

OneBeacon Insurance Group, Ltd.
Form 10-Q
May 02, 2008

UNITED STATES SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-Q

☒

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

For the period ended March 31, 2008

OR

☐

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

For the transition period from to

Commission file number 1-33128

ONEBEACON INSURANCE GROUP, LTD.

(Exact name of Registrant as specified in its charter)

Bermuda

(State or other jurisdiction of
incorporation or organization)

**601 Carlson Parkway
Minnetonka, Minnesota**

(Address of principal executive offices)

98-0503315

(I.R.S. Employer
Identification No.)

55305

(Zip Code)

Registrant's telephone number, including area code: **(952) 852-2431**

Indicate by check mark whether the Registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Exchange Act during the preceding 12 months (or for such shorter period that the Registrant was required to file such reports), and (2) has been subject to such filing

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requirements for the past 90 days. Yes ☒ No ☐

Indicate by check mark whether the Registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, or a smaller reporting company. See the definitions of large accelerated filer, accelerated filer and smaller reporting company in Rule 12b-2 of the Exchange Act.

Large accelerated filer ☐

Accelerated Filer ☒

Non-accelerated filer ☐
(Do not check if a smaller
reporting company)

Smaller reporting company ☐

Indicate by check mark whether the Registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act).

Yes ☐ No ☒

As of April 30, 2008, 24,168,067 Class A common shares, par value of \$0.01 per share, and 71,754,738 Class B common shares, par value of \$0.01 per share, were outstanding.

ONEBEACON INSURANCE GROUP, LTD.

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PART 1. FINANCIAL INFORMATION**ITEM 1. Financial Statements****ONEBEACON INSURANCE GROUP, LTD.****CONSOLIDATED BALANCE SHEETS**

	March 31, 2008 (Unaudited)	December 31, 2007
	(\$ in millions, except share and per share amounts)	
Assets		
Investment Securities:		
Fixed maturity investments, at fair value (amortized cost \$2,527.0 and \$2,914.4)	\$ 2,583.0	\$ 2,966.6
Common equity securities, at fair value (cost \$722.4 and \$685.3)	833.0	832.1
Convertible bonds, at fair value (amortized cost \$366.8 and \$380.7)	360.2	389.2
Short-term investments, at amortized cost (which approximates fair value)	425.4	327.4
Held-to-maturity investments (assets held in trust):		
Fixed maturity investments, at amortized cost (estimated fair value \$303.7 and \$306.9)	302.0	305.5
Short-term investments, at amortized cost (which approximates fair value)	7.2	0.1
Other investments, at fair value (cost \$246.7 and \$292.7)	338.8	348.6
Total investments	4,849.6	5,169.5
Cash	43.9	49.4
Reinsurance recoverable on unpaid losses	955.0	958.9
Reinsurance recoverable on unpaid losses Berkshire Hathaway, Inc.	1,646.3	1,670.6
Reinsurance recoverable on paid losses	20.5	21.9
Premiums receivable	523.4	529.2
Securities lending collateral	315.4	438.9
Deferred acquisition costs	191.4	200.0
Ceded unearned premiums	78.9	68.1
Net deferred tax asset	24.4	23.5
Investment income accrued	26.2	33.7
Accounts receivable on unsettled investment sales	15.1	76.1
Other assets	301.5	301.7
Total assets	\$ 8,991.6	\$ 9,541.5
Liabilities		
Loss and LAE reserves	\$ 4,460.4	\$ 4,480.3
Unearned premiums	986.9	1,005.9
Debt	755.8	757.7
Securities lending payable	315.4	438.9
Preferred stock subject to mandatory redemption Berkshire Hathaway, Inc. (redemption value \$300.0)	288.9	278.4
Ceded reinsurance payable	108.8	102.8
Accounts payable on unsettled investment purchases	36.5	8.5
Other liabilities	425.9	562.5
Total liabilities	7,378.6	7,635.0
Common shareholders' equity		
Common shares and paid-in surplus (par value \$0.01; authorized, 200,000,000 shares; issued and outstanding, 95,995,608 and 98,465,204 shares)	1,031.9	1,084.4

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Retained earnings	581.8	641.0
Accumulated other comprehensive (loss) income, after-tax:		
Net unrealized gains on investments		168.1
Net unrealized foreign currency translation (losses) gains	(0.3)	12.2
Other comprehensive (loss) income items	(0.4)	0.8
Total common shareholders' equity	1,613.0	1,906.5
Total liabilities and common shareholders' equity	\$ 8,991.6	\$ 9,541.5

See Notes to Consolidated Financial Statements

ONEBEACON INSURANCE GROUP, LTD.

