premium ratably over the exposure period of the related insurance and reinsurance contracts. Exposure periods are based on underwriting and actuarial judgment and, as a result, are subject to potential variance. Unearned premium reserves are established to cover the remainder of the contract period. Policy acquisition costs are deferred and amortized over the period in which the related premiums are earned. Deferred policy acquisition costs are limited to their estimated realizable value based on the related unearned premiums, anticipated claims and claims adjustment expenses and anticipated net investment income.

#### *(ii) Funds held by ceding companies*

Funds held by ceding companies are carried at amortized cost using the effective interest rate method. These amounts are reported on a net basis where the effective right of offset exists.

#### *(iii) Claims and claims adjustment expenses*

The liability for claims and claims adjustment expenses represents the estimates of the ultimate cost of all claims incurred but not paid by the balance sheet date. It is based on individual case estimates received from ceding companies and a provision is also included for claims and claims adjustment expenses related to incurred but not reported claims ("IBNR"), including expected development on reported claims. The IBNR provision is established by qualified actuaries. Inherent in the estimate of ultimate claims are expected trends in frequency, claim severity, timing of claim payments, interest yields reporting and adjusting lags, potential disputes and other factors that could vary significantly as claims are settled.

# IMAGINE GROUP HOLDINGS LIMITED

Notes to Consolidated Financial Statements

December 31, 2006

*(Expressed in Thousands of United States Dollars)*

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## 2. Significant accounting policies (Continued)

### *(iii) Claims and claims adjustment expenses (Continued)*

Accordingly, ultimate claims could differ, perhaps substantially, from the best estimate recorded in these Consolidated Financial Statements. These estimates are continually reviewed and, as adjustments become necessary, such adjustments are reflected in net income for the year.

For a limited number of transactions entered into by the Company, the liability for claims and claims adjustment expenses is reported on a discounted basis, which estimates the present value of funds required to pay claims at future dates assuming appropriate interest rates and payment profiles. These reserves are discounted based on estimated loss payout patterns. Transactions where the discounting of reserves has been employed are based on management's belief that the timing and amount of claim payments and the amount of the liability are reliably determinable and where anticipated future investment income is an integral variable when pricing a particular contract. However, such liability is necessarily based on estimates and the ultimate liability may exceed the Group's estimates.

The claims provisions also include, where necessary, a reserve for unexpired risks where, at the balance sheet date, the estimated cost of future claims and related deferred acquisition costs are expected to exceed the unearned premium provision. The assessment of an unexpired risk provision is made in relation to lines or groupings of business that are managed together.

### e) *Investment contracts*

Contracts under which the transfer of insurance risk to the Group from the policyholder or ceding company is not significant are classified as investment contracts. Investment contracts are recognized as liabilities in the Consolidated Balance Sheet and are reviewed by qualified actuaries and adjusted accordingly. Contributions received from policyholders or ceding companies are not recognized in the Consolidated Statement of Income as premiums and are instead accounted for as investment contract liabilities. Claims are treated as an adjustment to the investment contract liability and are not reflected within the Consolidated Statement of Income unless the investment contract liability is insufficient. Where there is a recovery or an amount receivable under these types of contracts, the amount is reported as an investment contract asset on the Consolidated Balance Sheet. Income from these contracts is recognized as the related services are provided and is reflected within fee income on investment contracts on the Consolidated Statement of Income.

# IMAGINE GROUP HOLDINGS LIMITED

Notes to Consolidated Financial Statements

December 31, 2006

*(Expressed in Thousands of United States Dollars)*

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## 2. Significant accounting policies (Continued)

### f) Revenue

The Group's revenue comprises the following:

#### *(i) Net earned premiums from insurance contracts*

The accounting policies for the recognition of revenue from insurance contracts are disclosed in Note 2(d).

#### *(ii) Fee income from investment contracts*

The accounting policies for the recognition of revenue from investment contracts are disclosed in Note 2(e).

#### *(iii) Net investment income*

Investment income from financial assets comprises interest and dividend income, unrealized gains and losses on financial instruments designated as fair value through profit or loss and trading, as well as realized gains and losses on all financial instruments. Income on available-for-sale fixed maturities, loans and receivables is recognized using the effective interest rate method. Dividend income from available-for-sale equities is recognized when the right to receive payment is established (i.e. the ex-dividend date). Investment income is reported net of investment management fees and other investment related expenses.

### g) Investments and structured insurance assets

The Group classifies its investments in the following categories: trading, fair value through profit or loss, loans and receivables as well as available-for-sale. The classification is dependent on the purpose for which the investments were acquired. Management determines the classification of its investments at the time of the purchase.

#### *i) Fixed maturities, equities and short-term investments*

Investments in fixed maturities and equities are classified as available-for-sale. Available-for-sale investments are initially recorded at fair value, including transaction costs and are subsequently recorded at fair value based on published market bid prices. Unrealized gains and losses arising from changes in fair value are included within a separate component of shareholders' equity until the investment is derecognized or is determined to be impaired. On derecognition or impairment, the cumulative unrealized gains or losses previously reported within shareholders' equity are transferred to the Consolidated Statement of Income. Realized gains and losses arising from the sale of these investments, which are determined by specific identification, are included within net realized investment gains and losses and include adjustments for declines in value that are considered other than temporary.

Short-term investments, which have a maturity of three months to one year at the date of acquisition, are classified as loans and receivables and carried at amortized cost, which approximates their fair value.

# IMAGINE GROUP HOLDINGS LIMITED

Notes to Consolidated Financial Statements

December 31, 2006

*(Expressed in Thousands of United States Dollars)*

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## 2. Significant accounting policies (Continued)

### g) *Investments and structured insurance assets (Continued)*

#### i) *Fixed maturities, equities and short-term investments (Continued)*

All 'regular way' purchases and sales of investment securities are recognized at the trade date, which is the date that the Group commits to purchase or sell the financial instrument. Regular way purchases or sales of investments require delivery of assets within the time frame generally established by regulation or convention in the market place.

#### ii) *Structured insurance assets*

Structured insurance assets consist of assets sourced from insurance or insurance related business and include purchased insurance claims and purchased commission rights as well as loans to existing and potential clients. Structured insurance assets are financial assets with fixed or determinable payments that are not quoted in an active market. The claims and commission cash flows of the purchased insurance claims and commission rights are considered to be determinable.

##### *Purchased insurance claims:*

In purchasing insurance claims, the Group does not act as an insurer and does not assume any obligation to pay claims or to cover their inherent litigation or arbitration exposures. The Group receives the assignment of the right to pursue recovery of the value of the remaining insurance claims or reinsurance recoveries.

Purchased insurance claims are recorded at amortized cost. Revenue is recognized by applying the effective interest method to the cash flows which are expected to be received over the term to maturity of the claims.

##### *Purchased commission rights:*

In purchasing commission rights, the Group does not act as an insurer and does not assume any obligation to pay claims or to cover their inherent litigation or arbitration exposures. The Group receives the assignment of the right to receive commission for the remaining duration of the underlying insurance policies.

Prior to January 1, 2005, the loans made to acquire these commission rights were designated as loans and receivables and carried at amortized cost using the effective interest rate method (the loans are effectively repaid from the commission flows). Under two of these arrangements, the Group is entitled to profit sharing, where the value of this right fluctuates based on the anticipation of the likely level and timing of future profits. These rights are embedded derivatives and are separated from the host contracts as their risks and characteristics are not closely related to those of the underlying host contracts. The embedded derivatives are accounted for as trading investments and continue to be remeasured at their fair value based on discounted cash flow models.

# IMAGINE GROUP HOLDINGS LIMITED

Notes to Consolidated Financial Statements

December 31, 2006

*(Expressed in Thousands of United States Dollars)*

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## 2. Significant accounting policies (Continued)

### *Purchased commission rights (Continued)*

Subsequent to January 1, 2005, purchased commission arrangements are designated on inception as a 'financial asset at fair value through profit or loss' as they are managed and their performance evaluated on a fair value basis, in accordance with the Group's documented investment strategy for these investments. Financial assets at fair value through profit or loss are measured at fair value and changes therein are recognized within net investment income on the Consolidated Statement of Income. In the absence of an active market, the fair value of these financial assets has been determined by a valuation technique based on a current, observable, arm's length transaction.

The commissions due to the Group under these arrangements have credit and actuarial risks. The Group takes on the credit risk of the insurance carriers who have the ultimate payment obligation for each asset type. The majority of these insurance carriers are single "A" investment grade and the assets have short repayment durations of between one and five years. In addition, the Group takes on actuarial risk in the form of the uncertain timing and amount of future payment of the commissions; these can be interrupted or terminated if any of the following events occur: (i) the policy is cancelled by the insured or annual premiums are not paid ("lapse risk"); (ii) the insured becomes sick and makes a claim under the insurance policy ("morbidity risk"); or (iii) the insured dies and the policy expires ("mortality risk").

These actuarial risks are modeled using data drawn from the insurance carriers, current Society of Actuaries Long Term Care Studies, as well as data from other public and non-public sources, and are used to project the future commission payments the Group can expect to receive from a portfolio of long-term care policies. The purchase price paid is based on discounting these cash flows using a U.S. Treasury yield curve on the purchase date, adjusted for a credit margin reflecting the insurance carriers' credit risk of making these estimated commission payments over time.

### *Loans to existing and potential clients:*

Loans and other receivables are financial assets with fixed or determinable payments that are not quoted in an active market. These investments are initially recognized at cost, being the fair value of the consideration paid for the acquisition of the investment. All transaction costs directly attributable to the acquisition are also included in the cost of the investment. Subsequent to initial recognition, these loans and other receivables are carried at amortized cost, using the effective interest method. Gains and losses are recognized in the Consolidated Statement of Income when the investments are derecognized or impaired, as well as through the amortization process.

### *h) Derivative financial instruments*

Derivative financial instruments are classified as held for trading unless they are designated as effective hedging instruments. All derivatives are carried as assets when the fair values are positive and as liabilities when the fair values are negative. Embedded derivatives are treated as separate derivatives and are recorded at fair value if their economic characteristics and risks are not closely related to those of the related host contract and the host contract is not itself recorded at fair value through the income statement.

# IMAGINE GROUP HOLDINGS LIMITED

Notes to Consolidated Financial Statements

December 31, 2006

*(Expressed in Thousands of United States Dollars)*

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## 2. Significant accounting policies (Continued)

### *h) Derivative financial instruments (Continued)*

Embedded derivatives in insurance contracts that meet the definition of an insurance contract are not separated out and measured at fair value. Derivative financial instruments held for trading are typically entered into with the intention to settle in the near future. These instruments are initially recorded at fair value. Subsequent to initial recognition, these instruments are remeasured at fair value. Fair value adjustments and realized gains and losses are recognized in the Consolidated Statement of Income.

Derivative financial instruments designated as hedging instruments, for example, forward currency contracts are entered into by the Group to hedge its risks associated with foreign currency fluctuations.

For the purpose of hedge accounting, hedges are classified as:

- cash flow hedges, when they hedge exposure to variability in cash flows of a recognized asset or liability or a highly probable forecasted transaction.
- fair value hedges, when they hedge exposure to changes in the fair value of a recognized asset or liability or an unrecognized firm commitment, or an identified portion of such asset, liability or firm commitment, that is attributable to a particular risk.

The following are the criteria for applying hedge accounting:

- formal documentation of the hedging instrument, hedged item, hedging objective, strategy and relationship is prepared before hedge accounting is applied.
- the hedge is documented at inception showing that it is expected to be highly effective in offsetting the risk in the hedged item throughout the reporting period and the hedge is effective on an ongoing basis.
- for a cash flow hedge, a forecast transaction that is the subject of the hedge must be highly probable and must present an exposure to variations in cash flows that could ultimately affect the income statement.

### *Cash flow hedges*

Such derivative financial instruments are initially recognized at fair value on the date on which the derivative contract is entered into. The effective portion of the gain or loss on the hedging instrument is recognized directly in shareholders' equity, while the ineffective portion is recognized in the Consolidated Statement of Income. Amounts taken to equity are transferred to the Consolidated Statement of Income when the hedged transaction impacts the Consolidated Statement of Income, such as when hedged financial income or financial expense is recognized or when the forecast sale or purchase occurs. When the hedged item is the cost of a non-financial asset or liability, the amounts taken to equity are transferred to the initial carrying amount of the non-financial asset or liability.

# IMAGINE GROUP HOLDINGS LIMITED

Notes to Consolidated Financial Statements

December 31, 2006

(Expressed in Thousands of United States Dollars)

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## 2. Significant accounting policies (Continued)

### *Cash flow hedges (Continued)*

If the forecast transaction is no longer expected to occur, amounts previously recognized in shareholders' equity are transferred to the Consolidated Statement of Income. If the hedging instrument expires or is sold, terminated or exercised without replacement or rollover, or if its designation as a hedge is revoked, amounts previously recognized in shareholders' equity remain in equity until the forecast transaction occurs.

### *Fair value hedges*

Such derivative financial instruments are initially recognized at fair value on the date on which the derivative contract is entered into. Changes in the fair value of the derivatives are recognized in the Consolidated Statement of Income together with changes in the fair value of the hedged items that are attributable to the hedged risk.

For fair value hedges relating to items carried at amortized cost, the adjustment to carrying value is amortized through the Consolidated Statement of Income over the remaining term of maturity.

Amortization may begin as soon as an adjustment exists and shall begin no later than when the hedged item ceases to be adjusted for changes in its fair value attributable to the risk being hedged.

When an unrecognized firm commitment is designated as a hedged item, the subsequent cumulative change in the fair value of the firm commitment attributable to the hedged risk is recognized as an asset or liability with a corresponding gain or loss recognized in the Consolidated Statement of Income. The change in the fair value of the hedging instrument is also recognized in the Consolidated Statement of Income.

The Group discontinues fair value hedge accounting if the hedging instrument expires, is sold, terminated or exercised, the hedge no longer meets the criteria for hedge accounting or the Group revokes the designation.

### *i) Cash and cash equivalents*

In its presentation of the Consolidated Statement of Cash Flows, the Group considers all investments with an original maturity of three months or less to be cash equivalents.

### *j) Corporation taxes*

Corporation tax comprises both current and deferred tax. Corporation tax is recognized in the Consolidated Statement of Income except to the extent that it relates to items recognized directly to equity, in which case it is recognized in equity.

Current corporation tax is the expected tax payable on the taxable income for the year, using tax rates enacted or substantively enacted at the balance sheet date, and any adjustment to tax payable in respect of previous years.

Deferred tax is provided using the balance sheet liability method, providing for temporary differences between the carrying amounts of assets and liabilities for financial reporting purposes and the amounts used for taxation purposes.

# IMAGINE GROUP HOLDINGS LIMITED

Notes to Consolidated Financial Statements

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*(Expressed in Thousands of United States Dollars)*

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## 2. Significant accounting policies (Continued)

### j) Corporation taxes (Continued)

The following temporary differences are not provided for: the initial recognition of goodwill or the initial recognition of an asset or a liability in a transaction which is not a business combination and at the time of the transaction, affects neither accounting or taxable income as well as differences relating to investments in subsidiaries to the extent that they are unlikely to reverse in the foreseeable future. The amount of deferred tax provided is based on the expected manner of realization or settlement of the carrying amount of assets and liabilities, using tax rates enacted or substantively enacted at the balance sheet date.

A deferred tax asset is recognized only to the extent that it is probable that future taxable profits will be available against which the asset can be utilized. Deferred tax assets are reduced to the extent that it is no longer probable that the related tax benefit will be realized.

### k) Financial instruments: fair values and financial risks

Fair value disclosures with respect to certain financial instruments are separately included in the notes to the Consolidated Financial Statements where appropriate. The carrying values of other financial instruments, including cash and cash equivalents, accrued investment income, funds held by ceding companies, premiums and other reinsurance balances receivable, other assets, reinsurance balances payable and accounts payable and other liabilities approximate their fair value due to their short-term nature.

The estimates of fair values presented herein are subjective in nature and are not necessarily indicative of the amounts that the Group would actually realize in a current market exchange. This is largely because intangible assets such as internally generated goodwill are not included on the Consolidated Balance Sheet and these would need to be taken into account when considering the fair value of the Group. Any differences would not be expected to be material. Certain items such as deferred policy acquisition costs, prepaid reinsurance premiums and deferred income taxes, the liability for claims and claims adjustment expenses and unearned premiums are excluded from fair value disclosure. Thus the total fair value amounts cannot be aggregated to determine the underlying fair value of the Group.

