

S&T BANCORP INC  
Form 10-Q  
August 07, 2014  
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SECURITIES AND EXCHANGE COMMISSION  
WASHINGTON, DC 20549

FORM 10-Q

(Mark One)

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

For the quarterly period ended June 30, 2014

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 0-12508

S&T BANCORP, INC.  
(Exact name of registrant as specified in its charter)

Pennsylvania  
(State or other jurisdiction of incorporation or organization) 25-1434426  
(IRS Employer Identification No.)

800 Philadelphia Street, Indiana, PA 15701  
(Address of principal executive offices) (zip code)

800-325-2265  
(Registrant's telephone number, including area code)

Not Applicable

(Former name, former address, and former fiscal year, if changed since last report)

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

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (Section 232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). 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 definition 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  Smaller reporting company

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

APPLICABLE ONLY TO CORPORATE ISSUERS:

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Indicate the number of shares outstanding of each of the issuer's classes of common stock, as of the latest practical date.

Common Stock, \$2.50 Par Value - 29,796,397 shares as of July 31, 2014

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S&T BANCORP, INC. AND SUBSIDIARIES

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CONSOLIDATED BALANCE SHEETS

	June 30, 2014	December 31, 2013
	(Unaudited)	(Audited)
(dollars in thousands, except share data)		
<b>ASSETS</b>		
Cash and due from banks, including interest-bearing deposits of \$54,575 and \$53,594 at June 30, 2014 and December 31, 2013, respectively	\$ 130,235	\$ 108,356
Securities available-for-sale, at fair value	588,488	509,425
Loans held for sale	3,102	2,136
Portfolio loans, net of unearned income	3,725,079	3,566,199
Allowance for loan losses	(46,580)	(46,255)
Portfolio loans, net	3,678,499	3,519,944
Bank owned life insurance	61,348	60,480
Premises and equipment, net	36,665	36,615
Federal Home Loan Bank and other restricted stock, at cost	15,818	13,629
Goodwill	175,820	175,820
Other intangible assets, net	3,146	3,759
Other assets	94,909	103,026
<b>Total Assets</b>	<b>\$4,788,030</b>	<b>\$4,533,190</b>
<b>LIABILITIES</b>		
Deposits:		
Noninterest-bearing demand	\$1,089,999	\$992,779
Interest-bearing demand	307,897	312,790
Money market	301,719	281,403
Savings	1,024,050	994,805
Certificates of deposit	1,141,581	1,090,531
<b>Total Deposits</b>	<b>3,865,246</b>	<b>3,672,308</b>
Securities sold under repurchase agreements	25,269	33,847
Short-term borrowings	185,000	140,000
Long-term borrowings	20,636	21,810
Junior subordinated debt securities	45,619	45,619
Other liabilities	49,073	48,300
<b>Total Liabilities</b>	<b>4,190,843</b>	<b>3,961,884</b>
<b>SHAREHOLDERS' EQUITY</b>		
Common stock (\$2.50 par value)		
Authorized—50,000,000 shares		
Issued—31,197,365 shares at June 30, 2014 and December 31, 2013	77,993	77,993
Outstanding—29,797,204 shares at June 30, 2014 and 29,737,725 shares at December 31, 2013		
Additional paid-in capital	78,570	78,140
Retained earnings	485,277	468,158
Accumulated other comprehensive income (loss)	(6,026)	(12,694)
Treasury stock 1,400,161 shares at June 30, 2014 and 1,459,640 shares at December 31, 2013, (at cost)	(38,627)	(40,291)
<b>Total Shareholders' Equity</b>	<b>597,187</b>	<b>571,306</b>

Total Liabilities and Shareholders' Equity	\$4,788,030	\$4,533,190
See Notes to Consolidated Financial Statements		

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S&T BANCORP, INC. AND SUBSIDIARIES  
CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME  
(Unaudited)