CONSOLIDATED STATEMENTS OF OPERATIONS AND COMPREHENSIVE (LOSS) INCOME

(Unaudited)

	Three months ended March 31,	
	2008	2007
	(\$ in millions, except per share amounts)	
Revenues		
Earned premiums	\$ 455.3	\$ 468.9
Net investment income	50.1	50.6
Net realized investment gains	3.7	54.9
Change in net unrealized investment gains	(59.1)	
Net other revenues	3.6	3.1
Total revenues	453.6	577.5
Expenses		
Loss and LAE	300.9	288.2
Policy acquisition expenses	84.7	78.3
Other underwriting expenses	70.1	90.9
General and administrative expenses	4.4	2.4
Accretion of fair value adjustment to loss and LAE reserves	3.0	4.0
Interest expense on debt	11.5	11.4
Interest expense dividends on preferred stock subject to mandatory redemption	7.1	7.6
Interest expense accretion on preferred stock subject to mandatory redemption	10.5	8.2
Total expenses	492.2	491.0
Pre-tax (loss) income	(38.6)	86.5
Income tax benefit (provision)	14.3	(26.0)
Net (loss) income	(24.3)	60.5
Change in net unrealized gains and losses for investments held		43.6
Recognition of net unrealized gains and losses for investments sold		(36.3)
Change in foreign currency translation		1.5
Change in other comprehensive income and loss items	(1.2)	0.2
Comprehensive net (loss) income	\$ (25.5)	\$ 69.5
Basic and diluted (loss) earnings per share		
Basic:		
Net (loss) income available to common shareholders	\$ (0.25)	\$ 0.61
Diluted:		
Net (loss) income available to common shareholders	\$ (0.25)	\$ 0.61
Dividends declared and paid per common share	\$ 2.24	\$ 0.21

See Notes to Consolidated Financial Statements

ONEBEACON INSURANCE GROUP, LTD.
CONSOLIDATED STATEMENTS OF COMMON SHAREHOLDERS EQUITY
(Unaudited)

	Common shareholders equity	Common shares and paid-in surplus (\$ in millions)	Retained earnings	Accum. other comprehensive income (loss), after-tax
Balances at January 1, 2008	\$ 1,906.5	\$ 1,084.4	\$ 641.0	\$ 181.1
Adjustment to adopt SFAS No. 159, after-tax			180.6	(180.6)
Net loss	(24.3)		(24.3)	
Accrued option expense	0.3	0.3		
Repurchases and retirements of Class A common shares	(52.8)	(52.8)		
Dividends	(215.5)		(215.5)	
Other comprehensive loss, after-tax	(1.2)			(1.2)
Balances at March 31, 2008	\$ 1,613.0	\$ 1,031.9	\$ 581.8	\$ (0.7)

	Common shareholders equity	Common shares and paid-in surplus (\$ in millions)	Retained earnings	Accum. other comprehensive income, after-tax
Balances at January 1, 2007	\$ 1,777.2	\$ 1,115.9	\$ 474.4	\$ 186.9
Adjustment to adopt FIN 48	(0.3)		(0.3)	
Net income	60.5		60.5	
Accrued option expense	0.3	0.3		
Dividends	(21.0)		(21.0)	
Other comprehensive income, after-tax	9.0			9.0
Balances at March 31, 2007	\$ 1,825.7	\$ 1,116.2	\$ 513.6	\$ 195.9

See Notes to Consolidated Financial Statements

ONEBEACON INSURANCE GROUP, LTD.