Credit risk is the risk that a counterparty will be unable to pay amounts in full when due. The maximum exposure to credit risk is represented by the carrying amount of each financial asset in the Consolidated Balance Sheet, including cash and investments, funds held by ceding companies, premiums and other reinsurance balances receivable, investment contract assets and reinsurance losses recoverable. Management monitors the exposure to credit risk on an ongoing basis and credit evaluations are performed for all potential and existing ceding companies.

Cash and short-term investments are placed with financial institutions of a high credit quality and the credit risk associated with fixed maturities, derivative financial instruments and structured insurance assets are disclosed in Notes 9, 10 and 11. Premiums and other reinsurance balances receivable, investment contract assets and the reinsurers' share of claims and claims adjustment expenses are reported net of any provision for impairment and funds held by ceding companies are carefully monitored with reference to the credit quality of the ceding company.

# IMAGINE GROUP HOLDINGS LIMITED

Notes to Consolidated Financial Statements

December 31, 2006

*(Expressed in Thousands of United States Dollars)*

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## 2. Significant accounting policies (Continued)

### k) *Financial instruments: fair values and financial risks (Continued)*

Interest rate risk is the exposure to the effects of fluctuations in the prevailing levels of market interest rates on the Group's financial position and cash flows. The Group's exposure to interest rate risk is disclosed in Notes 9, 11, 14, 16 and 24.

### l) *Employee benefits*

#### i) *Defined contribution pension plans*

Obligations for contributions to defined contribution pension plans are recognized within operating expenses in the Consolidated Statement of Income as incurred. The Group does not offer defined benefit pension plans.

#### ii) *Compensation plans*

The Group has in place various compensation plans which are offered to employees of the Group, as described more fully in Note 20. The new compensation plans came into effect on January 1, 2006 and replaced the previous Long-term Incentive Plan. Costs incurred that are related to short-term compensation plans are expensed as the related service is provided. The increase in the vested portion of the long-term compensation plans is recognized within the operating expenses of the Group in the year incurred.

#### iii) *Share-based payment transactions*

During the year, the Group implemented an Employee Share Option Plan ("ESOP") which provides eligible employees with a choice of settlement through cash or the issuance of shares. The ESOP is described more fully in Note 20.

The fair value of the options granted to employees is recognized as an employee expense within operating expenses, with a corresponding increase in accounts payable and other liabilities, over the period in which the employees become unconditionally entitled to the options. The liability is remeasured at each reporting date and at the settlement date with any changes in the fair value of the liability being recognized within the Consolidated Statement of Income.

The fair value of employee stock options is measured using the standard binomial option pricing model, but taking into account particular features which are common to employee share options. Measurement inputs include share price on the measurement date, exercise price of the instrument, expected volatility, expected life of the instruments, expected dividends and the risk-free interest rate based on similarly dated zero coupon government bonds of the country in whose currency the exercise price is expressed.

# IMAGINE GROUP HOLDINGS LIMITED

Notes to Consolidated Financial Statements

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## 2. Significant accounting policies (Continued)

### *m) Foreign currency*

#### *i) Functional and presentation currency*

The functional currency of the Group is the currency of the primary economic environment in which it operates. These Consolidated Financial Statements are presented in United States dollars which is the Group's presentation currency. A foreign operation is a subsidiary, the activities of which are based or conducted in a country or currency other than those of the reporting entity.

#### *ii) Foreign currency transactions*

Foreign currency transactions are transactions undertaken by the Group or one of its subsidiaries in a currency other than its functional currency. Foreign currency transactions are translated into the functional currency at the foreign exchange rate in effect at the date of the transactions.

Foreign currency monetary assets and liabilities are translated into functional currency at the exchange rate in effect at the balance sheet date. Foreign exchange differences arising on translation are recognized in the Consolidated Statement of Income. Foreign currency non-monetary assets and liabilities which are measured at historical cost are recorded at the exchange rate in effect at the date of transaction. Foreign currency non-monetary assets and liabilities which are measured at fair value are recorded at the exchange rate in effect at the date that fair value was determined.

Foreign exchange differences arising on the translation of equity instruments classified as available-for-sale are recognized in the unrealized investment gains (losses) in shareholders' equity. For monetary assets designated as available-for-sale, translation differences are calculated as if they were carried at amortized cost and so are recognized in the Consolidated Statement of Income, whilst foreign exchange differences arising from fair value gains and losses are included in the unrealized (losses) gains in shareholders' equity.

#### *iii) Financial statements of foreign operations*

The results and financial position of a foreign operation are translated into United States dollars as follows:

- assets and liabilities are translated at the foreign exchange rates in effect at the balance sheet date; and
- income and expenses are translated at average rates approximating the foreign exchange rates in effect at the dates of the transactions.

Foreign exchange differences arising from the translation to United States dollars are recognized directly in shareholders' equity within the cumulative translation adjustment ("CTA") reserve. When a foreign operation is disposed of, in part or in full, the relevant amount in the CTA reserve is transferred to the Consolidated Statement of Income.

# IMAGINE GROUP HOLDINGS LIMITED

Notes to Consolidated Financial Statements

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*(Expressed in Thousands of United States Dollars)*

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## 2. Significant accounting policies (Continued)

### n) *Goodwill and negative goodwill*

Business combinations are accounted for using the purchase method of accounting. This involves recognizing identifiable assets (including previously unrecognized intangible assets) and liabilities (including contingent liabilities and excluding future restructuring) of the acquired business at fair value.

Goodwill acquired in a business combination is initially measured at cost being the excess of the cost of the business combination over the Group's interest in the net fair value of the identifiable assets, liabilities and contingent liabilities. Following initial recognition, goodwill is measured at cost less any accumulated impairment losses. When the excess is negative (negative goodwill), it is recognized immediately in the Consolidated Statement of Income.

Goodwill is tested for impairment, annually or more frequently if events or changes in circumstances indicate that the carrying value may be impaired. For the purpose of impairment testing, goodwill acquired in a business combination is, from the acquisition date, allocated to each of the Group's cash-generating units ("CGU"), or groups of CGU's, that are expected to benefit from the synergies of the combination, irrespective of whether other assets or liabilities of the Group are assigned to those units or groups of units. Each unit or group of units to which the goodwill is allocated:

- represents the lowest level within the Group at which the goodwill is monitored for internal management purposes; and
- is not larger than a segment based on either the Group's primary or secondary reporting format determined in accordance with IAS 14 - Segment Reporting.

Impairment is determined by assessing the recoverable amount of the CGU (or group of CGU's), to which the goodwill relates. The recoverable amount is the higher of its fair value less costs to sell and its value-in-use, determined on an individual asset (or CGU) basis, unless the individual asset (or CGU) does not generate cash flows that are largely independent from those of other assets or groups of assets (or groups of CGU's). Previously recorded impairment losses for goodwill are not reversed in future periods. If a CGU is impaired, the impairment first goes against the carrying amount of goodwill before going against the carrying amount of other assets on a pro rata basis.

When goodwill forms part of a CGU (group of CGU's) and part of the operation within that unit is disposed of, the goodwill associated with the operation disposed of is included in the carrying amount of the operation when determining the gain or loss on disposal of the operation. Goodwill disposed of in this circumstance is measured based on the relative values of the operation disposed of and the portion of the CGU retained.

When subsidiaries are sold, the difference between the selling price and the net assets plus cumulative translation differences and unamortized goodwill is recognized in the Consolidated Statement of Income.

# IMAGINE GROUP HOLDINGS LIMITED

Notes to Consolidated Financial Statements

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## 2. Significant accounting policies (Continued)

### *o) Impairment*

The carrying amounts of the Group's assets, other than deferred tax assets, are assessed at each balance sheet date to determine whether there is any indication of impairment. If any such indication exists, the asset's recoverable amount is estimated and the carrying value is reduced to the estimated recoverable amount by means of an impairment charge to the Consolidated Statement of Income. In the case of goodwill the recoverable amount is estimated at each balance sheet date even if there is no indication of impairment.

When a decline in the fair value of an available-for-sale security has been recognized directly in shareholders' equity and there is objective evidence that the asset is impaired, the cumulative loss that had been recognized directly in shareholders' equity is recognized in the Consolidated Statement of Income even though the financial assets have not been derecognized. The cumulative loss that is recognized in the Consolidated Statement of Income is the difference between the acquisition cost and the current fair value less any impairment loss previously recognized in the Consolidated Statement of Income. A significant decline in fair value below cost or a decline that persists for a significant period of time is considered evidence of impairment.

### *i) Calculation of recoverable amount*

The recoverable amount of the Group's originated loans and receivables is calculated as the present value of estimated future cash flows, discounted at the original effective interest rate inherent in the asset. Originated loans and receivables with a short duration are not discounted.

The recoverable amount of non-financial assets is the greater of their net selling price and value in use. In assessing value in use, the estimated future cash flows are discounted to their present value using a pre-tax discount rate that reflects current market assessments of the time value of money and the risks specific to the asset. For an asset that does not generate largely independent cash inflows, the recoverable amount is determined for the CGU to which the asset belongs.

### *ii) Reversals of impairment*

An impairment loss in respect of an originated loan or a receivable is reversed if the subsequent increase in recoverable amount can be related objectively to an event occurring after the impairment loss was recognized. An impairment loss is reversed only to the extent that the asset's carrying amount does not exceed the carrying amount that would have been determined if no impairment loss had been recognized.

An impairment loss with respect to equity instruments classified as available-for-sale is not reversed through the Consolidated Statement of Income. If the fair value of a debt instrument classified as available-for-sale increases and the increase can be objectively related to an event occurring after the impairment loss was recognized, the impairment loss is reversed with the amount of the reversal recognized within the Consolidated Statement of Income. In respect of all other assets, an impairment loss is reversed if there has been a change in the estimates used to determine the recoverable amount. An impairment loss is reversed only to the extent that the asset's carrying amount does not exceed the carrying amount that would have been determined if no impairment loss had been recognized.

# IMAGINE GROUP HOLDINGS LIMITED

Notes to Consolidated Financial Statements

December 31, 2006

*(Expressed in Thousands of United States Dollars)*

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## 2. Significant accounting policies (Continued)

*p) Operating lease payments*

Payments made under operating leases are recognized in the Consolidated Statement of Income on a straight-line basis over the term of the respective lease. Assets under operating leases are not recognized on the Consolidated Balance Sheet.

*q) Loans payable and related finance costs*

Interest bearing loans are recognized initially at fair value less any attributable transaction costs. Subsequent to initial recognition, interest bearing loans are stated at their amortized cost with any difference between cost and redemption value being recognized in the Consolidated Statement of Income over the term of the loan using the effective interest rate method.

*r) Provisions*

Provisions are recognized when the Group has a present obligation (legal or constructive) as a result of a past event and it is probable that an outflow of resources embodying economic benefits will be required to settle the obligation and a reliable estimate can be made of the amount of the obligation. When the Group expects some or all of a provision to be reimbursed, the reimbursement is recognized as a separate asset but only when the reimbursement is virtually certain. The expense relating to any provision is presented in the Consolidated Statement of Income net of any reimbursement. If the effect of the time value of money is material, provisions are determined by discounting the expected future cash flows at a pre-tax rate that reflects current market assessments of the time value of money and, when appropriate, the risks specific to the liability. When discounting is used, the increase in the provision due to the passage of time is recognized as a finance cost. Provisions are included within accounts payables and other liabilities on the Consolidated Balance Sheet.

*s) Offsetting*

Financial assets and liabilities are offset and the net amount reported in the Consolidated Balance Sheet only when there is a legally enforceable right to offset the recognized amounts and there is an intention to settle on a net basis, or to realize the assets and settle the liability simultaneously. Under certain reinsurance contracts, the Group offsets amounts carried as funds held by ceding companies against the corresponding liability for claims and claims adjustment expenses or investment contract liability where the intention is to settle on a net basis, or to realize the assets and settle the liability simultaneously.

# IMAGINE GROUP HOLDINGS LIMITED

Notes to Consolidated Financial Statements

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## 2. Significant accounting policies (Continued)

### t) *New standards and interpretations not yet adopted*

The following new standards, amendments to standards and interpretations were not effective for the year ended December 31, 2006, and have not yet been applied in preparing these Consolidated Financial Statements:

- *IFRS 7 - Financial Instruments*: Disclosures and the amendments to IAS 1 Presentation of Financial Statements: Capital Disclosures require extensive disclosures about the significance of financial instruments for an entity's financial position and performance, and qualitative and quantitative disclosures on the nature and extent of risks. IFRS 7 and amended IAS 1, which become mandatory for the Group's 2007 consolidated financial statements, will require extensive additional disclosures with respect to the Group's financial instruments and share capital.
- *IFRS 8 - Operating Segments* requires segment disclosure based on the components of the Group that management monitors in making decisions about operating matters as well as qualitative disclosures on segments. Segments will be reportable based on threshold tests related to revenues, results and assets. IFRS 8 will become mandatory for the Group's 2009 consolidated financial statements, and will require additional disclosures with respect to the Group's operating segments.
- *IFRIC 8 - Scope of IFRS 2 Share-based Payment* addresses the accounting for share-based payment transactions in which some or all goods or services received cannot be specially identified. IFRIC 8 will become mandatory for the Group's 2007 consolidated financial statements, with retrospective application required. It is not expected to have any impact on the consolidated financial statements.
- *IFRIC 9 - Reassessment of Embedded Derivatives* requires that a reassessment of whether an embedded derivative should be separated from the underlying host contract should be made only when there are changes to the contract. IFRIC 9, which becomes mandatory for the Group's 2007 consolidated financial statements, is not expected to have any impact on the consolidated financial statements.
- *IFRIC 10 - Interim Financial Reporting and Impairment* prohibits the reversal of an impairment loss recognized in a previous interim period in respect of goodwill, an investment in an equity instrument or a financial asset carried at cost. IFRIC 10 will become mandatory for the Group's 2007 consolidated financial statements, and is not expected to have any impact on the consolidated financial statements.
- *IFRIC 11 - IFRS 2 – Group and Treasury Share Transactions* addresses the classification of a share-based payment transaction (as equity or cash-settled), in the financial statements of the entity whose employees are entitled to the share-based payment, where equity instruments of the parent or another group company are transferred in settlement of the obligation. IFRIC 11, which becomes mandatory for the Group's 2008 consolidated financial statements, is not expected to have any impact on the consolidated financial statements.

# IMAGINE GROUP HOLDINGS LIMITED

Notes to Consolidated Financial Statements

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## 2. Significant accounting policies (Continued)

### *u) Events after the balance sheet date*

These Consolidated Financial Statements are adjusted to reflect events that occurred between the balance sheet date and the date when these Consolidated Financial Statements are authorized for issue, provided they give evidence of conditions that existed at the balance sheet date. Events that are indicative of conditions that arose after the balance sheet date are disclosed, but do not result in an adjustment to these Consolidated Financial Statements.

## 3. Critical accounting estimates and judgments in applying accounting policies

The preparation of these Consolidated Financial Statements in accordance with IFRS requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities as well as the disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenue and expenses during the reporting period. Actual results could differ from those estimates. The estimates and underlying assumptions are reviewed on a periodic basis. Revisions to accounting estimates are recognized in the year in which the estimate is revised if the revisions affect only that year or in the year of revision and future years if the revision affects both current and future years.

The Group's critical accounting policies and estimates and the application of these policies and estimates are outlined below:

### *i) Key sources of estimation uncertainty*

Notes 2(d) and 14 contain information about the assumptions and estimates and uncertainties relating to the liability for claims and claims adjustment expenses and Note 4 discloses the risk factors associated with its insurance and reinsurance contracts. Notes 2(g) and 11 contain information about the assumptions and uncertainty related to the structured insurance assets.

### *ii) Critical accounting judgments in applying the Group's accounting policies*

#### *Insurance contract classification*

Contracts are classified as insurance contracts where they transfer significant insurance risk from the holder of the contract to the Group (See Note 2(c)). There are a number of contracts issued where the Group exercises judgment with regards to the level of insurance risk transferred.

Typically these are contracts which contain a significant financial risk component. The level of insurance risk is assessed by considering whether there are any scenarios with commercial substance in which the Group is required to pay significant additional benefits. These benefits are those which exceed the amounts payable if no insured or reinsured event were to occur.

# IMAGINE GROUP HOLDINGS LIMITED

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## 4. Insurance and financial risk management

### Underwriting strategy

The Group underwrites property, casualty, life and accident & health reinsurance risks, and where licensed, insurance risks, in many countries around the world. Business is written either through Syndicates which the Group manages at Lloyd's of London ("Lloyd's"), or through the Group's specialist underwriting teams which develop specialty products for individual insurers, reinsurers, corporations, captives, risk retention groups and other risk pooling vehicles and associations.