	Three Months Ended June 30,		Six Months Ended June 30,	
(dollars in thousands, except per share data)	2014	2013	2014	2013
<b>INTEREST INCOME</b>				
Loans, including fees	\$36,614	\$35,765	\$72,263	\$70,810
Investment Securities:				
Taxable	2,184	1,879	4,167	3,742
Tax-exempt	979	815	1,908	1,648
Dividends	95	94	199	196
Total Interest Income	39,872	38,553	78,537	76,396
<b>INTEREST EXPENSE</b>				
Deposits	2,476	2,951	4,986	6,153
Borrowings and junior subordinated debt securities	541	1,006	1,105	1,978
Total Interest Expense	3,017	3,957	6,091	8,131
<b>NET INTEREST INCOME</b>	36,855	34,596	72,446	68,265
Provision for loan losses	(1,134)	)1,023	(845)	)3,330
Net Interest Income After Provision for Loan Losses	37,989	33,573	73,291	64,935
<b>NONINTEREST INCOME</b>				
Securities gains, net	40	—	41	2
Wealth management fees	2,837	2,820	5,792	5,396
Debit and credit card fees	2,724	3,150	5,226	5,601
Service charges on deposit accounts	2,574	2,495	5,083	4,943
Insurance fees	1,425	1,643	3,102	3,418
Mortgage banking	264	911	396	1,393
Gain on sale of merchant card servicing business	—	—	—	3,093
Other	1,907	1,848	3,547	3,827
Total Noninterest Income	11,771	12,867	23,187	27,673
<b>NONINTEREST EXPENSE</b>				
Salaries and employee benefits	15,772	14,725	31,148	30,792
Data processing	2,219	2,137	4,314	4,801
Net occupancy	1,984	1,958	4,214	4,127
Furniture and equipment	1,277	1,230	2,548	2,538
Marketing	960	793	1,578	1,482
Other taxes	893	915	1,524	1,914
Professional services and legal	875	1,171	1,538	2,145
FDIC insurance	579	707	1,210	1,483
Other	5,606	4,750	11,005	10,720
Total Noninterest Expense	30,165	28,386	59,079	60,002
Income Before Taxes	19,595	18,054	37,399	32,606
Provision for income taxes	4,875	3,951	8,646	6,173
Net Income	\$14,720	\$14,103	\$28,753	\$26,433
Earnings per share—basic	\$0.49	\$0.47	\$0.97	\$0.89
Earnings per share—diluted	\$0.49	\$0.47	\$0.97	\$0.89
Dividends declared per share	\$0.17	\$0.15	\$0.33	\$0.30
Comprehensive Income	\$18,343	\$6,651	\$35,421	\$18,220

See Notes to Consolidated Financial Statements

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S&T BANCORP, INC. AND SUBSIDIARIES  
CONSOLIDATED STATEMENTS OF CHANGES IN SHAREHOLDERS' EQUITY  
(Unaudited)

(dollars in thousands, except shares and per share data)	Common Stock	Additional Paid-in Capital	Retained Earnings	Accumulated Other Comprehensive Income (Loss)	Treasury Stock	Total
Balance at January 1, 2013	\$77,993	\$77,458	\$436,039	\$ (13,582 )	\$(40,486 )	\$537,422
Net income for six months ended June 30, 2013	—	—	26,433	—	—	26,433
Other comprehensive income (loss), net of tax	—	—	—	(8,213 )	—	(8,213 )
Cash dividends declared (\$0.30 per share)	—	—	(8,918 )	—	—	(8,918 )
Treasury stock issued for restricted awards (22,189 shares, net of 16,093 forfeitures)	—	—	(296 )	—	210	(86 )
Recognition of restricted stock compensation expense	—	261	—	—	—	261
Tax expense from stock-based compensation	—	(47 )	—	—	—	(47 )
Balance at June 30, 2013	\$77,993	\$77,672	\$453,258	\$ (21,795 )	\$(40,276 )	\$546,852
Balance at January 1, 2014	\$77,993	\$78,140	\$468,158	\$ (12,694 )	\$(40,291 )	\$571,306
Net income for six months ended June 30, 2014	—	—	28,753	—	—	28,753
Other comprehensive income (loss), net of tax	—	—	—	6,668	—	6,668
Cash dividends declared (\$0.33 per share)	—	—	(9,810 )	—	—	(9,810 )
Treasury stock issued for restricted awards (80,455 shares, net of 20,976 forfeitures)	—	—	(1,824 )	—	1,664	(160 )
Recognition of restricted stock compensation expense	—	430	—	—	—	430
Tax expense from stock-based compensation	—	—	—	—	—	—
Balance at June 30, 2014	\$77,993	\$78,570	\$485,277	\$ (6,026 )	\$(38,627 )	\$597,187

See Notes to Consolidated Financial Statements



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S&T BANCORP, INC. AND SUBSIDIARIES  
CONSOLIDATED STATEMENTS OF CASH FLOWS  
(Unaudited)