CONSOLIDATED STATEMENTS OF CASH FLOWS

(Unaudited)

	Three months ended			
	2008	March 31, (\$ in millions)	2007	
Cash flows from operations:				
Net (loss) income	\$	(24.3)	\$	60.5
Charges (credits) to reconcile net (loss) income to cash flows used for operations:				
Net realized investment gains		(3.7)		(54.9)
Change in net unrealized investment gains		59.1		
Net realized gains from sale of common stock of subsidiary		(1.0)		
Dividends paid on mandatorily redeemable preferred stock of subsidiaries				7.6
Other operating items:				
Net change in loss and LAE reserves		(19.9)		(63.8)
Net change in unearned premiums		(19.0)		(13.6)
Net change in ceded reinsurance payable		6.0		13.0
Net change in premiums receivable		5.8		26.6
Net change in reinsurance recoverable on paid and unpaid losses		29.6		34.0
Net change in other assets and liabilities		(128.6)		(115.2)
Net cash used for operations		(96.0)		(105.8)
Cash flows from investing activities:				
Net maturities, purchases and sales of short-term investments		(96.8)		(8.0)
Purchases of short-term held-to-maturity investments		(7.1)		
Sales of fixed maturity investments		541.2		467.5
Maturities of fixed maturity investments		112.7		161.3
Maturities of investments held-to-maturity		3.4		6.9
Sales of common equity securities		75.8		99.4
Sales of convertible bonds		55.1		18.2
Sales of other investments		18.4		16.0
Purchases of fixed maturity investments		(265.8)		(467.9)
Purchases of common equity securities		(108.8)		(65.8)
Purchases of convertible bonds		(41.9)		(61.8)
Purchases of other investments		(18.5)		(5.7)
Sales of common stock of subsidiary, net of sales costs		4.2		
Net change in unsettled investment purchases and sales		89.0		(27.7)
Net acquisitions of property and equipment		(0.1)		(1.2)
Net cash provided from investing activities		360.8		131.2
Cash flows from financing activities:				
Repayment of debt		(2.0)		(2.0)
Repurchases and retirements of Class A common shares		(52.8)		
Cash dividends paid to common shareholders		(215.5)		(21.0)
Dividends paid on mandatorily redeemable preferred stock of subsidiaries				(7.6)
Net cash used for financing activities		(270.3)		(30.6)
Net decrease in cash during period		(5.5)		(5.2)
Cash balance at beginning of period		49.4		41.5
Cash balance at end of period	\$	43.9	\$	36.3
Supplemental cash flows information:				
Interest paid	\$	0.8	\$	0.9
Net Federal income taxes paid		18.6		42.3

See Notes to Consolidated Financial Statements

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

NOTE 1. Nature of Operations and Summary of Significant Accounting Policies

Basis of presentation

These interim consolidated financial statements include the accounts of OneBeacon Insurance Group, Ltd. (the Company or the Registrant) and its subsidiaries (collectively, OneBeacon) and have been prepared in accordance with accounting principles generally accepted in the United States of America (GAAP). The OneBeacon operating companies are U.S.-based property and casualty insurance writers, substantially all of which operate in a multi-company pool. OneBeacon offers a wide range of specialty, commercial and personal products and services sold primarily through select independent agencies and brokers.

OneBeacon was acquired by White Mountains Group, Ltd. (White Mountains) from Aviva plc (Aviva, formerly CGNU) in 2001 (the OneBeacon Acquisition). White Mountains is a holding company whose businesses provide property and casualty insurance, reinsurance and certain other products. During the fourth quarter of 2006, White Mountains sold 27.6 million or 27.6% of the Company's common shares in an initial public offering. Prior to the initial public offering, OneBeacon was a wholly-owned subsidiary of White Mountains. As of March 31, 2008, White Mountains owned 74.7% of the Company's common shares. Within this report, the term OneBeacon is used to refer to one or more entities within the consolidated organization, as the context requires. The Company is a Bermuda exempted limited company with its headquarters located at the Bank of Butterfield Building, 42 Reid Street, 6th Floor, Hamilton HM 12, Bermuda. The Company's U.S. headquarters are located at 1 Beacon Lane, Canton, Massachusetts 02021, its principal executive office is located at 601 Carlson Parkway, Minnetonka, Minnesota 55305 and its registered office is located at Clarendon House, 2 Church Street, Hamilton HM 11, Bermuda. OneBeacon's reportable segments are Primary Insurance Operations and Other Operations, as defined below.

OneBeacon's Primary Insurance Operations segment includes the results of substantially all of its insurance operations. OneBeacon's Other Operations segment consists of the Company and its intermediate holding companies.