As a result, the two operating divisions of the Group are its operations at Lloyd's and its speciality business written outside of Lloyd's of London ("Non-Lloyd's"). Within Lloyd's, experienced management and specialist underwriters are employed to write property, financial institutions, and accident & health business, as well as non-U.S. employers liability, professional liability, medical malpractice and workers' compensation. The Group underwrites at Lloyd's supported by its own capital as well as by the capital of third-party institutions and individual "Names" which is provided on an annual basis. The Group's Non-Lloyd's operations include specialist underwriters who create customized programs covering property, professional, employers and general liability, hospitality liability, workers' compensation, trucking, auto GAP and non-standard auto, long-term care and other primarily long-tail classes.

Critical to the Group's strategy is managing its insurance and financial risks. The Group's objective is to achieve an appropriate risk and return balance. Specific underwriting objectives are established for each account written at Lloyd's and for each individual transaction in the case of Non-Lloyd's business.

While these objectives may differ in detail with respect to business written through Lloyd's and Non-Lloyd's, many of the same principles of underwriting control are applied throughout, namely:

- the use of experienced underwriters, with appropriate actuarial support, which are the most important part of the Group's business process;
- restrictions on the size of transactions either individually, as a part of a portfolio or both;
- an acceptable trade-off between potential return and downside exposure, whether on an individual transaction or portfolio basis;
- aggregate limits based on a balance of industry and internally developed models as well as management and underwriting judgment;
- peer reviews on an individual transaction basis, as well as periodically on a portfolio basis;
- dedicated risk management and reserving staff independent of the underwriting teams; and
- specific individual, team, or committee authorizations to bind business, appropriate to the size and nature of the transactions and the markets in which they are written.

The Group uses several methods to assess and monitor its insurance risk exposures both for individual risks and the overall portfolio including concentrations by product line and geographic region. These methods include the use of internal and external models that measure risk under multiple future economic and loss scenarios.

# IMAGINE GROUP HOLDINGS LIMITED

Notes to Consolidated Financial Statements

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## 4. Insurance and financial risk management (Continued)

### Underwriting strategy (Continued)

#### Lloyd's Business

For the Lloyd's business, the Group's underwriting strategy seeks diversity to ensure a balanced portfolio and is based on underwriting a large portfolio of similar risks over a number of years in order to produce reduced variability of the outcome. The underwriting strategy is set out in the annual business plans submitted to Lloyd's for each account that establishes the classes of business to be written, the territories in which business is to be written and the industry sectors in which the Group is prepared to underwrite. This strategy is communicated to individual underwriters through detailed underwriting authorities that set out the limits that any one underwriter can write by line size, class of business, territory and industry in order to ensure appropriate risk selection within the broader portfolio. The vast majority of general insurance and reinsurance contracts written at Lloyd's are annual in nature and the underwriters have the right to refuse renewal or to change the terms and conditions of the contract at its renewal. The Group manages its exposure to volatility on its Lloyd's business by:

- employing experienced underwriters with strong track records;
- writing diversified risks by geography, client and class of business;
- conducting peer underwriting reviews of each risk written, along with periodic reviews of each account;
- monitoring its catastrophe exposure using internal and independent stochastic computer models and limiting its catastrophe exposure according to agreed limits.
- purchasing reinsurance designed to protect each account against significant aggregations or event-based risk.

#### Non-Lloyd's Business

Since its inception, the Group has focused on providing specialty products to clients whose needs may not be met efficiently through traditional products. These specialty products generally limit the claims paid by the Group in return for sharing the contract profitability with the client. These specialty products provide an alignment of risk and reward between clients and the Group, as well as a more limited potential downside. The classes of business written by the specialty product underwriters are broadly consistent with classes covered by its Lloyd's operations.

Business is written on both a prospective basis, in that coverage is for future events, and in some rare circumstances, on a retrospective basis, where losses have already been incurred at the time of the contract but may still pose risk in terms of development, numbers of claims, loss amounts, loss adjustment expenses or other uncertainties.

For the Non-Lloyd's business, underwriting guidelines define the process of assessing our potential risks and returns. These guidelines encompass minimum return requirements, probabilities of loss, transaction limits, negative potential outcomes, internal underwriting procedures and business risk monitoring and control. The guidelines stipulate an underwriting process that the Group applies in order to properly evaluate and price its exposure and requires:

- pricing risks using proprietary stochastic models for each risk underwritten to enable the underwriting teams to properly evaluate possible outcomes of the transaction under review;
- including other loss mitigating features such as sub-limits and aggregate limits of liability;

# IMAGINE GROUP HOLDINGS LIMITED

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## 4. Insurance and financial risk management (Continued)

### Non-Lloyd's Business (Continued)

- conducting an actuarial peer review, along with accounting, credit, tax and legal reviews for each transaction; and
- senior management review and approval by a committee of the board of the company writing the business prior to binding.

### **Terms and conditions**

The Group's non-Lloyd's business provides contractually capped coverages that use one or more contract terms to limit the net loss that the Group could incur. In exchange for this limit of losses, the Group often accepts a cap on the potential return that can be achieved by returning the profits in excess of a level specified in the contract. Some of the elements used to effect these limitations on the Group include sub-limits and loss corridors, annual and term aggregate limits, swing-rated or sliding scale commissions and contractual provisions to reduce exposure or early terminate contracts if loss triggers are exceeded or to require premium rate increases in underlying business. While many of these loss mitigating elements also appear in the Group's Lloyd's based contracts, the primary focus in providing these coverages on a specialty basis is to provide a lower cost product that transfers a lower level of risk than Lloyd's based contracts while enabling financial participation by the client.

### **Reinsurance purchasing strategy**

The Group reinsures a portion of the risks which it underwrites, where appropriate and cost effective, to control its exposures to losses and protect capital resources. Generally, this reinsurance relates to its Lloyd's business where the reinsurance purchased is designed to protect against significant aggregations or event-based risk. The proposed reinsurance program for each line of business is approved by management and by the Group's Lloyd's Underwriting Committee, as part of the business plan review and approval process. On the Non-Lloyd's business, reinsurance is generally not purchased as such transactions, on a gross basis, are already within the Group's risk tolerance. Availability and price are important factors in determining how successful we are in meeting our objectives for purchasing adequate, cost effective coverage.

The Group purchases a combination of proportional and non-proportional reinsurance treaties. In addition, facultative reinsurance may be purchased in certain specified circumstances. All purchases of facultative reinsurance are subject to pre-approval by management.

The purchase of any reinsurance protection contains counterparty credit risk. The Group has a Broker Vetting and Reinsurance Security Committee ("BVRSC") that is responsible for setting the minimum security criteria for acceptable reinsurance and for monitoring the purchase of reinsurance against those criteria. The BVRSC monitors the ongoing adequacy of the reinsurance program, as well as works with the Group's finance and risk management teams to establish provisions for potential and actual bad debts due from reinsurers. The BVRSC also evaluates and approves intermediaries who produce business for the Group.

The reinsurance bad debt provisions, which consider both the inability and unwillingness to pay are calculated on a reinsurer by reinsurer basis, based largely on the credit rating of the reinsurer. The Group monitors the financial condition of its reinsurers on an ongoing basis as part of this reinsurance bad debt calculation process. (See also Note 14)

# IMAGINE GROUP HOLDINGS LIMITED

Notes to Consolidated Financial Statements

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## 4. Insurance and financial risk management (Continued)

### Asset/liability matching (“ALM”)

The goal of the ALM process is to manage asset and liability cash flows on a cash flow or duration basis within specified tolerances.

The Group establishes specific asset portfolios for certain major transactions or blocks of business to profitably fund its liabilities within acceptable levels of risk. Objectives for effective duration, yield curve sensitivity, liquidity, asset sector concentration and credit quality are established. The estimates used in determining the approximate amounts and timing of claims payments to our clients are regularly re-evaluated. Many of these estimates are inherently subjective and could impact the Group’s ability to achieve its asset/liability management goals and objectives. Please refer to the Key Assumptions and Sensitivities in Note 14 for more comprehensive details with respect to the acceleration of claims payout risk.

### Lines of business

#### i) Casualty

##### a) *Product features*

The Group writes casualty insurance and reinsurance on a worldwide basis. The coverages provided include general liability, professional indemnity including physician liability, contractors’ liability, employers’ liability, public liability, financial institution liability, workers’ compensation, non-standard auto and trucking coverage. Under these contracts and the primary contracts underlying the reinsurance coverages which the Group provides, compensation is paid for injury suffered primarily by parties other than the insured as a result of the acts or negligence of the insured.

A common characteristic of casualty business is the length of time it can take for claims to emerge and reach their ultimate claims cost which in turn adds uncertainty to the loss estimation process. The timing of claim reporting and settlement is a function of a number of factors, including the nature of the coverage, the policy provisions, the jurisdiction in which the contract is written, and whether the Group is providing insurance or reinsurance coverage. Typically, general, professional and contractors’ liability claims have a longer tail than bodily injury claims.

The majority of bodily injury claims have a relatively short tail, with most of the claims for a given accident year settled in full within four years.

General liability claims may have a considerable lag in the reporting and payment of claims. For some emerging claims, the reporting lag (that is, the time between the occurrence of the insured event and its reporting) may be in excess of ten years. In these cases, there is scope for the Group to earn investment income due to the time delay between the receipt of premiums and the payment of claims.

Factors contributing to the uncertainties in loss provision estimation include the reporting lag, regulatory and legal developments, the number of parties involved in the claim, whether the insured event is over multiple time periods and the potential amounts of the claim. The loss provisioning process is detailed in Note 14.

# IMAGINE GROUP HOLDINGS LIMITED

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## 4. Insurance and financial risk management (Continued)

### *b) Management of risks*

The key risks associated with these contracts are underwriting risk, competitive risk, economic risk, claims experience risk and the potential for policyholders to misstate, underestimate, exaggerate or fabricate losses.

Factors contributing to the uncertainties in loss provision estimation include the reporting lag, regulatory and legal developments, the number of parties involved in the claim, whether the insured event is over multiple time periods and the potential amount of the claim. The loss provisioning process is detailed in Note 14.

For bodily injury liability contracts, the key risk is the trend for courts in the United Kingdom and the United States of America to award higher levels of compensation. In pricing contracts, the Group makes an assumption that costs will increase in line with the latest available research.

Risks arising from casualty insurance and reinsurance contracts are managed primarily through appropriate pricing, product design, risk selection, investment strategy, rating and the purchase of reinsurance protection. The Group monitors and reacts to changes in the general economic and commercial environment in which it operates to ensure that the liability risks written satisfy the Group's criteria for profitability.

A discussion of additional risks related to our casualty underwriting and loss estimates can be found in Note 14.

### **ii) Property**

#### *a) Product features*

The Group writes property insurance and reinsurance programs on a worldwide basis. Classes written include catastrophe, per risk excess of loss, pro rata reinsurance and auto GAP. Property insurance and reinsurance indemnifies, subject to any limits or excesses, the insured or reinsured against the loss or damage to their own material property and business interruption arising from this damage. Auto and trucking GAP insurance reimburses the insured for the difference between the loan or lease balance due on the vehicle, and the proceeds of the primary insurance policy in the event the vehicle is stolen, accidentally damaged beyond repair, or otherwise declared an insured total loss.

The event giving rise to a claim for damage to buildings or contents usually occurs suddenly (fire, flood, hurricane or earthquake) and the cause is, for the most part, easily determinable. Property business is classified as "short tail" meaning that the claim will be notified promptly and can be settled usually without delay. In certain events, the approximate cause or causes of catastrophic loss, the nature and extent of the damage, the economic cost of repairs and replacement, the amount of the insured loss arising from the event or its after effects, the recoverability of reinsurance and the timeliness of reporting may prove to be challenging. While not necessarily long-tail in nature, the ability to estimate losses from catastrophic events in a timely fashion is not always assured.

# IMAGINE GROUP HOLDINGS LIMITED

Notes to Consolidated Financial Statements

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*(Expressed in Thousands of United States Dollars)*

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## 4. Insurance and financial risk management (Continued)

### *b) Product features (Continued)*

The primary risks related to GAP insurance on automobiles and trucks relate to physical damage frequency, parameter misestimation and accelerated depreciation. Detailed actuarial models or exposures, industry and client specific loss histories, prudent assumptions that are more conservative than historical results, and contractual protections like adjustable rates, assumed values and vehicle quality, and client loss participation, enable us to mitigate the exposure to the Group.

### *c) Management of risks*

The key risks associated with these contracts are underwriting risk, competitive risk and claims experience risk (including the variable incidence of natural disasters).

Underwriting risk for property exposures is the risk that the Group does not charge and collect premiums that are appropriate for the different properties it insures or reinsures. The risk on any underlying policy will vary according to many factors such as location, safety measures in place and the age of property. For homeowners' property insurance or reinsurance it is expected that there will be large numbers of properties with similar risk profiles. However, for commercial business this will not be the case. Many commercial property proposals comprise a unique combination of location, type of business, and safety measures in place. Calculating a premium commensurate with the risk for these policies will ordinarily require more judgment. These risks are managed primarily through the underwriting and pricing process. The Group adheres to strict underwriting criteria to ensure that the risk of losses is acceptable to the Group. The Group also monitors the underwriting process of its ceding companies through the conduct of periodic underwriting audits. In addition, catastrophe reinsurance is purchased and catastrophe event sub-limits within contracts are used to protect the Group against an accumulation of losses from a single event.

### **iii) Life & Health**

#### *a) Product features*

The Group writes a range of life & health reinsurance coverages, including:

- Catastrophic reinsurance of life, accident, medical and workers compensation portfolios;
- Reinsurance of long-term nursing home and health care insurance policies;
- Stop loss reinsurance on individual and group medical insurance policies; and
- Reinsurance of single premium, impaired and immediate payout annuities.

Within Lloyd's, the Group writes excess of loss and a limited number of per risk reinsurance programs to protect life, accident, medical and workers compensation portfolios. A small number of risk excess of loss contracts are also written. Catastrophic risks are written on a two life warranty basis. The portfolio is reinsured to reduce pre event losses to the Group.

The Group also writes quota share reinsurance of long-term care insurance policies for select clients. Long-term care insurance provides benefits to policyholders covering a wide range of health and social services, which may include adult day care, custodial care, home care, hospice care, and nursing care, but generally not care in a hospital. The underlying policies are in guaranteed renewable form and cannot be cancelled by the insurer, however, they are eligible for actuarially supported premium rate increases.

# IMAGINE GROUP HOLDINGS LIMITED

Notes to Consolidated Financial Statements

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*(Expressed in Thousands of United States Dollars)*

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## 4. Insurance and financial risk management (Continued)

### iii) Life & Health (continued)

#### a) Product features (continued)

The Group participates in the annuity market through the provision of quota share reinsurance. The majority of annuities being reinsured involve payouts to impaired lives for the remainder of their lifetime. Mortality and other risk estimation for impaired lives is a specialty area. While industry data is not readily available, loss estimates are carefully derived based on loss data on standard lives, proprietary experience, and the opinions of expert reviewers and industry bodies.

The Group reinsures specific and aggregate medical stop loss policies written by a number of insurance and reinsurance clients. Pricing and profitability targets are aligned through contract features, including quota share participations, management fees, ceding allowances and profit commissions. Underlying portfolios reinsured may be group or individual medical policies.

#### b) Management of risks

As with any catastrophic reinsurance, life & health reinsurance coverages protecting life, accident, medical and workers compensation policies are subject to significant, volatile, loss making events. Underwriting standards, technical pricing models, experienced underwriters, long-standing relationships, geographic balance, and ceded reinsurance enable us to assess, manage and monitor the exposures written within this account. The significant exposure to this account arises primarily from man-made or non-man made catastrophes. Significant loss of life scenarios are considered as part of aggregate monitoring and are estimated on an individual contract basis. However, a loss event of a magnitude not seen in recent history could produce meaningful losses for this account.

The key risks arising under long-term care insurance policies relate to the length of the period over which benefits become payable, and the potential inflation of daily benefit costs. These risks are managed through the pricing and rating on initial sale and renewal of the underlying policies, where experience and trends in benefit costs are factored into premium rates. Adjustable rates and limits, and significant co-participations encourage an appropriate alignment of risk and reward. The Group monitors the underwriting process of its ceding companies through review of regular reports received and the conduct of periodic underwriting audits.

Reinsurance of medical portfolios involves risk related primarily to medical care utilization, medical care inflation, and medical diagnostic or therapeutic evolution. The Group monitors developments in medical care closely, protecting clients who are established providers with years of experience in this field. Actuarial modeling, annual rate manual adjustments, structural protections designed to align interest, and diversification in terms of clients and geography, enable us to mitigate exposures consistent with our risk appetite.