(dollars in thousands)	Six Months Ended June 30,	
	2014	2013
<b>OPERATING ACTIVITIES</b>		
Net income	\$28,753	\$26,433
Adjustments to reconcile net income to net cash provided by operating activities:		
Provision for loan losses	(845	)3,330
Provision for unfunded loan commitments	182	302
Depreciation and amortization	2,309	3,061
Net amortization of discounts and premiums	1,898	1,776
Stock-based compensation expense	395	254
Securities gains, net	(41	)(2 )
Net gain on sale of merchant card servicing business	—	(3,093 )
Tax expense from stock-based compensation	—	47
Mortgage loans originated for sale	(13,057	)(37,706 )
Proceeds from the sale of loans	13,475	57,667
Gain on the sale of loans, net	(85	)(647 )
Net increase in interest receivable	(243	)(1,222 )
Net decrease in interest payable	(186	)(1,241 )
Net decrease in other assets	10,016	17,243
Net increase (decrease) in other liabilities	1,199	(20,981 )
Net Cash Provided by Operating Activities	43,770	45,221
<b>INVESTING ACTIVITIES</b>		
Purchases of securities available-for-sale	(108,845	)(66,495 )
Proceeds from maturities, prepayments and calls of securities available-for-sale	36,343	23,240
Proceeds from sales of securities available-for-sale	1,418	94
Net (payments for) proceeds from Federal Home Loan Bank stock	(2,189	)1,356
Net increase in loans	(169,209	)(103,846 )
Proceeds from sale of loans not originated for resale	4,108	—
Purchases of premises and equipment	(1,719	)(1,400 )
Proceeds from the sale of premises and equipment	64	576
Proceeds from the sale of merchant card servicing business	—	4,750
Net Cash Used in Investing Activities	(240,029	)(141,725 )
<b>FINANCING ACTIVITIES</b>		
Net increase (decrease) in core deposits	141,888	(26,999 )
Net increase in certificates of deposit	50,972	36,842
Net (decrease) increase in securities sold under repurchase agreements	(8,578	)11,569
Net increase in short-term borrowings	45,000	50,000
Repayments of long-term borrowings	(1,174	)(11,136 )
Repayment of junior subordinated debt	—	(45,000 )
Treasury shares purchased-net	(160	)(86 )
Cash dividends paid to common shareholders	(9,810	)(8,918 )
Tax expense from stock-based compensation	—	(47 )
Net Cash Provided by Financing Activities	218,138	6,225
Net increase (decrease) in cash and cash equivalents	21,879	(90,279 )

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Cash and cash equivalents at beginning of period	108,356	337,711
Cash and Cash Equivalents at End of Period	\$130,235	\$247,432
Supplemental Disclosures		
Loans transferred to held for sale	\$1,300	\$—
Interest paid	6,278	9,372
Income taxes paid, net of refunds	8,400	5,155
Transfers of loans to other real estate owned	\$274	\$180
See Notes to Consolidated Financial Statements		

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S&T BANCORP, INC. AND SUBSIDIARIES  
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

NOTE 1. BASIS OF PRESENTATION

Principles of Consolidation

The interim Consolidated Financial Statements include the accounts of S&T Bancorp, Inc., or S&T, and its wholly owned subsidiaries. All significant intercompany transactions have been eliminated in consolidation. Investments of 20 percent to 50 percent of the outstanding common stock of investees are accounted for using the equity method of accounting.

Basis of Presentation

The accompanying unaudited interim Consolidated Financial Statements of S&T have been prepared in accordance with generally accepted accounting principles, or GAAP, in the United States for interim financial information and with the instructions to Form 10-Q and Article 10 of Regulation S-X. Accordingly, they do not include all of the information and footnotes required by GAAP for complete financial statements and should be read in conjunction with our annual report on Form 10-K for the year ended December 31, 2013, filed with the Securities and Exchange Commission, or SEC, on February 21, 2014. In the opinion of management, the accompanying interim financial information reflects all adjustments, including normal recurring adjustments, necessary to present fairly our financial position and the results of operations for each of the interim periods presented. Results of operations for interim periods are not necessarily indicative of the results of operations that may be expected for a full year or any future period.

Reclassification

Certain amounts in the prior periods' financial statements and footnotes have been reclassified to conform to the current period's presentation. The reclassifications had no significant effect on our results of operations or financial condition.