All significant intercompany transactions have been eliminated in consolidation. These interim financial statements include all adjustments, consisting of a normal recurring nature, considered necessary by management to fairly present the financial position, results of operations and cash flows of OneBeacon. These interim financial statements may not be indicative of financial results for the full year and should be read in conjunction with the Company's 2007 Annual Report on Form 10-K. The preparation of financial statements in conformity with GAAP requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities as of the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates. Refer to the Company's 2007 Annual Report on Form 10-K for a complete discussion regarding OneBeacon's significant accounting policies. Certain amounts in the prior period financial statements have been reclassified to conform with the current presentation.

Recently Adopted Changes in Accounting Principles

Fair Value Measurements

On January 1, 2008, OneBeacon adopted Financial Accounting Standards Board (FASB) Statement of Financial Accounting Standards (SFAS) No. 157, Fair Value Measurements (SFAS 157). SFAS 157 provides a revised definition of fair value, establishes a framework for measuring fair value and expands financial statement disclosure requirements for fair value information. Under SFAS 157, fair value is defined as the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants (an exit price). The Statement establishes a fair value hierarchy that distinguishes between inputs based on market data from independent sources (observable inputs) and a reporting entity's internal assumptions based upon the best information available when external market data is limited or unavailable (unobservable inputs). The fair value hierarchy in SFAS 157 prioritizes fair value measurements into three levels based on the nature of the inputs. Quoted prices in active markets for identical assets or liabilities have the highest priority (Level 1), followed by observable inputs other than quoted prices, including prices for similar but not identical assets or liabilities (Level 2) and unobservable inputs, including the reporting entity's estimates of the assumptions that market participants would use, having the lowest priority (Level 3). See Note 5 for further financial statement disclosure required pursuant to SFAS 157.

Fair Value Option

On January 1, 2008, OneBeacon adopted SFAS No. 159, *The Fair Value Option for Financial Assets and Financial Liabilities* (SFAS 159). SFAS 159 allows companies to make an election, on an individual instrument basis, to report financial assets and liabilities at fair value. The election must be made at the inception of a transaction and may not be reversed. The election may also be made for existing financial assets and liabilities at the time of adoption. Unrealized gains and losses on assets or liabilities for which the fair value option has been elected are reported in revenues.

OneBeacon has made the fair value election for its portfolio of available-for-sale securities and its investments in limited partnerships, hedge funds and private equity interests. See Note 5 for further discussion. Upon adoption, OneBeacon recorded an adjustment of \$180.6 million to reclassify net unrealized gains, after tax, and net unrealized foreign currency translation gains, after tax, related to investments from accumulated other comprehensive income to opening retained earnings. Subsequent to adoption, OneBeacon's portfolio of available-for-sale securities was reclassified as trading and changes in fair value are reported in revenues before the effect of tax. See Note 5 for further discussion. The Company believes that making the election results in reporting its investment results on a basis consistent with one of its operating principles, namely to manage investments for total return.

Recent Accounting Pronouncements

Business Combinations and Non-controlling Interests

In December 2007, the FASB issued SFAS No. 141 (Revised 2007), *Business Combinations* (SFAS 141R) and SFAS No. 160, *Noncontrolling Interests* an amendment to ARB 51 (SFAS 160). SFAS 141R requires the acquiring company to recognize the fair value of all assets acquired and liabilities assumed at their fair values at the acquisition date, with certain exceptions including income taxes which will continue to be accounted for under SFAS No. 109, *Accounting for Income Taxes* (SFAS 109). This represents a basic change in approach from the old cost allocation method originally described in SFAS 141. In addition, SFAS 141R changes the accounting for step acquisitions since it requires recognition of all assets acquired and liabilities assumed, regardless of the acquirer's percentage of ownership in the acquiree. This means that the acquirer will measure and recognize all of the assets, liabilities and goodwill, not just the acquirer's share. Assets and liabilities arising from contractual contingencies are to be recognized at the acquisition date, at fair value. Non-contractual contingencies are to be recognized when it is more likely than not that they meet the Statement of Financial Accounting Concepts No. 6, *Elements of Financial Statements (A Replacement of FASB Concepts Statement No. 3 Incorporating an Amendment of FASB Concepts Statement No. 2)* criteria for an asset or liability. Previously under SFAS 141, recognition of preacquisition contingencies was deferred until the criteria in SFAS No. 5, *Accounting for Contingencies*, (SFAS 5) had been met. Changes in the amount of deferred taxes arising from a business combination are to be recognized in either income or through a change in contributed capital, depending on the circumstances. Previously under SFAS 109, such changes were recognized through goodwill. Acquisition related costs, such as legal fees and due diligence costs would be expensed and would not be recognized as part of goodwill. The classification of insurance and reinsurance contracts are re-evaluated at the acquisition date only if their terms were changed in connection with the acquisition.