In reinsuring impaired life annuities, profitability is impacted by longevity and investment experience varies from that initially expected. Longevity risks arise as the annuities are paid for the lifetime of the insured lives. This risk is managed through the initial pricing of the annuity as well as the margins within the pricing of the reinsurance contract. The pricing assumption is based on both historic information of the ceding company and externally generated information on mortality experience, including allowances for future mortality improvements and adjustments for impaired lives. Investment risk depends on the extent to which the annuity payments under the contracts have been matched by suitable invested assets. The Group seeks to minimize this risk through investing in assets with matching returns and duration.

# IMAGINE GROUP HOLDINGS LIMITED

Notes to Consolidated Financial Statements

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*(Expressed in Thousands of United States Dollars)*

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## 4. Insurance and financial risk management (Continued)

### iv) Long-term care reinsurance

#### a) Product features

The Group provides reinsurance on a quota share basis for long-term care policies. Long-term care insurance provides benefits to policyholders covering a wide range of health and social services, which may include adult day care, custodial care, home care, hospice care, and nursing care, but generally not care in a hospital. The underlying policies are in guaranteed renewable form and cannot be cancelled by the insurer, however, they are eligible for actuarially supported premium rate increases.

#### b) Management of risks

The key risks arising under long-term care insurance policies relate to the length of the period over which benefits become payable, and the potential inflation of daily benefit costs. These risks are managed through the pricing and rating on initial sale and renewal of the underlying policies, where experience and trends in benefit costs are factored into premium rates. The Group monitors the underwriting process of its ceding companies through review of regular reports received and the conduct of periodic underwriting audits.

### v) Specialty investments/structured insurance assets

#### a) Product features

The Group invests in specialized opportunities that merge its insurance and reinsurance expertise with its investment expertise. These include the:

- purchase of undervalued assets such as long-term care commissions and insolvent claims purchased at a deep discount; and
- advance of modest loans (less than \$5,000) to assist clients establish risk pooling vehicles thereby fostering long-term relationships for future reinsurance opportunities.

The Group purchases assignments of the right to collect commissions from different portfolios of long-term care insurance policies issued by several investment grade insurance carriers. Under these arrangements, the commissions are paid into separate trusts, which pay amounts due to the Group on a pre agreed formula based on the amount of commissions collected by the trusts and the expenses of the trusts. (See Note 11)

The Group also purchases the right to collect insurance claims against certain insolvent and impaired insurance companies operating under Schemes of Arrangement ("Schemes") in the London insurance market. The Group estimates the value of the claim and the ability of the Schemes to pay the claim over time. The claims purchased to date are already agreed with the participating, solvent insurers and are due and payable by the insolvent Schemes, albeit at a reduced level reflecting the Scheme's degree of financial impairment. (See Note 11)

The Group makes loans of generally between \$1,000 to \$5,000 for select clients who are establishing risk retention groups, managing general agencies, or small insurance companies. These clients have demonstrated strong track records and an in-depth knowledge of and experience with a niche market opportunity. The loans are structured for early repayment and pay an attractive interest rate. Through these efforts, the Group develops a longer term reinsurance relationship with niche oriented insurance and reinsurance underwriting teams.

# IMAGINE GROUP HOLDINGS LIMITED

Notes to Consolidated Financial Statements

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## 4. Insurance and financial risk management (Continued)

### v) Specialty investments/structured insurance assets (Continued)

#### *b) Management of risks*

The Group is exposed to credit risk on these specialty investments. The credit exposure is minimized through credit reviews performed as part of the underwriting process and the requirement for collateral to be provided on the amounts due to the Group wherever possible. The Group deals with investment grade counterparties on the long-term care commission business and prices the insolvent claims purchases to take account of the increased credit risk in dealing with lower grade counterparties.

The long-term care commission business is also subject to the risk that the underlying long-term care policies lapse resulting in the commission flows ceasing. Lapse of the underlying policies occurs when the policyholder dies ("mortality risk") or simply discontinues payment of premiums ("lapse risk"). Due to premium waivers in the event of illness, morbidity also impacts continued commission flows. These risks are managed in the pricing of the assignments by use of actuarial mortality and morbidity tables and historic data regarding the lapse rates in long-term care insurance portfolios.

#### **Concentrations and aggregations of insurance risk**

A key aspect of the insurance risk faced by the Group arises from the concentration of insurance risk which may exist where a particular event or series of events could impact significantly upon the Group's liability for claims and claims adjustment expenses. Such concentrations may arise from a single insurance or reinsurance contract or through the accumulation of risk under a number of contracts exposed to similar events.

Concentrations of risk can arise from both high-severity, low-frequency events, such as natural disasters and from situations where the underwriting of risk is biased towards a particular area of risk, such as a particular type of business or a particular geographic region.

#### **High-severity, low-frequency events**

By their nature, the timing of high-severity, low-frequency events, which trigger significant losses due to concentration/aggregation of exposures, are uncertain and their occurrence is expected to be rare. However, these types of events represent a risk to the Group because, although unlikely in any given financial year, should they occur they have the potential to result in a significant adverse financial impact on the Group ranging from a strain on its cash flow to a reduction in its profitability and, in the most serious of such events or combinations of events, capital adequacy implications. These financial consequences should be considered in the light of their likely occurrence, and therefore, the table below provides an indication of the gross and net expected losses based on exposures and reinsurance protections as at December 31, 2006 and the estimated frequency of the indicated events, which is based on the most recent research available to the Group.

# IMAGINE GROUP HOLDINGS LIMITED

Notes to Consolidated Financial Statements

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## 4. Insurance and financial risk management (Continued)

### High-severity, low-frequency events (Continued)

	Expected gross losses before <u>reinsurance</u>	Expected net losses after <u>reinsurance</u>	Frequency <u>(in years)</u>
Japanese Earthquake	\$ 76,869	\$ 37,818	1 in 250
Florida Windstorm	95,945	43,260	1 in 250
California Earthquake	94,608	45,215	1 in 250
European Windstorm	88,741	38,060	1 in 250

The estimated gross and net losses above are reported before taxes and cover the Group's property and life & health portfolios, in the case of the latter, particularly its personal accident business. The estimates do not include provision for losses that may potentially arise from the Group's casualty portfolio from such catastrophe events. Estimated net losses are reported net of recoveries from reinsurers/retrocessionaires and net of all estimated reinstatement premiums, both inwards and outwards.

The Group's key methods in managing these risks include:

#### (i) Underwriting controls

The risk is managed through appropriate underwriting controls. For the Non-Lloyd's business, underwriting guidelines place specific limitations on leverage characteristics and negative potential outcomes, both at the specific individual transaction level and at the entire portfolio level.

For the Lloyd's business, key downside and concentration aggregation controls include maximum line sizes for individual transactions and pre-determined portfolio aggregate limits set by geographic zone or territory.

#### (ii) Reinsurance purchased

These risks are also managed by the use of reinsurance, particularly with respect to the Group's Lloyd's business. The reinsurance purchased is designed to protect each account against significant aggregations or event-based risk. Key elements of the property catastrophe reinsurance program for the year ended December 31, 2006 include:

- the first \$17,500 loss is retained by the Group (2005 - \$6,000 with 25% of the \$2,500 in excess of the \$6,000 layer also retained); and
- the reinsurance program then provides coverage for 100% of \$51,500 excess of the \$17,500 layer thus providing protection for gross losses of up to \$69,000 from a single event (2005 - 75% of the \$2,500 excess of \$6,000 layer as well as 100% of \$60,500 in excess of \$8,500).

# IMAGINE GROUP HOLDINGS LIMITED

Notes to Consolidated Financial Statements

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## 4. Insurance and financial risk management (Continued)

### Monitoring concentrations and aggregate exposures

The Group monitors these concentrations and aggregate exposures at the time of underwriting an individual risk and on a regular basis thereafter by reviewing reports which show the key concentrations and aggregations to which the Group is exposed. The Group uses a number of modeling tools to monitor aggregations and to simulate catastrophe losses in order to measure the effectiveness of its reinsurance programs and the net exposure to the Group. A number of additional stress and scenario tests were run using these models during the year.

### Claims development

Claims development information is disclosed in order to illustrate the insurance risk inherent in the Group. The tables below compare the development over time of the estimated ultimate cost of claims on an accident year basis. The top part of these tables provide a review of ultimate claim cost estimates and demonstrates how these estimates have changed at subsequent reporting or accident year end dates. The estimates are increased or decreased as losses are paid and more information becomes available with respect to the likely frequency and severity of unpaid claims. Data in the tables related to acquired businesses are included from the acquisition date. The lower part of the tables provides a reconciliation of the total provision for claims and claims adjustment expenses included in the Consolidated Balance Sheet as at December 31, 2006 and the estimate of cumulative claims. While the information in these tables provide a historical perspective on the adequacy of unpaid claims estimates established in previous years, readers of these Consolidated Financial Statements are cautioned against extrapolating redundancies or deficiencies of the past on current unpaid loss balances. The production of the claims development triangles involves a range of assumptions and the use of data from different systems. As such, the triangles may be subject to minor adjustments over time. The Group believes that the estimate of total claims and claims adjustment expenses outstanding as at December 31, 2006 is adequate. However, due to the inherent uncertainties in the provisioning process, it cannot be assumed that such balances will ultimately prove to be adequate. See Note 14 for details on the reserving process.

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## 4. Insurance and financial risk management (Continued)

### Claims development (Continued)

#### Analysis of claims development – gross

<u>Accident Year</u>	<u>2002</u>	2003	<u>2004</u>	<u>2005</u>	<u>2006</u>	<u>Total</u>
Estimate of cumulative claims:						
At the end of accident year	\$ 579,768	\$ 235,981	\$ 682,111	\$ 496,789	\$ 424,700	
One year later	613,758	265,355	693,004	502,894	-	
Two years later	611,863	257,753	693,683	-	-	
Three years later	611,811	257,269	-	-	-	
Four years later	611,804	-	-	-	-	
Estimate of cumulative claims	<u>611,804</u>	<u>257,269</u>	<u>693,683</u>	<u>502,894</u>	<u>424,700</u>	2,490,350
Cumulative payments						<u>(1,259,875)</u>
						1,230,475
Effect of discounting						<u>(100,244)</u>
						1,130,231
Add: net discounted reserves on annuity contracts						314,922
Less: reserves offset against funds withheld						<u>(72,223)</u>
Claims and claims adjustment expenses						<u>\$ 1,372,930</u>

#### Analysis of claims development – net

<u>Accident Year</u>	<u>2002</u>	<u>2003</u>	<u>2004</u>	<u>2005</u>	<u>2006</u>	<u>Total</u>
Estimate of cumulative claims:						
At the end of accident year	\$ 579,768	\$ 230,985	\$ 554,842	\$ 374,639	\$ 390,648	
One year later	613,754	260,016	567,003	383,662	-	
Two years later	611,860	253,828	575,380	-	-	
Three years later	611,777	250,353	-	-	-	
Four years later	611,770	-	-	-	-	
Estimate of cumulative claims	<u>611,770</u>	<u>250,353</u>	<u>575,380</u>	<u>383,662</u>	<u>390,648</u>	2,211,813
Cumulative payments						<u>(1,116,732)</u>
						1,095,081
Effect of discounting						<u>(100,244)</u>
						994,837
Add: net discounted reserves on annuity contracts						314,922
Less: reserves offset against funds withheld						<u>(72,223)</u>
Claims and claims adjustment expenses						<u>\$ 1,237,536</u>

# IMAGINE GROUP HOLDINGS LIMITED

Notes to Consolidated Financial Statements

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## 4. Insurance and financial risk management (Continued)

### Claims development (Continued)

As indicated in the tables above, the changes in ultimate estimated claims have been relatively modest during 2006. In relation to the 2002 and prior accident years, there have been no notable reserve movements to report. In relation to the 2003 accident year, the reserves for the Group's Lloyd's operations have shown a level of redundancy which has resulted in releases to the reserves associated with that accident year. On the 2004 accident year, the reserves carried by Syndicate 1400 have deteriorated, however, these reserves are protected by the contingent note which was issued on the acquisition of the Danish Re group of companies. As a result, this deterioration is substantially offset by a similar reduction in the carrying value of the Group's contingent note payable (See Note 16). In general, the non-Lloyd's portfolio performed as expected during 2006 with the exception of a small number of contracts resulting in deterioration to the 2004 and 2005 accident years of approximately \$4,000 and \$9,000 respectively.

## 5. Segmental Reporting

### (i) Primary reporting format – business segments

As at December 31, 2006, the Group is organized on a worldwide basis into three main business segments: Property, Casualty and Life & Health (see Note 4 for more details on these segments). The segment results for the year ended December 31, 2006 are as follows:

	Total of				
	Property	Casualty	P&C	Life & Health	Total
Gross written premiums	\$ 178,066	\$ 357,671	\$ 535,737	\$ 182,003	\$ 717,740
Ceded premiums	(22,823)	(24,166)	(46,989)	(14,918)	(61,907)
Net written premiums	155,243	333,505	488,748	167,085	655,833
Change in unearned premiums	(32,413)	(21,499)	(53,912)	(842)	(54,754)
Net earned premiums	122,830	312,006	434,836	166,243	601,079
Claims and claims adjustment expenses incurred	(90,852)	(242,460)	(333,312)	(151,455)	(484,767)
Policy acquisition costs	(21,207)	(60,468)	(81,675)	(3,244)	(84,919)
Allocated operating expenses	(13,060)	(18,815)	(31,875)	(8,353)	(40,228)
Segment underwriting (loss) income	(2,289)	(9,737)	(12,026)	3,191	(8,835)
Fee income on investment contracts	2,575	(6,746)	(4,171)	11,187	7,016
Allocated operating expenses	(1,711)	(2,027)	(3,738)	(2,810)	(6,548)
Segment investment income	5,816	32,671	38,487	32,154	70,641
<b>Segment operating result</b>	<b>\$ 4,391</b>	<b>\$ 14,161</b>	<b>\$ 18,552</b>	<b>\$ 43,722</b>	<b>\$ 62,274</b>
Net investment income (corporate)					41,189
Other income					4,915
Net foreign exchange gains					1,213
Loss on disposal of subsidiary					(17,093)
Unallocated operating expenses (Corporate)					(16,659)
Finance costs					(9,106)
Income before corporation taxes					66,733
Corporation tax expense					(8,046)
<b>Net income for the year</b>					<b>\$ 58,687</b>

# IMAGINE GROUP HOLDINGS LIMITED

Notes to Consolidated Financial Statements

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## 5. Segmental Reporting (Continued)

### (i) Primary reporting format – business segments: (Continued)

The segment assets and liabilities as at December 31, 2006 are as follows:

	Property	Casualty	Total of P&C	Life & Health	Total
Segment assets	\$ 444,727	\$ 1,465,607	\$ 1,910,334	\$ 399,912	\$ 2,310,246
Unallocated assets (Corporate)					296,768
Total assets					<u>\$ 2,607,014</u>
Segment liabilities	\$ 314,812	\$ 1,139,393	\$ 1,454,205	\$ 349,376	\$ 1,803,581
Unallocated liabilities (Corporate)					230,098
Total liabilities					<u>\$ 2,033,679</u>

The segment results for the year ended December 31, 2005 are as follows:

	Property	Casualty	Total of P&C	Life & Health	Total
Gross written premiums	\$ 94,979	\$ 337,225	\$ 432,204	\$ 162,247	\$ 594,451
Ceded premiums	(28,525)	(33,030)	(61,555)	(11,346)	(72,901)
Net written premiums	66,454	304,195	370,649	150,901	521,550
Change in unearned premiums	(6,923)	(24,845)	(31,768)	(1,120)	(32,888)
Net earned premiums	59,531	279,350	338,881	149,781	488,662
Claims and claims adjustment expenses incurred	(105,605)	(213,583)	(319,188)	(134,259)	(453,447)
Policy acquisition costs	(12,159)	(50,876)	(63,035)	(3,422)	(66,457)
Allocated operating expenses	(8,512)	(16,295)	(24,807)	(5,356)	(30,163)
Segment underwriting (loss) income	(66,745)	(1,404)	(68,149)	6,744	(61,405)
Fee income on investment contracts	4,783	11,882	16,665	8,444	25,109
Allocated operating expenses	(2,164)	(1,355)	(3,519)	(2,308)	(5,827)
Segment investment income	4,581	16,775	21,356	19,258	40,614
<b>Segment operating result</b>	<b>\$ (59,545)</b>	<b>\$ 25,898</b>	<b>\$ (33,647)</b>	<b>\$ 32,138</b>	<b>\$ (1,509)</b>
Net investment income (Corporate)					17,055
Other income					1,500
Net foreign exchange gains					3,182
Impairment charge on disposal group held for sale					(5,000)
Unallocated operating expenses (Corporate)					(26,313)
Finance costs					(3,765)
Loss before corporation taxes					(14,850)
Corporation tax recovery					17,420
<b>Net income for the year</b>					<u><b>\$ 2,570</b></u>