Use of Estimates

The preparation of financial statements in conformity with GAAP requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosures of contingent assets and liabilities at the date of the financial statements. Actual results could differ from those estimates.

Recently Adopted Accounting Standards Updates, or ASU

Presentation of an Unrecognized Tax Benefit When a Net Operating Loss Tax Credit Carry forward Exists

In July 2013, the Financial Accounting Standards Board (FASB) issued ASU No. 2013-11, Presentation of an Unrecognized Tax Benefit When a Net Operating Loss Tax Credit Carry forward Exists. The ASU requires that entities should present an unrecognized tax benefit as a reduction of the deferred tax asset for a net operating loss, or NOL, or similar tax loss or tax credit carry forward rather than as a liability when the uncertain tax position would reduce the NOL or other carry forward under the tax law. The new standard is effective for fiscal years, and interim periods within those years, beginning after December 15, 2013, and should be applied prospectively to all unrecognized tax benefits that exist at the effective date. Retrospective application is permitted. The adoption of this ASU had no impact on our results of operations or financial position.

Obligations Resulting from Joint and Several Liability Arrangements for Which the Total Amount of the Obligation is Fixed at the Reporting Date

In February 2013, the FASB issued ASU No. 2013-04, Obligations Resulting from Joint and Several Liability Arrangements for Which the Total Amount of the Obligation is Fixed at the Reporting Date. The ASU requires the measurement of obligations resulting from joint and several liability arrangements for which the total amount of the obligation is fixed at the reporting date as the sum of the amount the reporting entity agreed to pay on the basis of its arrangement with its co-obligors as well as any additional amount that the entity expects to pay on behalf of its co-obligors. The new standard is effective retrospectively for fiscal years and interim periods within those years,

beginning after December 15, 2013, and early adoption is permitted. The adoption of this ASU had no impact on our results of operations or financial position.

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S&T BANCORP, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS – continued

NOTE 1. BASIS OF PRESENTATION – continued

Recently Issued Accounting Standards Updates not yet Adopted

Share-Based Payment Awards with Performance Targets

In June 2014, the FASB issued ASU No. 2014-12, Share-Based Payment Awards with Performance Targets. The main provisions of ASU 2014-12 require that a performance target included in a share-based payment award that affects vesting and that could be achieved after the requisite service period be treated as a performance condition. Therefore, under the existing stock compensation guidance in Topic 718, the performance target should not be reflected in estimating the grant-date fair value of the award. The standard is effective for annual periods and interim periods beginning after December 15, 2015. We do not expect that this ASU will have a material impact on our results of operations or financial position.

Repurchase-To-Maturity Transactions, Repurchase Financings and New Disclosures

In June 2014, the FASB issued ASU No. 2014-11, Repurchase-to-Maturity Transactions, Repurchase Financings, and New Disclosures to change the accounting for repurchase-to-maturity transactions and certain linked repurchase financings. This will result in accounting for both types of arrangements as secured borrowings on the balance sheet and require new disclosures to (i) increase transparency about the types of collateral pledged in secured borrowing transactions and (ii) enable users to better understand transactions in which the transferor retains substantially all of the exposure to the economic return on the transferred financial asset throughout the term of the transaction. The disclosure for repurchase agreements, securities lending transactions, and repurchase-to-maturity transactions accounted for as secured borrowings is required to be presented for annual periods beginning after December 15, 2014, and for interim periods beginning after March 15, 2015. All other accounting and disclosure amendments in the ASU are effective for the first interim or annual period beginning after December 15, 2014. Earlier application for a public business entity is prohibited. We do not expect that this ASU will have a material impact on our results of operations or financial position.

Revenues from Contracts with Customers

In May 2014, the FASB issued ASU No. 2014-09, Revenues from Contracts with Customers. The core principle of the guidance is that an entity should recognize revenue to depict the transfer of promised goods or services to customers in an amount that reflects the consideration to which the entity expects to be entitled in exchange for those goods and services. The standard is required to be adopted by public business entities in annual periods beginning on or after December 15, 2016. The provisions do not apply to lease contracts, insurance contracts, financial instruments and other contractual rights or obligations (e.g. receivables, debt and equity securities, liabilities, debt, derivatives transfers, and servicing, etc.), guarantees, or non-monetary exchanges between entities. We are currently evaluating the impact of the adoption of this pronouncement on our consolidated financial statements.