SFAS 160 requires all companies to account for minority interests in subsidiaries as equity, clearly identified and presented separately from parent company equity. Once a controlling interest has been acquired, any subsequent acquisitions or dispositions of noncontrolling interest that do not result in a change of control are to be accounted for as equity transactions. Assets and liabilities acquired are measured at fair value only once; at the original acquisition date, i.e., the date at which the acquirer gained control. When a subsidiary is deconsolidated, any retained noncontrolling equity investment is to be measured at fair value with the gain or loss on the deconsolidation being measured using fair value rather than the carrying amount of the retained ownership interest.

SFAS 141R and SFAS 160 are effective for fiscal years beginning after December 15, 2008 and shall be applied prospectively. OneBeacon is in the process of evaluating the potential effect of adoption of SFAS 141R and SFAS 160.

Derivatives and Hedging Activities

In March 2008, the FASB issued SFAS No. 161, *Disclosures about Derivative Instruments and Hedging Activities* an Amendment of FASB Statement No. 133 (SFAS 161). SFAS 161 requires disclosure of the following: objectives for using derivative instruments in terms of underlying risk and accounting designation, the fair values of derivative instruments and their gains and losses in a tabular format, and information about credit-risk-related contingent features. SFAS 161 is effective for fiscal years and interim periods beginning after November 15, 2008. OneBeacon is in the process of evaluating the potential effect of adoption of SFAS 161.

NOTE 2. Acquisitions and Dispositions

During the first quarter of 2008, OneBeacon sold one of its inactive licensed subsidiaries, Midwestern Insurance Company (MWIC), to National Guaranty Insurance Company for \$4.2 million in cash and recorded a pre-tax gain of \$1.0 million through net other revenues.

NOTE 3. Reserves for Unpaid Loss and LAE

The following table summarizes the loss and LAE reserve activities of OneBeacon's insurance subsidiaries for the three months ended March 31, 2008 and 2007:

	Three months ended March 31, 2008		2007	
	(\$ in millions)			
Gross beginning balance	\$	4,480.3	\$	4,837.7
Less beginning reinsurance recoverable on unpaid losses		(2,629.5)		(2,842.6)
Net loss and LAE reserves		1,850.8		1,995.1
Loss and LAE incurred relating to:				
Current year losses		313.5		300.2
Prior year losses		(12.6)		(12.0)
Total incurred loss and LAE		300.9		288.2
Accretion of fair value adjustment to net loss and LAE reserves		3.0		4.0
Loss and LAE paid relating to:				
Current year losses		(68.1)		(76.0)
Prior year losses		(227.5)		(257.9)
Total loss and LAE payments		(295.6)		(333.9)
Net ending balance		1,859.1		1,953.4
Plus ending reinsurance recoverable on unpaid losses		2,601.3		2,820.5
Gross ending balance	\$	4,460.4	\$	4,773.9

During the three months ended March 31, 2008, OneBeacon experienced \$12.6 million of favorable development on prior accident year loss reserves due to lower than expected severity on non-catastrophe losses and favorable development on a prior accident year catastrophe. The favorable non-catastrophe development was primarily related to property in commercial lines and professional liability in specialty lines. During the three months ended March 31, 2007, OneBeacon experienced \$12.0 million of favorable development on prior accident year loss reserves. The favorable development was primarily related to lower than expected frequency for professional liability in specialty lines and lower than expected severity for automobile liability in personal lines partially offset by unfavorable development for multiple peril and workers compensation primarily for accident years 2001 and prior.

In connection with purchase accounting for the OneBeacon Acquisition, loss and LAE reserves and the related reinsurance recoverables were adjusted to fair value on the balance sheets. The net reduction to loss and LAE reserves is being recognized through an income statement charge ratably with and over the period the claims are settled. Accordingly, OneBeacon recognized \$3.0 million and \$4.0 million of such charges for the three months ended March 31, 2008 and 2007, respectively. As of March 31, 2008, the outstanding pre-tax unaccrued adjustment was \$14.4 million.