# IMAGINE GROUP HOLDINGS LIMITED

Notes to Consolidated Financial Statements

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## 5. Segmental Reporting (Continued)

### (i) Primary reporting format – business segments: (Continued)

The segment assets and liabilities of the Group as at December 31, 2005 are as follows:

	Property	Casualty	Total of P&C	Life & Health	Total
Segment assets	\$ 460,845	\$ 1,326,059	\$1,786,904	\$ 248,636	\$2,035,540
Unallocated assets (Corporate)					278,128
Total assets					<u>\$2,313,668</u>
Segment liabilities	\$ 341,290	\$ 1,025,862	\$1,367,152	\$ 202,130	\$1,569,282
Unallocated liabilities (Corporate)					216,777
Total liabilities					<u>\$1,786,059</u>

### (ii) Secondary reporting format – geographical segments

The Group's three business segments operate in the following geographical areas:

#### December 31, 2006

	North America	Europe	Rest of World	Worldwide	Total
Segment revenue	\$314,477	\$ 258,031	\$ 59,096	\$ 86,136	\$ 717,740
Segment assets	\$937,905	\$ 933,379	\$ 177,111	\$ 261,851	\$ 2,310,246
Unallocated assets (Corporate)					296,768
Total assets					<u>\$ 2,607,014</u>

#### December 31, 2005

	North America	Europe	Rest of World	Worldwide	Total
Segment revenue	\$ 251,356	\$ 175,537	\$ 48,649	\$ 118,909	\$ 594,451
Segment assets	\$ 865,904	\$ 497,429	\$ 224,951	\$ 447,256	\$ 2,035,540
Unallocated assets (Corporate)					278,128
Total assets					<u>\$ 2,313,668</u>

# IMAGINE GROUP HOLDINGS LIMITED

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## 6. Acquisition of subsidiaries and minority interests

### (i) Imagine Re-2006 (Luxembourg) (formerly Societe De Reassurances Des Activites Sucrieres)

On March 30, 2006, the Group acquired Imagine Re-2006 (Luxembourg) for \$7,781 satisfied in cash. There was no goodwill arising on this acquisition. The principal activity of Imagine Re-2006 (Luxembourg) is reinsuring other Imagine Group companies through quota share and stop loss agreements. For the period from the acquisition date to December 31, 2006, Imagine Re-2006 (Luxembourg) contributed a loss of \$1,021 to the Group's consolidated net income. If Imagine Re-2006 (Luxembourg) had been acquired from the start of the year, the written premium of the Group would have increased by \$nil and the net income by \$nil.

### (ii) Imagine Europe Re (formerly BHW Ruckversicherung S.A.)

On December 15, 2006, the Group acquired Imagine Europe Re for \$29,231 satisfied in cash. There was no goodwill arising on this acquisition. The principal activity of Imagine Europe Re is reinsuring other Imagine Group companies through quota share and stop loss agreements. For the period from the acquisition date to December 31, 2006, Imagine Europe Re contributed a loss of \$4,754 to the Group's consolidated net income. If Imagine Europe Re had been acquired from the start of the year the written premium of the Group would have increased by \$nil and the net income by \$78.

### (iii) Acquisition of minority interest in GMA Imagine Limited

On December 31, 2006, the Group acquired the remaining 33% in GMA Imagine Limited ("GMA") for \$1,958 satisfied in cash, increasing the Group's ownership from 67% to 100%. The carrying amount of GMA's net assets in the Consolidated Financial Statements on the date of acquisition was \$3,584. The Group recognized a decrease in minority interests of \$1,194 and goodwill of \$764.

These acquisitions were accounted for using the purchase method of accounting. The acquisitions had the following combined effect on the Group's consolidated assets and liabilities:

	Pre-acquisition carrying amounts	Fair value adjustments	Recognized values on acquisition
Cash and cash equivalents	\$ 44,126	\$ -	\$ 44,126
Other assets	1,301	-	1,301
Tax assets and recoveries	50	-	50
Accounts payable and other liabilities	(397)	-	(397)
Net deferred tax Liabilities	<u>(12,157)</u>	<u>5,284</u>	<u>(6,873)</u>
Net identifiable fair value assets and liabilities	32,923	5,284	38,207
Goodwill on acquisition (Note 13)			<u>764</u>
Consideration paid, satisfied in cash			38,971
Cash and cash equivalents acquired			<u>44,126</u>
Net cash inflow per consolidated statement of cash flows			\$ <u>5,155</u>

# IMAGINE GROUP HOLDINGS LIMITED

Notes to Consolidated Financial Statements

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(Expressed in Thousands of United States Dollars)

## 7. Loss on disposal of subsidiary

- a) On June 22, 2006, the Group disposed of one of its subsidiaries, Imagine Insurance A/S ("IIAS"). Management committed to a plan to sell this subsidiary on July 11, 2005 due to a strategic decision to reallocate capital resources to more profitable market segments. IIAS which was reported as held-for-sale as at December 31, 2005, was sold for proceeds of \$1,200 resulting in a loss on disposal of \$5,944. As a condition of this sale, another subsidiary of the Group entered into an Adverse Development Cover ("ADC") with the purchaser of IIAS in order to provide reinsurance protection with respect to a portion of the remaining exposure in IIAS. In January 2007, the ADC was commuted for a loss to the Group of \$10,619. As at December 31 2006, this loss was provided for and reflected within the expenses of \$13,811 as reported below.

The net losses during the year attributable to the sale of IIAS were as follows:

	<u>2006</u>
Revenue	\$ 2,662
Expenses	<u>(13,811)</u>
Loss before taxes	(11,149)
Loss on sale of subsidiary	<u>(5,944)</u>
Net loss for the year	\$ <u>(17,093)</u>

Effect of the disposal on the financial position of the Group at December 31, 2006 was as follows:

	<u>2006</u>
Cash and cash equivalents	\$ (57,670)
Fixed maturities	(23,414)
Accrued investment income	(169)
Premiums and other reinsurance balances receivable	(6,800)
Deferred policy acquisition costs	(10)
Prepaid reinsurance premiums	(185)
Reinsurance losses recoverable	(1,273)
Tax assets and recoveries	(781)
Other assets	78
Claims and claims adjustment expenses	1,415
Unearned premiums	200
Reinsurance balances payable	1,918
Investment contract liabilities	63,648
Accounts payable and other liabilities	<u>15,899</u>
Net identifiable assets and liabilities	\$ <u>(7,144)</u>
Consideration received, satisfied in cash	(1,200)
Cash and cash equivalents disposed of	<u>57,670</u>
Net cash outflow	\$ <u>56,470</u>

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## 7. Loss on disposal of subsidiary (Continued)

- b) As at December 31, 2005, the Group had classified IAS as held-for-sale comprising assets of \$65,877 and liabilities of \$50,816 before an impairment loss. The Group determined that an impairment charge of \$5,000 was appropriate arising from the measurement of the 'disposal group' at fair value less the appropriate estimated costs to sell. This impairment charge was recognized and reported separately on the Consolidated Statement of Income. The carrying value of the 'disposal group' as at December 31, 2005, net of impairment, was \$10,061.

	<u>2005</u>
Net assets held for sale prior to impairment charge	\$ 15,061
Less: impairment charge	<u>(5,000)</u>
Net assets held for sale after impairment charge	\$ <u>10,061</u>

### Assets classified as held for sale

	<u>2005</u>
Cash and cash equivalents	\$ 11,950
Short-term investments	24,542
Fixed maturities	27,280
Accrued investment income	211
Prepaid reinsurance premiums	1,449
Tax assets and recoveries	370
Other assets	<u>75</u>
	\$ <u>65,877</u>

### Liabilities classified as held for sale

	<u>2005</u>
Claims and claims adjustment expenses	\$ 1,048
Unearned premiums	2,033
Reinsurance balances payable	144
Investment contract liabilities	52,031
Accounts payable and other liabilities	<u>560</u>
	\$ <u>55,816</u>

## 8. Cash, cash equivalents and short-term investments

Cash, cash equivalents and short-term investments amounting to \$288,836 (2005 – \$371,409) have been pledged under insurance and reinsurance trust arrangements and are therefore not readily available for general use by the Group.

Cash and cash equivalents amounting to \$76,051 (2005 – \$7,362) have been pledged as collateral for letters of credit.

Cash and cash equivalents amounting to \$86 (2005 – \$1,936) have been pledged in support of derivative financial instruments (see Note 10).

Cash and cash equivalents amounting to \$10,500 (2005 – \$10,500) have been pledged to collateralize a loan payable (see Note 16).

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## 9. Fixed maturities

The amortized cost and fair value of investments in fixed maturities classified as available-for-sale are as follows:

<u>At December 31, 2006</u>	<u>Amortized Cost</u>	<u>Unrealized Gain</u>	<u>Unrealized Loss</u>	<u>Fair Value</u>
U.S. Government and agency securities	\$ 193,284	\$ 590	\$ 666	\$ 193,208
Non-U.S. Government securities	150,324	856	1,361	149,819
Corporate securities	508,315	2,191	4,292	506,214
Non-US corporate securities	68,260	15	1,472	66,803
Mortgage backed securities	316,385	1,934	1,811	316,508
Asset backed securities	20,536	338	1,122	19,752
Collateralized debt obligations	<u>27,743</u>	<u>404</u>	<u>122</u>	<u>28,025</u>
	<u>\$ 1,284,847</u>	<u>\$ 6,328</u>	<u>\$ 10,846</u>	<u>\$1,280,329</u>
<u>At December 31, 2005</u>	<u>Amortized Cost</u>	<u>Unrealized Gain</u>	<u>Unrealized Loss</u>	<u>Fair Value</u>
U.S. Government and agency securities	\$ 357,425	\$ 1,169	\$ 1,686	\$ 356,908
Non-U.S. Government securities	97,115	2,410	14	99,511
Corporate securities	211,727	473	1,750	210,450
Non-U.S. corporate securities	106,233	1,895	275	107,853
Mortgage backed securities	117,134	259	1,327	116,066
Asset backed securities	45,464	211	1,969	43,706
Collateralized debt obligations	14,979	2,050	-	17,029
Other	<u>5,960</u>	<u>-</u>	<u>54</u>	<u>5,906</u>
	<u>\$ 956,037</u>	<u>\$ 8,467</u>	<u>\$ 7,075</u>	<u>\$ 957,429</u>

Proceeds from the sale of investments in fixed maturities during the year amounted to \$900,189 (2005 – \$1,254,152). Gross realized gains of \$5,228 (2005 – \$5,360) and gross realized losses of \$1,709 (2005 – \$9,513) from these sales have been included within net investment income in the Consolidated Statement of Income.

The contractual maturities of investments in fixed maturities held at December 31, 2006 and December 31, 2005 are shown below. Actual maturities may differ from contractual maturities because certain borrowers may have the right to call or prepay obligations with or without prepayment penalties.

	<u>2006</u>	<u>2005</u>
Less than 1 year	\$ 194,251	\$ 200,223
1 - 5 years	438,975	415,691
5 - 10 years	219,138	129,153
Greater than 10 years	63,680	35,561
Mortgage and asset backed securities	336,260	159,772
Collateralized debt obligations	<u>28,025</u>	<u>17,029</u>
	<u>\$ 1,280,329</u>	<u>\$ 957,429</u>

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## 9. Fixed maturities (Continued)

The following table summarizes the composition of the fair value of available-for-sale fixed maturities by rating (primary rating source: Moody's Investors Service).

	<u>2006</u>		<u>2005</u>	
	<u>Fair Value</u>	<u>%</u>	<u>Fair Value</u>	<u>%</u>
Aaa, Treasury	\$ 758,764	59.3	\$ 665,517	69.5
Aa	200,681	15.7	75,110	7.8
A	195,206	15.2	153,941	16.1
Baa	96,204	7.5	10,058	1.1
Below Baa	6,449	0.5	-	0.0
Not rated	<u>23,025</u>	<u>1.8</u>	<u>52,803</u>	<u>5.5</u>
	\$ <u>1,280,329</u>	<u>100.0</u>	\$ <u>957,429</u>	<u>100.0</u>

In the normal course of insurance and reinsurance operations, the Group must secure its obligations under certain insurance and reinsurance contracts by collateralizing them with letters of credit or trust arrangements. These trusts and letters of credit may, in turn, be secured by the Group's fixed maturities. At December 31, 2006, the Group pledged \$865,572 (2005 – \$719,651) of its fixed maturities for insurance and reinsurance trust arrangements.

The following table summarizes the effective interest rates of the available-for-sale fixed maturities held at December 31, 2006 and 2005:

	<u>2006</u>	<u>2005</u>
	<u>%</u>	<u>%</u>
U.S. Government and agency securities	4.6	3.9
Non-U.S. Government securities	4.6	4.6
Corporate securities	5.4	5.0
Non-U.S. corporate securities	4.9	4.9
Mortgage backed securities	5.8	5.0
Asset backed securities	5.1	4.7
Collateralized debt obligations	9.8	11.5
Other	6.3	7.8

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## 10. Derivative financial instruments

The Group uses cash flow hedges to manage foreign exchange risk where a material unmatched Foreign exchange position exists. During the year, the Group hedged its exposure on a collateral account posted in pounds sterling. The Group will also buy credit protection from time to time through credit default swaps to hedge the credit risk associated with a particular counterparty. In the case of the credit default swaps, hedge accounting treatment was not obtained. Derivative financial instruments at December 31, 2006 and 2005 comprise the following:

<u>At December 31, 2006</u>	<u>Notional Amounts</u>	<u>Fair Value</u>		
		<u>Assets</u>	<u>Liabilities</u>	<u>Total</u>
Credit default swaps	28,400	\$ -	\$ (725)	\$ (725)
Foreign exchange hedge	69,737	<u>220</u>	<u>-</u>	<u>220</u>
		\$ <u>220</u>	\$ <u>(725)</u>	\$ <u>(505)</u>

<u>At December 31, 2005</u>	<u>Notional Amounts</u>	<u>Fair Value</u>		
		<u>Assets</u>	<u>Liabilities</u>	<u>Total</u>
Interest rate swaps	25,000	\$ 28	\$ -	\$ 28
Credit default swaps	8,000	<u>-</u>	<u>(1,496)</u>	<u>(1,496)</u>
		\$ <u>28</u>	\$ <u>(1,496)</u>	\$ <u>(1,468)</u>

Cash and cash equivalents amounting to \$86 (2005 - \$1,936) have been pledged in support of the derivative financial instruments. These instruments are with counterparties of Aaa credit quality.

The foreign exchange hedge matured on January 22, 2007. The latest maturity with respect to the credit default swaps is March 20, 2015.

## 11. Structured insurance assets

Structured insurance assets at December 31, 2006 and 2005 comprise the following:

		<u>2006</u>	<u>2005</u>
Purchased insurance claims (i)	\$	3,864	\$ 5,509
Commissions purchased (ii)		45,826	42,997
Embedded derivatives (ii)		21,067	19,400
Originated loans (iii)		<u>2,120</u>	<u>8,305</u>
	\$	<u>72,877</u>	\$ <u>76,211</u>

# IMAGINE GROUP HOLDINGS LIMITED

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*(Expressed in Thousands of United States Dollars)*

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## 11. Structured insurance assets (Continued)

### *i) Purchased insurance claims*

The amount of \$3,864 (2005 – \$5,509) above represents the cost of outstanding rights purchased by the Group to collect insurance claims against certain insolvent and impaired insurance companies operating under Schemes of Arrangement (“Schemes”) in the London insurance market.

Each Scheme’s initial dividend rate is published and known to the Group at the time of purchasing the claim. In determining the purchase price paid for a claim, the Group estimates the expected future dividend payments for each Scheme and discounts these cash flows using a U.S. Treasury yield curve on the purchase date, adjusted for a credit margin reflecting the Scheme’s credit risk of making these estimated dividend payments over time. The Group is also entitled to receive subsequent annual dividends through and including the final dividend paid out upon the closing of a given Scheme and liquidation of all that Scheme’s assets. The total period of recovery can range from two to seven years or more depending on the age of the respective Scheme.

During the year, the Group received \$3,316 (2005 – \$5,866) in Scheme dividends. Investment income of \$1,672 (2005 – \$2,919) has been recognized on these claims by applying an effective interest rate to the cash flows received during the year and those expected to be received over time.