Reporting Discontinued Operations and Disclosures of Disposals of Components of an Entity

In April 2014, the FASB issued ASU No. 2014-08, Reporting Discontinued Operations and Disclosures of Disposals of Components of an Entity, which changes the criteria for determining which disposals can be presented as discontinued operations and modifies related disclosure requirements. The guidance applies to all entities that dispose of components. It will significantly change current practices for assessing discontinued operations and affect an entity's income and earnings per share from continuing operations. An entity is required to reclassify assets and liabilities of a discontinued operation that are classified as held for sale or disposed of in the current period for all comparative periods presented. The ASU requires that an entity present in the statement of cash flows or disclose in a note either total operating and investing cash flows for discontinued operations, or depreciation, amortization, capital expenditures and significant operating and investing noncash items related to discontinued operations. Additional

disclosures are required when an entity retains significant continuing involvement with a discontinued operation after its disposal, including the amount of cash flows to and from a discontinued operation. The new standard applies prospectively after the effective date of December 15, 2014, and early adoption is permitted. We do not expect that this ASU will have a material impact on our results of operations or financial position.

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S&T BANCORP, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS – continued

NOTE 1. BASIS OF PRESENTATION – continued

Reclassification of Residential Real Estate Collateralized Consumer Mortgage Loans upon Foreclosure

In January 2014, the FASB issued ASU No. 2014-04, Reclassification of Residential Real Estate Collateralized Consumer Mortgage Loans upon Foreclosure. The ASU clarifies that an in substance repossession or foreclosure has occurred and a creditor is considered to have received physical possession of residential real estate property collateralizing a consumer mortgage loan, upon either the creditor obtaining legal title to the residential real estate property upon completion of a foreclosure or the borrower conveying all interest in the residential real estate property to the creditor to satisfy that loan through completion of a deed in lieu of foreclosure. Interim and annual disclosure is required of both the amount of foreclosed residential real estate property held by the creditor and the recorded investment in consumer mortgage loans collateralized by residential real estate property that are in the process of foreclosure. The new standard is effective using either the modified retrospective transition method or a prospective transition method for fiscal years and interim periods within those years, beginning after December 15, 2014, and early adoption is permitted. We do not expect that this ASU will have a material impact on our results of operations or financial position.

Accounting for Investments in Qualified Affordable Housing Projects

In January 2014, the FASB issued ASU No. 2014-01, Accounting for Investments in Qualified Affordable Housing Projects. The ASU permits reporting entities to make an accounting policy election to account for investments in qualified affordable housing projects using the proportional amortization method if certain conditions are met. The proportional amortization method permits the amortization of the initial cost of the investment in proportion to the tax credits and other tax benefits received, and recognizes the net investment performance in the income statement as a component of income tax expense (benefit). The new standard is effective retrospectively for fiscal years and interim periods within those years, beginning after December 15, 2014, and early adoption is permitted. We do not expect that this ASU will have a material impact on our results of operations or financial position.

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## S&amp;T BANCORP, INC. AND SUBSIDIARIES

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS – continued

## NOTE 2. EARNINGS PER SHARE

The following table reconciles the numerators and denominators of basic earnings per share with that of diluted earnings per share for the periods presented:

(dollars in thousands, except shares and per share data)	Three Months Ended June 30,		Six Months Ended June 30,	
	2014	2013	2014	2013
Numerator for Earnings per Share—Basic:				
Net income	\$ 14,720	\$ 14,103	\$ 28,753	\$ 26,433
Less: Income allocated to participating shares	29	36	64	81
Net Income Allocated to Shareholders	\$ 14,691	\$ 14,067	\$ 28,689	\$ 26,352
Numerator for Earnings per Share—Diluted:				
Net income	14,720	14,103	\$ 28,753	\$ 26,433
Net Income Available to Shareholders	\$ 14,720	\$ 14,103	\$ 28,753	\$ 26,433
Denominators for Earnings per Share:				
Weighted Average Shares Outstanding—Basic	29,684,300	29,654,018	29,672,611	29,637,825
Add: Dilutive potential shares	16,894	23,858	27,559	41,319
Denominator for Treasury Stock Method—Diluted	29,701,194	29,677,876	29,700,170	29,679,144
Weighted Average Shares Outstanding—Basic	29,684,300	29,654,018	29,672,611	29,637,825
Add: Average participating shares outstanding	58,973	74,994	66,563	91,530
Denominator for Two-Class Method—Diluted	29,743,273	29,729,012	29,739,174	29,729,355
Earnings per share—basic	\$ 0.49	\$ 0.47	\$ 0.97	\$ 0.89
Earnings per share—diluted	\$ 0.49	\$ 0.47	\$ 0.97	\$ 0.89
Warrants considered anti-dilutive excluded from dilutive potential shares	517,012	517,012	517,012	517,012
Stock options considered anti-dilutive excluded from dilutive potential shares	428,493	629,570	428,676	642,499
Restricted stock considered anti-dilutive excluded from dilutive potential shares	42,079	51,136	39,005	50,211