NOTE 4. Reinsurance

In the normal course of business, OneBeacon's insurance subsidiaries seek to limit losses that may arise from catastrophes or other events by reinsuring with third party reinsurers. OneBeacon remains liable for risks reinsured even if the reinsurer does not honor its obligations under reinsurance contracts.

Effective July 1, 2007, OneBeacon renewed its property catastrophe reinsurance program through June 30, 2008. The program provides coverage for OneBeacon's property business including automobile physical damage, as well as terrorism coverage for non-Terrorism Risk Insurance Act of 2002 (the Terrorism Act) events (excluding nuclear, biological, chemical and radiological). Under the program, the first \$150 million of losses resulting from any single catastrophe are retained and \$650 million of the next \$700 million of losses resulting from the catastrophe are reinsured. Any loss above \$850 million would be retained. In the event of a catastrophe, OneBeacon's property catastrophe reinsurance program is reinstated for the remainder of the original contract term by paying a reinstatement premium that is based on the percentage of coverage reinstated and the original property catastrophe coverage premium.

At March 31, 2008, OneBeacon had \$20.5 million of reinsurance recoverables on paid losses and \$2,818.4 million (gross of \$217.1 million in purchase accounting adjustments, as described in Note 3) that will become recoverable if claims are paid in accordance with current reserve estimates. The collectibility of balances due from OneBeacon's reinsurers is critical to OneBeacon's financial strength because reinsurance contracts do not relieve OneBeacon of its obligation to its insureds. OneBeacon is selective with its reinsurers, placing reinsurance with only those reinsurers having a strong financial condition. OneBeacon monitors the financial strength of its reinsurers on an ongoing basis. As a result, uncollectible amounts have historically not been significant. The following table provides a listing of OneBeacon's top reinsurers for its primary insurance operations, excluding industry pools and associations and affiliates of OneBeacon, based upon recoverable amounts, the percentage of total reinsurance recoverables and the reinsurers' A.M. Best ratings.

(\$ in millions)	Balance at March 31, 2008	% of total	A.M. Best Rating(1)
National Indemnity Company and General Reinsurance Corporation(2)	\$ 2,049.7	78%	A++
Tokio Marine and Nichido Fire	57.6	2%	A++
Munich Reinsurance America (formerly America Reinsurance Company)	46.3	2%	A+
Swiss Re	26.5	1%	A+
Liberty Mutual and subsidiaries(3)	25.7	1%	A

(1) A.M. Best ratings as detailed above are: A++ (Superior, which is the highest of fifteen ratings), A+ (Superior, which is the second highest of fifteen ratings) and A (Excellent, which is the third highest of fifteen ratings).

(2) Includes \$404.0 million of Third Party Recoverables, which NICO would pay under the terms of the NICO Cover if they are unable to collect from third party reinsurers. OneBeacon also has an additional \$304.6 million of Third Party Recoverables from various reinsurers, the majority of which are rated A or better by A.M. Best.

(3) At March 31, 2008, OneBeacon had assumed balances payable and expenses payable of approximately \$26.4 million under its renewal rights agreement with Liberty Mutual, which expired on October 31, 2003.

In connection with the OneBeacon Acquisition, Aviva caused OneBeacon to purchase two reinsurance contracts: a reinsurance contract with National Indemnity Company (NICO), for up to \$2.5 billion in old asbestos and environmental (A&E) claims and certain other exposures (the NICO Cover) and an adverse development cover from General Reinsurance Corporation (GRC) for up to \$570.0 million, comprised of \$400.0 million of adverse development on losses occurring in years 2000 and prior (the GRC Cover) in addition to \$170.0 million of reserves ceded as of the date of the OneBeacon Acquisition. The NICO Cover and GRC Cover, which were contingent on and occurred contemporaneously with the OneBeacon Acquisition, were put in place in lieu of a seller guarantee of loss and LAE reserves and are therefore accounted for as a seller guarantee under GAAP in accordance with Emerging Issues Task Force Technical Matter Document No. D-54 (EITF Topic D-54). NICO and GRC are wholly-owned subsidiaries of Berkshire Hathaway, Inc. (Berkshire).