### *ii) Commissions purchased and embedded derivatives*

Prior to January 1, 2005, the Group made loans under arrangements to purchase various assignments of the right to collect commissions from different portfolios of long-term care insurance policies issued by several investment grade insurance carriers. Under these arrangements, the commissions are paid into separate trusts, which then distribute the amounts due to the Group on a pre-agreed formula based on the amount of commissions collected net of the expenses of the trusts. At December 31, 2006, the outstanding balance amounted to \$45,826 (2005 – \$42,997) of which \$44,997 is carried as a financial asset with fair value through income and the remaining \$829 as an originated loan. These investments earn commission income at varying rates of interest per annum. The commission income earned for the year amounted to \$6,771 (2005 - \$7,794), which has been recorded within net investment income. (See Note 19)

In two of these arrangements, the Group has also been granted an effective right to share in the profits of the trusts above an agreed amount established at inception ranging from \$15,000 to \$15,750, but growing at a margin over the U.S. Treasury yield, thereafter. Under the initial version of IAS 39, this right was treated as an embedded derivative with the value of the right fluctuating based on the anticipation of the likely level and timing of future profits. At December 31, 2006, the net unrealized gain arising from the revaluation of the embedded derivative amounted to \$1,667 (2005 – \$1,530), which has been recorded within net investment income, with a corresponding increase in the amount of the embedded derivative asset.

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## 11. Structured insurance assets (Continued)

The remaining arrangement, which was entered into subsequent to January 1, 2005, is categorized as a financial asset with fair value through income, was remeasured during the year resulting in an unrealized fair value gain of \$13,636 (2005 - \$nil) which has been recorded within net investment income. The fair value was determined through the sale of a portion of this investment to a third-party during 2006, with the established market price being used to fair value the remaining portion of the investment as at December 31, 2006.

### *iii) Loans to existing and potential clients*

The Group makes loans to existing or potential clients who are in need of financing. The effective interest rates on these loans range between 9.9% and 20.0% (2005 - 4.1% and 20.0%). The latest maturity with respect to these loans is February 28, 2009 (2005 - September 30, 2006).

## 12. Deferred policy acquisition costs

	<u>2006</u>	<u>2005</u>
Balance at the beginning of year	\$ 36,305	\$ 23,330
Deferred policy acquisition costs paid during the year	84,590	73,233
Policy acquisition costs, charged to income	(84,919)	(66,457)
Deferred policy acquisition costs acquired during the year	-	7,808
Deferred policy acquisition costs novated during the year	-	(170)
Foreign exchange differences	<u>(1,033)</u>	<u>(1,439)</u>
Balance at the end of year	\$ <u>34,943</u>	\$ <u>36,305</u>

## 13. Goodwill

	<u>2006</u>	<u>2005</u>
<u>Cost</u>		
Balance at the beginning of the year	\$ 451	\$ -
Arising from business combinations (Note 6)	<u>764</u>	<u>451</u>
Balance at the end of the year	\$ <u>1,215</u>	\$ <u>451</u>
<u>Accumulated impairment losses</u>		
Balance at the beginning of the year	\$ -	\$ -
Impairment charge recorded during the year	<u>451</u>	<u>-</u>
Balance at the end of the year	\$ <u>451</u>	\$ <u>-</u>
Net carrying amount	\$ <u>764</u>	\$ <u>451</u>

During the year, the Group assessed the recoverable amount in respect of the goodwill which arose from the acquisition of two of the London platform companies during 2005. This assessment resulted in an impairment charge in the amount of \$451 (2005 - \$nil) which has been recognized within operating expenses.

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## 14. Claims and claims adjustment expenses and investment contract liabilities

(i) The movement in claims and claims adjustment expenses is as follows:

	<u>2006</u>	<u>2005</u>
Claims and claims adjustment expenses at the beginning of year	\$ 1,171,676	\$ 871,365
Less: reinsurers' share	(203,283)	(135,133)
Add: reserves offset against funds held by ceding companies	<u>42,486</u>	<u>111,229</u>
Net claims and claims adjustment expenses at the beginning of the year	<u>1,010,879</u>	<u>847,461</u>
<b>Add (Deduct):</b>		
<i>Incurred losses:</i>		
Current year	464,855	457,695
Prior years	<u>19,912</u>	<u>(4,248)</u>
Total incurred losses	<u>484,767</u>	<u>453,447</u>
<b>Deduct:</b>		
<i>Losses and loss expenses paid related to:</i>		
Current year	(59,357)	(97,743)
Prior years	<u>(222,765)</u>	<u>(219,815)</u>
Total losses and loss expenses paid	<u>(282,122)</u>	<u>(317,558)</u>
<b>Add (Deduct):</b>		
Net claims reserves acquired during the year	-	45,863
Foreign exchange differences	84,743	(37,161)
Net claims reserves novated during the year	(303)	-
Net change in the recovery against the contingent note payable (Note 16)	1,175	19,875
Amount reflected within the loss on disposal of subsidiary (Note 7)	10,619	-
Transferred to liabilities held for sale	<u>-</u>	<u>(1,048)</u>
Net claims and claims adjustment expenses at the end of year	1,309,758	1,010,879
Less: reserves offset against funds held by ceding companies	(72,222)	(42,486)
Add: reinsurers' share	<u>135,394</u>	<u>203,283</u>
Claims and claims adjustment expenses at the end of year	\$ <u>1,372,930</u>	\$ <u>1,171,676</u>

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## 14. Claims and claims adjustment expenses and investment contract liabilities (Continued)

- (ii) The process used to determine the assumptions for measuring liabilities arising out of insurance and investment contracts as well as the reinsurers' share thereof are as follows:

### **Overview**

The assumptions employed by the Group in the estimation of its insurance and reinsurance related assets and liabilities are intended to result in provisions which are sufficient to cover any liabilities arising out of all of its insurance and reinsurance contracts, including both contracts under which the Group accepts significant insurance risk ("insurance contracts") and those which do not contain significant insurance risk but may contain financial risk ("investment contracts"). In establishing reserves, the Group utilizes the same integrated, multi-disciplinary approach that it uses to establish its insurance and reinsurance prices. After initial analysis and reserving projection by the reserving actuaries in the Group's Risk Management team, focusing on the structure of the contracts, the development of the contracts since inception and latest available information, preliminary results are shared with the appropriate personnel of the Group to ensure that the most comprehensive set of information possible is incorporated into the reserving process. These personnel may include the underwriters, pricing actuaries, claims and finance professionals, external professional advisors and, as appropriate, the senior management team. Following this comprehensive process, the Chief Risk Officer recommends the appropriate level of reserves for claims and claims adjustment expenses to the Board of Directors for adoption.

Setting appropriate reserves for claims and claims adjustment expenses is an inherently uncertain process. Claims reserves represent the estimate, at a given point in time, of the ultimate settlement and adjustment costs of losses incurred. Inherent in the estimate of ultimate claims are such factors as expected trends in frequency, claim severity, the occurrence of catastrophic events, the timing of claim payments and interest yields that could vary significantly as claims develop and are settled. The uncertainty in loss estimation is particularly pronounced for long-tail lines where information typically emerges over time. In the overall reserve setting process, provisions for economic inflation and changes in the social and legal environment are considered. The uncertainty inherent in the reserving process tends to be even greater for reinsurance companies compared to primary insurance companies. This is mainly due to the time lag in reporting information from the insurer to the reinsurer and differing reserving practices among ceding companies. As a result, actual claims and claims adjustment expenses may deviate, perhaps materially, from the ultimate costs reflected in the Group's current reserves for claims and claims adjustment expenses.

### **Overall reserving basis**

Provision is made as at the balance sheet date for the expected ultimate cost of settlement of all claims incurred in respect of events up to that date, whether reported or not, together with related allocated claims handling expenses, less amounts already paid. These reserve amounts are calculated in accordance with generally accepted actuarial principles.

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## 14. Claims and claims adjustment expenses and investment contract liabilities (Continued)

### Data

The sources of data used as inputs for the assumptions surrounding claims reserving includes data sources internal to the Group, data received per contractual agreements from counterparties that the Group reinsures, data provided by various professional advisors engaged by the Group and publicly available industry and market observable data. The assumptions are verified to ensure that they are consistent with observable market information or other published information where possible. For some transactions where sufficient claims or premium data is not available with which to make a reliable estimate of claims development, such as in the case where the insured or reinsured party is a start-up entity, prudent assumptions that are in line with the assumptions used in the underlying pricing of the insurance or reinsurance contract are typically utilized.

### Reserves for Claims and Claims Adjustment Expenses

Claims reserves fall into two categories: reserves for reported claims and claims adjustment expenses ("Case Reserves") and reserves for IBNR.

#### *Case Reserves*

Upon receipt of a notice of claim from an insured or reinsured party, the Group establishes case reserves for the estimated amount of the ultimate settlement. These Case Reserves are usually determined by the amount of reserves reported by the insured or reinsured party and may be subsequently amended, as deemed necessary, following the Group's internal review processes.

Reinsurance Case Reserves are generally established by the ceding insurance company and reviewed by the Group. In assessing Case Reserves, the Group utilizes its in-house claims function, third party administrators ("TPA's") and other professional advisors as required. Case Reserves are assessed on a case-by-case, policy-by-policy basis with due regard to the circumstances of the claim, policy coverage, terms and conditions, information available from loss adjusters and historical experience with respect to the size of comparable claims. Case estimates are reviewed regularly and are updated as and when new information arises.

For the Group's annuity business, Case Reserves represent an estimation of the future benefit payments to annuity policyholders and are determined on a seriatim basis for all underlying policies remaining in-force at the time of valuation. The actuarial present value of the future annuity benefits for each policy is calculated using assumptions for expected future mortality and a given set of discount rates. These assumptions are reviewed regularly and revised where deemed necessary.

#### *IBNR*

The estimation of IBNR claims is generally subject to a greater degree of uncertainty than the estimates of claims already notified where more information is typically available. IBNR claims may often not be reported to the Group until many years after the occurrence of the underlying event giving rise to the claim.

These IBNR reserves include estimated legal and other claims adjustment expenses where appropriate. The Group calculates its IBNR reserves by using generally accepted actuarial techniques and in doing so utilizes actuarial tools and techniques that rely on historical client-specific and industry loss data, pricing information and statistical models, as well as the Group's own pricing analyses. The reserve analysis typically relies upon the basic assumption that past experience, adjusted for the effect of current developments and likely trends, is an appropriate basis to estimate the current liability for claims and claims adjustment expenses.

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## 14. Claims and claims adjustment expenses and investment contract liabilities (Continued)

The key statistical methodologies used, which remain unchanged from prior years, are as follows:

- Expected loss ratio methods, which use the Group's expectation of the loss ratio for a class of business;
- Benchmarking methods, which use the experience of comparable, more mature, classes and industry benchmarks to estimate the cost of claims;
- Stochastic methods which use probability distributions of losses to estimate the expected losses ceded to the Group; and
- Life annuity reserving methodologies, which determine the actuarial present value of expected future benefits.

The actual method or blend of methodologies used varies by the accident year (or underwriting year) being considered, the class of insurance and/or reinsurance contracts and observed historical claims development.

To the extent that these methods use historical claims development information, they may assume that the historical claims development pattern will occur again in the future. There are reasons why this may not be the case, which, insofar as they can be identified, have been allowed for by modifying the methodologies described. Such reasons include:

- Economic, legal, political and social trends (for example, a difference in the expected level of inflation);
- Changes in the mix of insurance and/or reinsurance contracts incepted;
- Changes in the reporting time lag between the insured and the reinsured and the insurer and the reinsurer;
- Changes in the reserving processes and/or practices of the insured and/or reinsured; and
- The impact of large losses and catastrophes. Large claims are generally assessed separately and are measured on a case-by-case basis or projected separately in order to allow for the possible distorting effects on development and incidence of these large claims.

The claims provisions also include, where necessary, a reserve for unexpired risks where, at the balance sheet date, the estimated cost of future claims and related deferred acquisition costs are expected to exceed the unearned premium provision. The assessment of an unexpired risk provision is made in relation to lines or groupings of business that are managed together.

### Uncertainty

The provision estimation difficulties differ by class of business and/or type of transaction for a number of reasons, including differences in the:

- Terms and conditions of the underlying contracts (See Note 4);
- Complexity of claims;
- Severity of individual claims;
- Period between the occurrence and subsequent reporting of claims; and
- Length of time over which benefits are projected to be paid in the future.

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## 14. Claims and claims adjustment expenses and investment contract liabilities (Continued)

As the estimation of the reserves for claims and claims adjustment expenses is an inherently uncertain process, quantitative techniques frequently have to be supplemented by professional and managerial judgment. In addition, trends that have affected the development of reserves in the past may not necessarily occur or continue to affect reserve development to the same degree in the future.

### Discounting of Claims and Claims Adjustment Reserves

In line with the IFRS framework and the practice of many reinsurance companies reporting under this framework, the Group typically discounts its reserves for claims and claims adjustment expenses for retrospective transactions, life and annuity contracts and for prospective transactions involving long tailed liabilities.

The liability for claims and claims adjustment expenses for eleven (2005 – nine) contracts have been calculated on a discounted basis. The rates of interest used in discounting these contracts range from 0.64% to 5.84% (2005 – 2.40% to 5.70%). The effect of discounting these claims reserves is to decrease the liability for claims and claims adjustment expenses at December 31, 2006 by approximately \$184,292 (2005 – \$153,800).

The sensitivity of all discounted contracts was tested with respect to parallel shifts of +/- 100 basis points in the underlying yield curves, resulting in an aggregate average increase (decrease) of \$31,100 (2005 – \$27,600) or approximately 3.8% (2005 – 4.0%) of the total discounted reserves for claims and claims adjustment expenses.

Included within the prior years' development in claims incurred is an amount of \$25,176 (2005 – \$12,171) which relates to the unwinding of the discount on those contracts where the Group carries discounted reserves.

### Reinsurers' Share of Claims and Claims Adjustment Expenses

The Group purchases a range of excess of loss, quota share and other reinsurance or retrocessional contracts principally for its Lloyd's business. IBNR provisions and provisions for outstanding claims and claims adjustment expenses are initially estimated at a gross level and a separate calculation is carried out to estimate the size of the related reinsurance losses recoverable. The methodologies use historical data, gross IBNR estimates and take into account directly the terms and conditions of the insurance and reinsurance contracts to estimate the carrying value of the reinsurance losses recoverable.

Reinsurance contracts do not relieve the Group of its obligations to the underlying insured or reinsured. Failure of reinsurers to honor their obligations could result in losses to the Group. Consequently, allowances are established for amounts deemed uncollectible arising from either the inability or unwillingness of the reinsurer to pay. The Group evaluates the financial condition of its reinsurers on an ongoing basis and monitors concentrations of credit risk arising from similar geographic regions, activities, or the economic characteristics of its reinsurers to minimize the exposure to significant losses from reinsurer insolvencies. The Group's general policy is to only reinsure companies rated by Standard & Poor's or A.M. Best as minimum 'A-' at the time of ceding the reinsurance.

As at December 31, 2006, \$135,394 (2005 – \$203,283) was recoverable from reinsurers and retrocessionaires, net of allowances for doubtful accounts amounting to \$11,900 (2005 – \$16,478). Of the total reinsurers' share of claims and claims adjustment expenses, not more than 10% is recoverable from any one reinsurer.

# IMAGINE GROUP HOLDINGS LIMITED

Notes to Consolidated Financial Statements

December 31, 2006

(Expressed in Thousands of United States Dollars)

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## 14. Claims and claims adjustment expenses and investment contract liabilities (Continued)

### Key assumptions and sensitivities

The reserving for each transaction will incorporate a number of assumptions which may well differ from transaction to transaction and/or may differ by line or type of business. The assumptions that have the greatest effect on the measurement of the Group's reserves for claims and claims adjustment expenses and its reinsurers' share of claims and claims adjustment expenses are as follows:

#### Acceleration of claims payout for non-life discounted deals

The Group discounts a number of non-life reinsurance transactions for the time value of money. This will necessarily involve certain assumptions about the expected payout of claims and the duration of these liabilities. Should claims payout faster than anticipated, the ultimate liability may exceed the Group's estimates. By way of illustration, the sensitivity of the liability for claims and claims adjustment expenses to a one year advancement (retardation) of all payments relative to the base case payout pattern is an increase (decrease) in the reserves for claims and claims adjustment expenses of approximately \$23,800 (2005 - \$30,000) or approximately 4.8% of the total discounted liability for claims and claims adjustment expenses. This is in addition to the sensitivity of the liability for claims and claims adjustment expenses to the discount rate assumption described above.

#### Property catastrophe exposure

The 2005 Year of Account of Syndicate 2121 was significantly impacted by hurricane activity during the year ended December 31, 2005, particularly Hurricanes Katrina, Rita and Wilma. The Group's reserves as at December 31, 2006 reflect the latest information available.