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S&T BANCORP, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS – continued

NOTE 3. FAIR VALUE MEASUREMENT

We use fair value measurements when recording and disclosing certain financial assets and liabilities. Securities available-for-sale, trading assets and derivatives are recorded at fair value on a recurring basis. Additionally, from time to time, we may be required to record other assets at fair value on a nonrecurring basis, such as loans held for sale, impaired loans, other real estate owned, or OREO, mortgage servicing rights, or MSRs, and certain other assets. Fair value is the price that would be received to sell an asset or paid to transfer a liability in the principal or most advantageous market in an orderly transaction between market participants at the measurement date. An orderly transaction is a transaction that assumes exposure to the market for a period prior to the measurement date to allow for marketing activities that are usual and customary for transactions involving such assets or liabilities; it is not a forced transaction. In determining fair value, we use various valuation approaches, including market, income and cost approaches. The fair value standard establishes a hierarchy for inputs used in measuring fair value that maximizes the use of observable inputs and minimizes the use of unobservable inputs by requiring that observable inputs be used when available. Observable inputs are inputs that market participants would use in pricing an asset or liability, which is developed, based on market data we have obtained from independent sources. Unobservable inputs reflect our estimate of assumptions that market participants would use in pricing an asset or liability, which are developed based on the best information available in the circumstances.

The fair value hierarchy gives the highest priority to unadjusted quoted market prices in active markets for identical assets or liabilities (Level 1 measurement) and the lowest priority to unobservable inputs (Level 3 measurement). The fair value hierarchy is broken down into three levels based on the reliability of inputs as follows:

Level 1: valuation is based upon unadjusted quoted market prices for identical instruments traded in active markets.

Level 2: valuation is based upon quoted market prices for similar instruments traded in active markets, quoted market prices for identical or similar instruments traded in markets that are not active and model-based valuation techniques for which all significant assumptions are observable in the market or can be corroborated by market data.

Level 3: valuation is derived from other valuation methodologies, including discounted cash flow models and similar techniques that use significant assumptions not observable in the market. These unobservable assumptions reflect estimates of assumptions that market participants would use in determining fair value.

A financial instrument's level within the fair value hierarchy is based on the lowest level of input that is significant to the fair value measurement. Our policy is to recognize transfers between any of the fair value hierarchy levels at the end of the reporting period in which the transfer occurred.

The following are descriptions of the valuation methodologies that we use for financial instruments recorded at fair value on either a recurring or nonrecurring basis.

Recurring Basis

Securities Available-for-Sale

Securities available-for-sale include both debt and equity securities. We obtain fair values for debt securities from a third-party pricing service which utilizes several sources for valuing fixed-income securities. We validate prices received from our pricing service through comparison to a secondary pricing service and broker quotes. We review the methodologies of the pricing service which provides us with a sufficient understanding of the valuation models, assumptions, inputs and pricing to reasonably measure the fair value of our debt securities. The market valuation sources for debt securities include observable inputs rather than significant unobservable inputs and are classified as Level 2. The service provider utilizes pricing models that vary by asset class and include available trade, bid and other market information. Generally, the methodologies include broker quotes, proprietary models and vast descriptive terms and conditions databases, as well as extensive quality control programs.

Marketable equity securities that have an active, quotable market are classified as Level 1. Marketable equity securities that are quotable, but are thinly traded or inactive, are classified as Level 2. Marketable equity securities that are not readily traded and do not have a quotable market are classified as Level 3.

Trading Assets

We use quoted market prices to determine the fair value of our trading assets. Our trading assets are held in a Rabbi Trust under a deferred compensation plan and are invested in readily quoted mutual funds. Accordingly, these assets are classified as Level 1.