Under the terms of the NICO Cover, NICO receives the economic benefit of reinsurance recoverables from certain of OneBeacon's third party reinsurers (Third Party Reinsurers) in existence at the time the NICO Cover was executed (Third Party Recoverables). As a result, the Third Party Recoverables serve to protect the \$2.5 billion limit of NICO coverage for the benefit of OneBeacon. OneBeacon estimates that on an incurred basis, net of Third Party Recoverables, as of March 31, 2008 it has used approximately \$2.1 billion of the coverage provided by NICO. Approximately \$1.0 billion of these incurred losses have been paid by NICO through March 31, 2008. Since entering into the NICO Cover, \$40.4 million of the \$2.1 billion of utilized coverage from NICO related to uncollectible Third Party Recoverables. To the extent that actual experience differs from OneBeacon's estimate of ultimate A&E losses and Third Party Recoverables, future losses could utilize some or all of the protection remaining under the NICO Cover.

Pursuant to the GRC Cover, OneBeacon is not entitled to recover losses to the full contract limit if such losses are reimbursed by GRC more quickly than anticipated at the time the contract was signed. OneBeacon intends to only seek reimbursement from GRC for claims which result in payment patterns similar to those supporting its recoverables recorded pursuant to the GRC Cover. The economic cost of not submitting certain other eligible claims to GRC is primarily the investment spread between the rate credited by GRC and the rate achieved by OneBeacon on its own investments. This cost, if any, is expected to be small.

NOTE 5. Investment Securities

OneBeacon's invested assets are comprised of securities and other investments held for general investment purposes and assets held in an irrevocable grantor trust account. Refer to the Company's 2007 Annual Report on Form 10-K for a complete discussion regarding the trust account.

Prior to adoption of SFAS 159, OneBeacon's fixed maturity investments and common equity securities, excluding convertible bonds which are described below, held for general investment purposes, were classified as available-for-sale and reported at fair value. Net unrealized investment gains and losses on available-for-sale securities were reported net, after-tax, as a separate component of shareholders' equity. Changes in net unrealized investment gains and losses, after-tax, were reported as a component of other comprehensive income. Upon adoption of SFAS 159 on January 1, 2008, the portfolio of fixed maturity investments and common equity securities, excluding convertible bonds, held for general investment purposes were reclassified as trading. Trading securities are reported at fair value as of the balance sheet date as determined by quoted market prices when available. Realized and unrealized investment gains and losses on trading securities are reported, pre-tax in revenues. See *Recently Adopted Changes in Accounting Principles* of Note 1 for further discussion.

OneBeacon has elected the fair value option under SFAS 159 for its investments in convertible bonds effective January 1, 2008. Convertible bonds are carried at fair value with changes therein recorded in revenues as unrealized investment gains or losses. See *Recently Adopted Changes in Accounting Principles* of Note 1 for further discussion. Prior to adoption of SFAS 159, OneBeacon recorded its convertible bonds in accordance with SFAS No. 155, *Accounting for Certain Hybrid Instruments*, an amendment to Statements No. 133 and 140 (SFAS 155). Under SFAS 155, OneBeacon had accounted for the convertible bonds on a fair value basis with changes in fair value recorded through income as realized investment gains or losses.

The fixed maturity investments held in the trust account are classified as held-to-maturity as OneBeacon has the ability and intent to hold the investments until maturity. Securities classified as held-to-maturity are recorded at amortized cost.

Short-term investments consist of money market funds, certificates of deposit and other securities which, at the time of purchase, mature or become available for use within one year. Certain of the investments purchased to fund the trust matured within one year and were therefore reflected as short-term investments. In addition, interest payments on the assets in the trust may be reinvested in short-term investments. Short-term investments are carried at amortized cost, which approximated fair value as of March 31, 2008 and December 31, 2007.

Other investments include limited partnerships, hedge funds and private equity interests. Prior to January 1, 2008, changes in OneBeacon's interest in other investments accounted for using the equity method were included in net realized investment gains (losses). Changes in OneBeacon's interest in other investments not accounted for under the equity method were reported, net of tax, as a component of common shareholders' equity with changes therein reported, after-tax, as a component of other comprehensive income. Upon adoption of SFAS 159 on January 1, 2008, OneBeacon measures its investments in limited partnerships, hedge funds and private equity interests at fair value with changes therein reported in revenues on a pre-tax basis. See *Recently Adopted Changes in Accounting Principles* of Note 1 for further discussion.

Investment securities are regularly reviewed for impairment based on criteria that include the extent to which cost exceeds market value, the duration of the market decline, the financial health of and specific prospects for the issuer and the ability and intent to hold the investment to recovery. Investment losses that are determined to be other than temporary are recognized in revenues through net realized investment gains (losses). Realized gains and losses resulting from sales of investment securities are accounted for using the weighted average method. Premiums and discounts on fixed maturity investments are accreted to income over the anticipated life of the investment.