#### Lloyd's syndicate 1400 run-off business exposure

The Group has exposure to the run-off of various discontinued lines of business underwritten by one of its Lloyd's syndicates, Syndicate 1400, during the period from 2000 to 2002 and in particular these exposures relate to two lines of business, namely liability excess of loss and the motor excess of loss. In establishing the claims reserves for these lines of business, assumptions regarding the future development of claims and claims adjustment expenses are necessary. The calculation of reserves is complicated by the long-tailed nature of these liabilities, the volatility of recent claims development and the fact that the original underwriters responsible for this business are no longer employed by the Group.

However, under the terms of the purchase of the original parent company of Syndicate 1400, Dan Re, 50% of the purchase consideration was deferred in the form of a contingent note payable under which the Group is indemnified for deterioration in the technical reserves as reported in the audited consolidated financial statements of Dan Re for the year ended December 31, 2004. (See Note 16 for more detail with respect to the contingent note payable). This deterioration was anticipated at the time of acquisition based on third-party reserve reviews conducted as part of the Group's due diligence. The contingent note provides substantial protection against deterioration on these reserves. As at December 31, 2006, the Group has established a recovery against the note in the amount of \$18,700 (2005 - \$19,875) as a result of the deterioration estimated at that date. Based on current estimates of the final principal amount of the note at its maturity, inclusive of accrued interest, the unutilized protection remaining under this note is approximately \$33,900 (2005 - \$31,000) as at December 31, 2006.

# IMAGINE GROUP HOLDINGS LIMITED

Notes to Consolidated Financial Statements

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## 14. Claims and claims adjustment expenses and investment contract liabilities (Continued)

### Impaired lives annuities

The Group has significant exposure to the impaired lives annuity market in the United Kingdom. The key risks for the Group are those concerning mortality (longevity) risk and investment return on the invested assets. The estimation of mortality for impaired lives is a highly specialized area. The mortality assumptions used in setting the liability for claims and claims adjustment expenses are based on standard mortality tables and then adjusted for the impaired lives, various diseases and the views of industry experts with respect to improvements in mortality. The underlying standard mortality tables used are PML92 and PFL92 (U.K. industry tables) with initial mortality improvements incorporated by way of the U.K. CMI medium cohort adjustment tables. The impairment life adjustments are based on ten years of experience in the U.K. impaired lives annuity market. The Group engaged an external actuarial consultancy firm to review the methodology and assumptions used by the ceding company in the determination of the expected mortality rates. The overall conclusion reached by the consulting actuaries confirmed that the Group's approach to determining impaired mortality was reasonable. The Group has also tested the sensitivity of the reserves for claims and claims adjustment expenses to the mortality assumptions by estimating the reserves using 90% and 110% of the best estimate mortality rates. The result is an increase of approximately \$19,100 and decrease of approximately \$16,300 respectively, or an average variance of approximately 5.6% of the current level of discounted claims reserves. The rates of interest used in discounting the reserves for the impaired lives annuities business range from 0.64% to 5.01% (2005 – 2.4% to 3.9%).

With regard to investment risk, the Group's policy is to adopt a matched asset-liability profile. The detailed ALM position is reviewed quarterly with the intent of ensuring that the Group remains largely neutral to movements in the yield curve.

### Excess long tailed liability contracts

The Group has exposure to a number of excess long-tail liability type contracts with underlying exposures covering general and public liability, workers' compensation and medical malpractice. These exposures typically have low frequency and high severity characteristics coupled with significant time lags for the emergence of actual claims activity. The reserving approach typically adopted for these transactions, particularly at the early stages of development, uses the pricing model and assumptions. Deviations in actual experience from these assumptions are reflected in the quarterly reserving reviews carried out by Group.

## 15. Unearned premiums

	<u>2006</u>	<u>2005</u>
Unearned premiums at the beginning of year	\$ 164,635	\$ 105,967
Change in unearned premiums (gross)	54,525	27,763
Change in unearned premiums reflected within the loss on disposal of subsidiary	(1,759)	-
Unearned premiums acquired during the year	-	39,581
Unearned premiums novated or commuted	(3,095)	(1,594)
Unearned premiums transferred to liabilities held for sale	-	(2,033)
Foreign exchange differences	<u>(3,146)</u>	<u>(5,049)</u>
Unearned premiums at the end of year	\$ <u>211,160</u>	\$ <u>164,635</u>

# IMAGINE GROUP HOLDINGS LIMITED

Notes to Consolidated Financial Statements

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## 16. Loans payable

Loans payable at December 31, 2006 and 2005 comprise the following:

	<u>2006</u>	<u>2005</u>
Senior loan - net of recovery (i)	\$ 31,935	\$ 27,046
Investment related loan (ii)	10,000	10,000
Subordinated loans (iii)	110,000	50,000
Other loan	<u>-</u>	<u>173</u>
	<u>\$ 151,935</u>	<u>\$ 87,219</u>

- (i) In connection with the acquisition of Danish Re (Bermuda) Limited ("Dan Re") on December 31, 2004, the Group issued a contingent note in the principal amount of \$46,603, which bears interest at a rate equal to U.S. six-month LIBOR plus 100 basis points per annum, compounded on a semi-annual basis in arrears. Interest accruing on this note is due and payable in full on the maturity date of January 31, 2008 or upon completion of the December 31, 2007 audited consolidated financial statements of Dan Re.

The terms of this loan state that the principal amount of the note shall be subject to further upward or downward adjustment for any positive or adverse development on any insurance or reinsurance related balances occurring between the December 31, 2004 and December 31, 2007 audited consolidated financial statements of Dan Re. In the case of a positive reserve variance, the upward adjustment amount shall be equal to 50% of the positive reserve variance. In the case of a negative reserve variance, the adjustment amount shall be equal to 100% on the first \$10,000 and to the extent that the variance exceeds this amount, 90% on the excess portion. The principal amount of the note may also be adjusted to satisfy any claims relating to representations and warranties given by the vendor in connection with the acquisition. In the case of an event of default, principal and interest on the note would become payable immediately.

The contingent note has been recognized in these Consolidated Financial Statements at its discounted value of \$50,635 (2005 - \$46,921) inclusive of accrued interest, less an amount recoverable of \$18,700 (2005 - \$19,875) against the contingent note based on the results of a provisional determination of the adverse development on the reinsurance related balances of Dan Re as at December 31, 2006. The contingent note is discounted using a discount rate of six-month LIBOR plus 300 basis points, which management believes to be the appropriate market rate for a similar instrument of an issuer with a similar credit rating. Given that the Group has the legally enforceable right and intends to settle the outstanding contingent note payable net of the recovery established against this note, the right of offset has been applied, reducing the net discounted value to \$31,935 (2005 - \$27,046) as at December 31, 2006.

- (ii) Included within loans payable is an amount of \$10,000 (2005 - \$10,000) borrowed as part of an investment transaction entered into during 2001. This loan matures in June 2007 and can be prepaid at the Group's option with no penalty before this date. Interest on the loan is equal to the U.S. three-month LIBOR plus 50 basis points. The loan is collateralized with cash and cash equivalents amounting to \$10,500 (2005 - \$10,500).

# IMAGINE GROUP HOLDINGS LIMITED

Notes to Consolidated Financial Statements

December 31, 2006

(Expressed in Thousands of United States Dollars)

## 16. Loans payable (Continued)

- (iii) On December 15, 2006, the Group borrowed \$110,000 from Bryson's International Limited, a shareholder of the Group. The amount outstanding under this loan shall initially bear interest at a rate equal to U.S. three-month LIBOR plus 200 basis points and be reset on the first day of each month thereafter. In addition, there is an annual facilitation fee of 100 basis points in relation to the loan. This loan is subordinated to the letter of credit obligations under both of the letter of credit facilities described in Note 18. A portion of the proceeds from this loan was used to retire the pre-existing subordinated loan of \$50,000 as previously provided by Trilon International Inc., another of the Group's shareholders.

## 17. Share capital

At December 31, 2006, the Group had an authorized share capital of 200,000,000 (2005 – 200,000,000) shares consisting of:

- a) 49,331,755 common shares (2005 – 49,331,755) with a par value of \$1 and an issue price of \$10.24 per share, and  
b) 150,236,000 (2005 – 150,236,000) undesignated shares with a par value of \$1 each.

At December 31, the issued and paid up share capital is as follows:

	<u>2006</u>	<u>2005</u>
<i>Common shares at a par value of \$1 per share:</i>		
49,331,755 (2005 – 49,331,755) common shares	\$ 49,332	\$ 49,332
Additional paid up capital	<u>429,083</u>	<u>429,083</u>
Total share capital	<u>\$ 478,415</u>	<u>\$ 478,415</u>

## 18. Liquidity resources

### (i) Letters of Credit

#### Non-Lloyd's Facility

Effective December 22, 2006, the Group renewed and expanded its letter of credit agreement (the "Non-Lloyd's Facility") with six (2005 – five) financial institutions, including ING Bank, N.V. London Branch as administrative agent and Barclays Bank PLC, New York Branch along with the Bank of Nova Scotia as lead issuing banks. Under the Non-Lloyd's Facility, the banks have agreed to provide letters of credit on an unsecured basis with a total capacity of \$370,000 (2005 – \$290,000).

Letters of credit under the Non-Lloyd's Facility mature 364 days from the date of issuance on an evergreen basis, meaning that they automatically renew each year unless utilized by the letter of credit beneficiary. Under the Non-Lloyd's Facility, the Group and/or certain of its subsidiaries must maintain certain covenants, including a minimum adjusted tangible net worth covenant and a maximum leverage covenant. A breach of any of these covenants, or certain other events set out in the credit agreement, would result in an event of default, upon which the Group may be required to provide the appropriate collateral under the Non-Lloyd's Facility. As at December 31, 2006, twenty-three (2005 – thirteen) letters of credit totaling \$222,614 (2005 – \$152,008) have been issued. The Group is in compliance with all of the covenants under the Non-Lloyd's Facility.

# IMAGINE GROUP HOLDINGS LIMITED

Notes to Consolidated Financial Statements

December 31, 2006

*(Expressed in Thousands of United States Dollars)*

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## 18. Liquidity resources (Continued)

### (i) Letters of Credit (Continued)

#### Lloyd's Facility

Effective November 28, 2006, the Group renewed and expanded its letter of credit agreement with four (2005 – three) financial institutions, including ING Bank, N.V. London Branch (as administrative agent and lead issuing bank) to establish a letter of credit facility (the “Lloyd’s Facility”) under which the issuing banks have agreed to provide letters of credit on an unsecured basis with a total capacity of £160,000/\$313,424. Under the previous agreement, the total capacity was £115,000/\$197,915 of which £80,000/\$137,680 was on an unsecured basis and £35,000/\$60,235 was on a secured basis. At December 31, 2006, three letters of credit totaling £135,000/\$264,452 (2005 – £76,839/\$132,240) have been issued under the Lloyd’s Facility. In addition, the Group has placed £35,631/\$69,797 on deposit with ING as administrative agent to support the solvency deficits for the open years of account of the relevant syndicates. Under the Lloyd’s Facility, the Group and/or certain of its subsidiaries must maintain certain covenants, including a minimum adjusted tangible net worth covenant and a maximum leverage covenant. A breach of any of these covenants, or certain other events set out in the credit agreement would result in an event of default upon which the Group may be required to provide the appropriate collateral under the Lloyd’s Facility. The Group is in compliance with all of the covenants under the Lloyd’s Facility.

#### Other secured letters of credit

The Group has also obtained four (2005 – two) letters of credit outside of the above facilities in the aggregate amount of \$6,289 (2005 – \$9,729), which have been collateralized with cash and short-term investments amounting to \$6,254 (2005 – \$7,362).

### (ii) Line of Credit

During 2005, the Group entered into a 365 day Line of Credit (the “Line”) in the aggregate amount of \$100,000 with Trilon International Inc, a shareholder of the Group. The Line will automatically renew for successive 365 day periods unless 90 days written notice is provided by either party to the agreement. The Line is intended to provide the Group with a liquid and readily-available source of capital to meet any short-term liquidity requirements that may arise from time to time. Outstanding amounts under the Line bear interest at U.S. six-month LIBOR plus 200 basis points. Any borrowings under the Line are subordinated to the letter of credit obligations under both of the letter of credit facilities described in part (i) of Note 18 above. Amounts borrowed during the year under this Line were repaid in full prior to December 31, 2006.

### (iii) Financial Support Agreement

Trilon International Inc., one of the Group’s shareholders, provides financial support in the form of a guarantee and/or indemnity in connection with certain reinsurance transactions written by the Group. On December 5, 2005, Trilon International Inc. renewed the financial support agreement extending the term to December 31, 2006 at a revised maximum aggregate amount of \$50,000. Further, on December 21, 2006, the agreement was renewed extending the term to December 31, 2007 at a revised aggregate amount of \$25,000.

# IMAGINE GROUP HOLDINGS LIMITED

Notes to Consolidated Financial Statements

December 31, 2006

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## 19. Net investment income

Net investment income is comprised of the following:

	<u>2006</u>	<u>2005</u>
Interest income	\$ 37,039	\$ 20,862
Investment income on reinsurance assets and funds held by ceding companies	47,324	31,289
Commission income (Note 11)	6,771	7,794
Investment income on purchased insurance claims (Note 11)	<u>1,672</u>	<u>2,919</u>
	92,806	62,864
Dividend income	2,232	1,648
Impairment losses	-	(2,954)
Investment expenses	(647)	(4,210)
Net unrealized investment gains	14,578	62
Net realized investment gains	<u>2,861</u>	<u>259</u>
	<u>\$ 111,830</u>	<u>\$ 57,669</u>

Impairment losses amounting to \$nil (2005 – \$2,954) were recognized during the year with respect to two collateralized debt obligations as a result of observable data indicating that there was a measurable decrease in the estimated future cash flows from these financial instruments since their initial recognition.

## 20. Compensation expenses

Included within operating expenses are the following categories of personnel expenses:

	<u>2006</u>	<u>2005</u>
Salaries and bonus	\$ 26,292	\$ 21,488
Vested portion of the Long Term Incentive Plan (ii)	7,391	8,529
Contributions to defined contribution plans (iii)	1,850	1,113
Share-based payments (iv)	2,000	-
Other employee benefits	<u>(344)</u>	<u>4,218</u>
	<u>\$ 37,189</u>	<u>\$ 35,348</u>

(i) As at December 31, 2006, there were 161 employees (2005 – 150) of the Group.

(ii) Compensation Plans

The Group has established compensation plans which are offered selectively to employees of the Group based on the terms of the individual employee's employment contract, job responsibilities, employment location, applicable local employment and tax regulations and other factors as may be established by the Board of Directors from time to time.

# IMAGINE GROUP HOLDINGS LIMITED

Notes to Consolidated Financial Statements

December 31, 2006

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## 20. Compensation expenses (Continued)

### Cash Bonus Compensation

The Cash Bonus Compensation Plan ("CBCP") provides selected employees with an opportunity to earn additional compensation based on their contribution to the profitability of the Group while aligning their interests with those of the Group's shareholders and promoting a long-term commitment to working for the Group. Awards are not compensation rights that accrue during a Year of Account and participants are not entitled to a partial settlement payment should they leave before the final awards are approved for that year.

All bonus awards under 100% of salary vest immediately. The portion of any award exceeding 100% of a participant's salary will vest over a two-year period beginning on January 1 following the Year of Account. Of the total award exceeding 100% of salary granted to a participant, 50% will vest on January 1 following the Year of Account (the "Initial Vesting Date"). The remaining 50% of the award will vest on the subsequent January 1 following the Initial Vesting Date.

### Production Compensation Plan

The Production Compensation Plan ("PCP") provides selected employees with an opportunity to earn long-term incentive compensation based on their contribution to the profitability of the Group. The PCP is based on contribution to the profitability of specified Qualified Transactions of the Group where a "Qualified Transaction" is, in summary, any insurance, reinsurance, or financial transaction bound or entered into by the Group, adjusted by the annual accretion or reduction in net present value. All awards shall vest over a maximum period of five years. The increase in the vested portion only of the PCP award is included within the operating expenses of the Group in the year incurred. This plan replaces the previous Long Term Incentive Plan ("LTIP"), which terminated on December 31, 2005.