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S&T BANCORP, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS – continued

NOTE 3. FAIR VALUE MEASUREMENT – continued

Derivative Financial Instruments

We use derivative instruments including interest rate swaps for commercial loans with our customers and we sell mortgage loans in the secondary market and enter into interest rate lock commitments. We calculate the fair value for derivatives using widely accepted valuation techniques, including discounted cash flow analysis on the expected cash flows of each derivative. Each valuation considers the contractual terms of the derivative, including the period to maturity, and uses observable market based inputs, such as interest rate curves and implied volatilities. Accordingly, derivatives are classified as Level 2.

We incorporate credit valuation adjustments into the valuation models to appropriately reflect both our own nonperformance risk and the respective counterparty's nonperformance risk in calculating fair value measurements. In adjusting the fair value of our derivative contracts for the effect of nonperformance risk, we have considered the impact of netting and any applicable credit enhancements and collateral postings.

Nonrecurring Basis

Loans Held for Sale

Loans held for sale consist of 1-4 family residential loans originated for sale in the secondary market and, from time to time, certain loans transferred from the loan portfolio to loans held for sale, all of which are carried at the lower of cost or fair value. The fair value of 1-4 family residential loans is based on the principal or most advantageous market currently offered for similar loans using observable market data. The fair value of the loans transferred from the loan portfolio is based on the amounts offered for these loans in currently pending sales transactions. Loans held for sale carried at fair value are classified as Level 3.

Impaired Loans

Impaired loans are carried at the lower of carrying value or fair value. Fair value is determined as the recorded investment balance less any specific reserve. We establish a specific reserve based on the following three impairment methods: 1) the present value of expected future cash flows discounted at the loan's original effective interest rate, 2) the loan's observable market price or 3) the fair value of the collateral less estimated selling costs when the loan is collateral dependent and we expect to liquidate the collateral. However, if repayment is expected to come from the operation of the collateral, rather than liquidation, then we do not consider estimated selling costs in determining the fair value of the collateral. Collateral values are generally based upon appraisals by approved, independent state certified appraisers.

Appraisals may be discounted based on our historical knowledge, changes in market conditions from the time of appraisal or our knowledge of the borrower and the borrower's business. Impaired loans carried at fair value are classified as Level 3.

OREO and Other Repossessed Assets

OREO and other repossessed assets obtained in partial or total satisfaction of a loan are recorded at the lower of recorded investment in the loan or fair value less cost to sell. Subsequent to foreclosure, these assets are carried at the lower of the amount recorded at acquisition date or fair value less cost to sell. Accordingly, it may be necessary to record nonrecurring fair value adjustments. Fair value, when recorded, is generally based upon appraisals by approved, independent state certified appraisers. Like impaired loans, appraisals on OREO may be discounted based on our historical knowledge, changes in market conditions from the time of appraisal or other information available to us. OREO and other repossessed assets are classified as Level 3.

Mortgage Servicing Rights

The fair value of MSRs is determined by calculating the present value of estimated future net servicing cash flows, considering expected mortgage loan prepayment rates, discount rates, servicing costs and other economic factors, which are determined based on current market conditions. The expected rate of mortgage loan prepayments is the most significant factor affecting the value of MSRs. MSRs are considered impaired if the carrying value exceeds fair

value. The valuation model includes significant unobservable inputs; therefore, MSRs are classified as Level 3.

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S&T BANCORP, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS – continued

NOTE 3. FAIR VALUE MEASUREMENT – continued

Other Assets

We measure certain other assets at fair value on a nonrecurring basis. Fair value is based on the application of lower of cost or fair value accounting, or write-downs of individual assets. Valuation methodologies used to measure fair value are consistent with overall principles of fair value accounting and consistent with those described above.

Financial Instruments

In addition to financial instruments recorded at fair value in our financial statements, fair value accounting guidance requires disclosure of the fair value of all of an entity's assets and liabilities that are considered financial instruments. The majority of our assets and liabilities are considered financial instruments. Many of these instruments lack an available trading market as characterized by a willing buyer and willing seller engaged in an exchange transaction. Also, it is our general practice and intent to hold our financial instruments to maturity and to not engage in trading or sales activities with respect to such financial instruments. For fair value disclosure purposes, we substantially utilize the fair value measurement criteria as required and explained above. In cases where quoted fair values are not available, we use present value methods to determine the fair value of our financial instruments.