OneBeacon's net investment income is comprised primarily of interest income associated with OneBeacon's fixed maturity investments, dividend income from its equity investments and interest income from its short-term investments. Net investment income for the three months ended March 31, 2008 and 2007 consisted of the following:

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	Three months ended March 31, (\$ in millions)	
	2008	2007
Investment income:		
Fixed maturity investments	\$ 42.9	\$ 44.0
Short-term investments	3.6	4.5
Common equity securities	4.8	3.3
Convertible bonds	1.6	1.3
Other investments	0.5	0.6
Total investment income	53.4	53.7
Less investment expenses	(3.3)	(3.1)
Net investment income, pre-tax	\$ 50.1	\$ 50.6

The composition of net realized investment gains consisted of the following:

		Three months ended March 31, 2008	2007
		(\$ in millions)	
Fixed maturity investments	\$	(6.7)	\$ 5.8
Common equity securities		4.1	40.6
Convertible bonds		3.7	
Other investments		2.6	8.5
Net realized investment gains, pre-tax	\$	3.7	\$ 54.9

During the three months ended March 31, 2008, OneBeacon recognized \$11.4 million in pre-tax other-than-temporary impairment charges. During the three months ended March 31, 2007, OneBeacon did not recognize any material pre-tax other-than-temporary impairment charges.

The components of OneBeacon's ending net unrealized investment gains on its available-for-sale investment portfolio were as follows:

	Year ended December 31, 2007 (\$ in millions)
Investment securities:(1)	
Gross unrealized investment gains	\$ 269.2
Gross unrealized investment losses	(32.9)
Net unrealized gains from investment securities	236.3
Income taxes attributable to such gains	(81.6)
Total net unrealized investment gains, after-tax	\$ 154.7

(1) Does not include deferred gains and losses on sales of investments between OneBeacon and entities under White Mountains' common control of \$13.4 million, after-tax, as of December 31, 2007.

In connection with the initial public offering, two irrevocable grantor trusts were established to economically defease the Company's mandatorily redeemable preferred stock. The assets of each trust are solely dedicated to payments of dividends and redemption amounts on the mandatorily redeemable preferred stock. The assets held in trust include fixed maturity and short-term investments which are classified and accounted for as held-to-maturity. During the second quarter of 2007, trust assets were utilized to redeem the \$20.0 million Zenith Insurance Company (Zenith) Preferred Stock (Zenith Preferred Stock). Refer to the Company's 2007 Annual Report on Form 10-K for a complete discussion of the economic defeasance of the Company's mandatorily redeemable preferred stock. The carrying value, gross unrealized investment gains and losses, and estimated market values of OneBeacon's fixed maturity held-to-maturity investments, carried at amortized cost, as of March 31, 2008 and December 31, 2007 were as follows:

Carrying Value	Gross unrealized gains	March 31, 2008 Gross unrealized	Net foreign currency gains	Estimated Fair Value
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				losses (\$ in millions)			
U.S. Government obligations	\$	302.0	\$	1.7	\$	\$	303.7
Total fixed maturity investments	\$	302.0	\$	1.7	\$	\$	303.7

				December 31, 2007 Gross unrealized losses (\$ in millions)		Net foreign currency gains	Estimated Fair Value
	Carrying Value		Gross unrealized gains				
U.S. Government obligations	\$	305.5	\$	1.4	\$	\$	306.9
Total fixed maturity investments	\$	305.5	\$	1.4	\$	\$	306.9

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The cost or amortized cost, gross unrealized investment gains and losses, and carrying values of OneBeacon's fixed maturity investments as of March 31, 2008 and December 31, 2007, were as follows:

	Cost or amortized cost	Gross unrealized gains	March 31, 2008 Gross unrealized losses (\$ in millions)	Net foreign currency gains	Carrying value
U.S. Government and agency obligations	\$ 384.4	\$ 28.3	\$	\$	\$ 412.7
Debt securities issued by industrial corporations	938.5	16.1	(16.1)	9.0	947.5
Municipal obligations	8.1	0.4			8.5
Asset-backed securities	995.1	16.0	(7.3)		1,003.8
Foreign government obligations					