### PC Compensation Plan

The PC Compensation Plan ("PC Plan") provides selected employees with an opportunity to earn long-term incentive compensation based on their contribution to the profitability of a specified Lloyd's underwriting syndicate which is managed by the Group's Lloyd's managing agency or agencies. The Profit Commission (the "PC") is defined as either:

- (a) PC Plan covering a specified Year of Account in accordance with the agreement between the individual capital providers to each Syndicate and the Managing Agent. The agreements will govern the closing of financial results and subsequent calculation and payment of PC under the PC Plan should any inconsistency between the PC Plan and the agreements arise; or
- (b) PC Plan covering a specific calendar year "GAAP" result. The agreement will govern the closing of financial results and subsequent calculation and payment of PC under the PC Plan should any inconsistency between the PC Plan and the agreement arise. All syndicate profit commission payments will be made on the declared consolidated GAAP result reported in U.S. dollars each of the ongoing business segments, adjusted to exclude appropriate movements in business lines discontinued.

# IMAGINE GROUP HOLDINGS LIMITED

Notes to Consolidated Financial Statements

December 31, 2006

*(Expressed in Thousands of United States Dollars)*

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## 20. Compensation expenses (Continued)

### (ii) Compensation Plans (Continued)

#### PC Compensation Plan (Continued)

Type (a) relates to syndicates where the support includes third party capital and type (b) relates to where syndicates are wholly supported by the Group's capital. If the closed financial result is negative this negative result will be carried forward to the next two calendar years so as to recover financial losses before calculating the PC payable to the participant. All awards shall vest over a maximum period of three years. The increase in the vested portion only of the PC Plan award is included within the operating expenses of the Group in the year incurred.

### (iii) Defined Contribution Retirement Plans

The Group also sponsors various defined contribution retirement plans, which allow eligible participants to make voluntary contributions pursuant to their respective jurisdictions. All employees of the Group are eligible to participate in the plans and contribute a percentage of their eligible earnings. The Group makes a contribution in cash to each participating employee which vests fully between one to five years.

### (iv) Employee Stock Option Plan

On January 1, 2006, the Group established an Employee Stock Option Plan (the "ESOP") which entitles key management personnel to purchase shares in the Group. During the year, 1,250,000 share options were granted under the ESOP, which gave the participants the choice of settlement by way of either cash settlement or through the issuance of shares. The terms and conditions of the grants made during the year are as follows:

Grant date	January 1, 2006	May 17, 2006
Number of options granted	750,000	500,000
Option life in years	10	10

The options granted on January 1, 2006 vest as to 20% on April 1, in the year following the date that the options were granted and 20% at the end of each subsequent April 1 anniversary date up to and including the last anniversary date after the grant. The options granted on May 17, 2006 vest as to 33.33% on April 1 in the year following the date that the options were granted, and 33.33% at the end of each subsequent April 1 anniversary date up to and including the third anniversary date after the grant.

# IMAGINE GROUP HOLDINGS LIMITED

Notes to Consolidated Financial Statements

December 31, 2006

(Expressed in Thousands of United States Dollars)

## 20. Compensation expenses (Continued)

### (iv) Employee Stock Option Plan (Continued)

The fair value of services received in return for share options granted is based on the fair value of the share options granted, measured using the binomial option pricing model, with the following inputs:

	January 1, 2006	May 17, 2006
Share price at grant date	\$ 10.67	\$ 10.67
Exercise price	\$ 10.67	\$ 10.67
Expected volatility	25%	25%
Expected dividend yield	0%	0%
Risk-free interest rate	4.37%	5.16%
Contractual option life in years	10	10

The estimated fair value of the stock options granted under the ESOP vary between \$3.74 to \$4.31 for the options granted on January 1, 2006 and between \$3.82 to \$4.07 for the options granted on May 17, 2006. The share-based payment expense recorded for the year and reflected within operating expenses on the Consolidated Statement of Income amounted to \$2,000 (2005 - \$nil). The corresponding liability amount, arising because the stock options are treated as being cash settled in their entirety, is reflected at fair value within accounts payable and other liabilities on the Consolidated Balance Sheet.

Additionally, a share based payment arrangement granted after November 7, 2002 exists, where 1,550,000 stock options were granted with an exercise price of \$10.15. The recognition and measurement principles in IFRS 2 – Share-based Payment have not been applied to this grant. These options were fully vested before IFRS 2 came into effect. They have an original contractual life of 10 years and none of these options have been exercised since they were granted.

The movement in the number and weighted average exercise price ("WAEP") of the share options for the year ended December 31, 2006 were as follows:

	<u>No. of options</u>	<u>WAEP</u>
Outstanding at the start of the year	1,550	\$ 10.15
Options granted during the year	<u>1,250</u>	<u>10.67</u>
Outstanding at the end of the year	<u>2,800</u>	\$ <u>10.38</u>
Exercisable at the end of the year	1,550	\$ 10.15

# IMAGINE GROUP HOLDINGS LIMITED

Notes to Consolidated Financial Statements

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## 20. Compensation expenses (Continued)

- (v) Included within the personnel expenses above are key management personnel compensation costs detailed within the categories prescribed by IAS 24 – Related Party Disclosures as follows:

	<u>2006</u>		<u>2005</u>
Short-term employee benefits	\$ 4,435	\$	2,773
Vested portion of LTIP	3,783		5,704
Share-based payments expense	2,000		-
Post employment benefits	<u>209</u>		<u>193</u>
	<u>\$ 10,427</u>	\$	<u>8,670</u>

## 21. Taxation

Imagine Insurance Company Limited, Imagine Reinsurance SCC and Imagine Reinsurance U.S. Limited are all registered as Qualifying Insurance Companies (“QICs”) under the Insurance Act 1996-32 of Barbados (the “Act”). Under the Act, the Companies are, as QICs, liable for tax on their taxable income at a rate of 25% (2005 – 30%). However, as their income is exclusively earned from foreign insurance business, the Companies are also eligible for a tax credit of 93%, the maximum allowance under Section 12H of the Barbados Income Tax Act, Cap 73. This has resulted in a net effective tax rate of 1.75% (2005 – 2.10%).

Under current Bermuda law, the Group and its subsidiaries domiciled in Bermuda, Pillar Insurance Company (Bermuda) Limited, Perspective Financial Products Limited and Affiliated Chemical Insurance Limited, are not required to pay any corporate income taxes in Bermuda on either income or capital gains. In the event of any such taxes being imposed, the Group has received undertakings from the Minister of Finance in Bermuda that they will be exempted from taxation until 2016.

Imagine U.S. Holdings Limited files a consolidated U.S. income tax return with its includable subsidiaries, Imagine Reinsurance U.S. Limited and Imagine Advisors, Inc. The current statutory tax rate in the United States is 34% (2005 – 34%).

Imagine Underwriting ApS (formerly Danish Re Underwriting Agencies ApS) is subject to a corporate tax rate of 28% (2005 – 28%) in Denmark. Imagine Re (Luxembourg) S.A., Imagine Finance S.a.r.l, Imagine Re (Europe) S.A. and Imagine Re (2006) S.A. are subject to a corporate tax rate of 30% (2005 – 30%) in Luxembourg. Imagine International Reinsurance Limited is subject to a tax rate of 12.5% (2005 – 12.5%) in Ireland.

# IMAGINE GROUP HOLDINGS LIMITED

Notes to Consolidated Financial Statements

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## 21. Taxation (Continued)

Danish Re Syndicates Limited, Danish Re (U.K.) Group Limited, GMA Imagine Limited, Imagine Corporate Capital Limited, Imagine Corporate Capital Nos. 2 to 6 Limited, Imagine Group (U.K.) Limited, Imagine Management Services Limited, Imagine Syndicate Management Limited, Imagine Underwriting Limited and Imagine Underwriting Services Limited are subject to a corporate tax rate of 30% (2005 – 30%) in the United Kingdom.

Corporation tax expense (recovery) comprises:

	<u>2006</u>	<u>2005</u>
<i>Current tax</i>		
Current year	\$ 8,742	\$ 5,669
Over provision in prior years	<u>(49)</u>	<u>(21)</u>
	<u>8,693</u>	<u>5,648</u>
<i>Deferred tax</i>		
Other temporary differences	3,460	1,206
Benefits of tax losses recognized	(394)	(20,881)
Under provision in prior years	<u>(3,713)</u>	<u>(3,393)</u>
	<u>(647)</u>	<u>(23,068)</u>
Corporation tax expense (recovery)	\$ <u><u>8,046</u></u>	\$ <u><u>(17,420)</u></u>
Reconciliation of taxes calculated at the applicable tax rate with corporation tax recoveries:		
Income (loss) before corporation taxes	\$ <u>66,733</u>	\$ <u>(14,850)</u>
Tax calculated at a tax rate of 0% (2005 – 0%)	-	-
Effect of different tax rates in other countries	15,094	(7,662)
Income not subject to tax	(36)	-
Expenses not deductible for tax purposes	2,129	49
Utilization of previously unrecognized tax losses	-	(828)
Over/under provision in prior years' current tax	230	(21)
Over/under provision in prior years' deferred tax	1,279	1,699
Tax credit for net foreign currency earnings of QICs	(10,634)	(10,033)
Use of unrecognized tax assets	-	(991)
Over/under provision in current year's current tax	<u>(16)</u>	<u>367</u>
Corporation tax expense (recovery)	\$ <u><u>8,046</u></u>	\$ <u><u>(17,420)</u></u>

# IMAGINE GROUP HOLDINGS LIMITED

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## 22. Deferred taxes

The movement on the net deferred tax account is as follows:

	<u>2006</u>	<u>2005</u>
At beginning of year	\$ (12,214)	\$ 13,245
Foreign exchange differences	(2,177)	(257)
Acquisition of subsidiaries (Note 6)	6,873	(5,403)
Income statement credit (Note 21)	(647)	(23,068)
Other	<u>(1,085)</u>	<u>3,269</u>
At end of year	\$ <u><u>(9,250)</u></u>	\$ <u><u>(12,214)</u></u>

The net deferred tax account is comprised as follows:

Deferred tax assets	\$ (16,281)	\$ (18,835)
Deferred tax liabilities	<u>7,031</u>	<u>6,621</u>
Net deferred tax account	\$ <u><u>(9,250)</u></u>	\$ <u><u>(12,214)</u></u>

Deferred tax assets consist of the following items:

	<u>2006</u>	<u>2005</u>
<b>Deferred tax assets:</b>		
Decelerated tax depreciation	\$ -	\$ 133
Provisions	1,047	34
Tax losses	14,405	18,658
Other	<u>829</u>	<u>10</u>
	\$ <u><u>16,281</u></u>	\$ <u><u>18,835</u></u>

Deferred tax liabilities consist of the following items:

	<u>2006</u>	<u>2005</u>
<b>Deferred tax liabilities:</b>		
Accelerated tax depreciation	\$ -	\$ 2
Accrued interest	196	173
Fair value gains	-	2,411
Reserves	<u>6,835</u>	<u>4,035</u>
	\$ <u><u>7,031</u></u>	\$ <u><u>6,621</u></u>

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## 23. Earnings per share

Basic earnings per share, is calculated by dividing the net income attributable to equity holders of the Group by the weighted average number of ordinary shares in issue during the year.

Diluted earnings per share is calculated adjusting the weighted average number of ordinary shares outstanding to assume conversion of all dilutive potential ordinary shares at the beginning of the year. The Group has one category of dilutive potential ordinary shares, namely share options as described in Note 20. For the share options, a calculation is performed to determine the number of shares that could have been acquired at fair value based on the monetary value of the subscription rights attached to the outstanding share options. The number of shares calculated as above is compared with the number of shares that would have been issued assuming the exercise of the share options.

	<u>2006</u>	<u>2005</u>
<b>Earnings basic and fully diluted</b>		
Net income attributable to ordinary equity holders of the parent	\$ <u>58,514</u>	\$ <u>2,393</u>
<b>Common shares</b>		
<b>Basic:</b>		
Weighted average shares outstanding	49,332	49,544
<b>Diluted:</b>		
Weighted average shares outstanding	49,332	49,544
Effect of dilutive securities		
Share options	<u>207</u>	<u>142</u>
Weighted average, as adjusted	49,539	49,686
<b>Earnings per Share</b>		
Basic	\$ 1.19	\$ 0.05
Diluted	\$ 1.18	\$ 0.05

## 24. Related party balances and transactions

Included within cash and cash equivalents are amounts totaling \$31 (2005 – \$690) on deposit with Trilon International Inc., a shareholder of the Group. These amounts earn interest at rates ranging from 4.61% to 4.89% (2005 – 1.90% to 3.80%) per annum.

Included within investment contract assets is \$12,500 (2005 – \$25,000) recoverable from Trilon International Inc. under the terms of the Financial Support Agreement described in Note 18 with respect to one of the Group's reinsurance contracts.

Included within reinsurance balances payable is an amount payable of \$nil (2005 – \$25,574) due to Century Property & Casualty Insurance Corporation, a related company, with respect to a reinsurance contract. The net underwriting income recorded on this contract during the year was \$151 (2005 – \$498).

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## 24. Related party balances and transactions (Continued)

Included within net investment income are investment asset management fees of \$1,691 (2005 – \$491) to Hyperion Capital Management Inc. and \$nil (2005 – \$1,250) for services provided by Brascan Strategic Asset Management LLC, both of which are considered to be related companies.

Included within operating expenses is rent expense of \$nil (2005 – \$110), for the rental of a property owned by a related company. Also included within operating expenses are key management personnel compensation costs as detailed separately in Note 20(v).

Included within finance costs is interest expense incurred on the subordinated loan from Trilon International Inc. in the amount of \$4,371 (2005 - \$231) up until the date when this loan was retired, and interest incurred on a subordinated loan from Brysons International Limited in the amount of \$377 (2005 - \$nil). Both of these lenders are shareholders of the Group (See Note 16).

## 25. Significant Subsidiaries

Particulars of the Group's principal subsidiaries, all of which are wholly owned, are shown below. Each one of these subsidiaries exceeded any applicable minimum capital requirements of the jurisdictions in which they are domiciled.

<u>Subsidiary</u>	<u>Country of incorporation</u>
Imagine Insurance Company Limited	Barbados
Imagine International Reinsurance Limited	Ireland
Imagine Group (UK) Limited	England
Imagine Syndicate Management Limited	England
Imagine Finance S.a.r.l.	Luxembourg

During 2006, the Group undertook a reorganization of certain of its European subsidiaries. This reorganization, which generally became effective as of October 1, 2006, included the creation of two new subsidiaries, Imagine Group (UK) Limited and Imagine Finance S.a.r.l. Imagine Group (UK) Limited, incorporated under the laws of England, is a direct wholly owned subsidiary of Imagine Insurance Company Limited and holds the shareholdings of all of the U.K. companies within the Imagine Group, including Imagine Syndicate Management Limited. Imagine Finance S.a.r.l., incorporated under the laws of Luxembourg, is a direct wholly owned subsidiary of Imagine Insurance Company Limited and holds the shareholdings of all of the non-U.K. European companies within the Imagine Group, including Imagine International Reinsurance Limited.

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## 26. Commitments and Contingencies

The Group leases office space under operating leases expiring in various years through 2012 (2005 – 2012). The future minimum rental payments related to these commitments are as follows:

	<u>2006</u>	<u>2005</u>
Less than one year	\$ 1,421	\$ 1,063
Between one and five years	4,466	2,099
More than five years	<u>99</u>	<u>114</u>
	\$ <u>5,986</u>	\$ <u>3,276</u>

Included in operating expenses for the year is rent expense on all of the Group's leased premises of \$1,550 (2005 – \$1,844).

From time to time, in connection with its operations, the Group and its subsidiaries are named as defendants in actions for damages and costs allegedly sustained by the plaintiffs including a former Chief Executive Officer of the Group. While it is not possible to estimate the outcome of the various proceedings at this time, such actions have generally been resolved with minimal damages or expense in excess of amounts provided for in these Consolidated Financial Statements and the Group believes that it will not incur any significant additional loss or expense in connection with such actions.

The insurance industry has been the subject of recent regulatory scrutiny, including reviews of transactions considered to involve non-traditional or finite reinsurance products. The Group, like many companies in this industry, received a subpoena in November 2004 from the U.S. Securities and Exchange Commission related to non-traditional products. The Group also received a similar subpoena in June 2005 from the U.S. District Court for the Southern District of New York. The Group is cooperating fully with these agencies and has submitted information in compliance with the subpoenas.

## 27. Comparative figures

Certain comparative amounts for 2005 have been reclassified to conform to the current year's presentation. Goodwill related to the acquisition of Imagine Re (Luxembourg) S.A. in the amount of \$3,960 has been reclassified as a deferred tax asset, better reflecting the economic substance of the transaction. As the deferred tax asset has been realized, the charge has been made to corporation tax expense as opposed to goodwill impairment as was previously the case. There was no impact on the net income after tax or shareholders' equity of the Group as a result of this change.

## 28. Events after the balance sheet date

Between the balance sheet date and the date when the Consolidated Financial Statements were authorized for issue there have been no adjusting events which require recognition or any material non-adjusting events, which require disclosure.