Cash and Cash Equivalents and Other Short-Term Assets

The carrying amounts reported in the Consolidated Balance Sheets for cash and due from banks, including interest-bearing deposits, approximate fair value.

Loans

The fair value of variable rate performing loans that may reprice frequently at short-term market rates is based on carrying values adjusted for credit risk. The fair value of variable rate performing loans that reprice at intervals of one year or longer, such as adjustable rate mortgage products, is estimated using discounted cash flow analyses that utilize interest rates currently being offered for similar loans and adjusted for credit risk. The fair value of fixed rate performing loans is estimated using discounted cash flow analyses that utilize interest rates currently being offered for similar loans and adjusted for credit risk. The fair value of nonperforming loans is based on their carrying values less any specific reserve. The carrying amount of accrued interest approximates fair value.

Bank Owned Life Insurance

Fair value approximates net cash surrender value.

Deposits

The fair values disclosed for deposits without defined maturities (e.g., noninterest and interest-bearing demand, money market and savings accounts) are by definition equal to the amounts payable on demand. The carrying amounts for variable rate, fixed-term time deposits approximate their fair values. Estimated fair values for fixed rate and other time deposits are based on discounted cash flow analysis using interest rates currently offered for time deposits with similar terms. The carrying amount of accrued interest approximates fair value.

Short-Term Borrowings

The carrying amounts of securities sold under repurchase agreements, federal funds purchased and other short-term borrowings approximate their fair values.

Long-Term Borrowings

The fair values disclosed for fixed rate long-term borrowings are determined by discounting their contractual cash flows using current interest rates for long-term borrowings of similar remaining maturities. The carrying amounts of variable rate long-term borrowings approximate their fair values.

Junior Subordinated Debt Securities

The variable rate junior subordinated debt securities reprice quarterly; therefore, the fair values are based on the carrying values.



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## S&amp;T BANCORP, INC. AND SUBSIDIARIES

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS – continued

## NOTE 3. FAIR VALUE MEASUREMENT – continued

## Loan Commitments and Standby Letters of Credit

Off-balance sheet financial instruments consist of commitments to extend credit and letters of credit. Except for interest rate lock commitments, estimates of the fair value of these off-balance sheet items are not made because of the short-term nature of these arrangements and the credit standing of the counterparties.

## Other

Estimates of fair value are not made for items that are not defined as financial instruments, including such items as our core deposit intangibles and the value of our trust operations.

The following tables present our assets and liabilities that are measured at fair value on a recurring basis by fair value hierarchy level at June 30, 2014 and December 31, 2013. There were no transfers between Level 1 and Level 2 for items measured at fair value on a recurring basis during the periods presented.

(dollars in thousands)	June 30, 2014			
	Level 1	Level 2	Level 3	Total
<b>ASSETS</b>				
Securities available-for-sale:				
Obligations of U.S. government corporations and agencies	\$—	\$270,248	\$—	\$270,248
Collateralized mortgage obligations of U.S. government corporations and agencies	—	94,604	—	94,604
Residential mortgage-backed securities of U.S. government corporations and agencies	—	46,389	—	46,389
Commercial mortgage-backed securities of U.S. government corporations and agencies	—	39,920	—	39,920
Obligations of states and political subdivisions	—	128,313	—	128,313
Marketable equity securities	179	8,835	—	9,014
Total securities available-for-sale	179	588,309	—	588,488
Trading securities held in a Rabbi Trust	3,117	—	—	3,117
Total securities	3,296	588,309	—	591,605
Derivative financial assets:				
Interest rate swaps	—	14,082	—	14,082
Interest rate lock commitments	—	292	—	292
Forward sale contracts	—	—	—	—
Total Assets	\$3,296	\$602,683	\$—	\$605,979
<b>LIABILITIES</b>				
Derivative financial liabilities:				
Interest rate swaps	\$—	\$14,050	\$—	\$14,050
Forward sale contracts	—	59	—	\$59
Total Liabilities	\$—	\$14,109	\$—	\$14,109

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## S&amp;T BANCORP, INC. AND SUBSIDIARIES

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS – continued

## NOTE 3. FAIR VALUE MEASUREMENT – continued

(dollars in thousands)	December 31, 2013			Total
	Level 1	Level 2	Level 3	
<b>ASSETS</b>				
Securities available-for-sale:				
Obligations of U.S. government corporations and agencies	\$—	\$234,751	\$—	\$234,751
Collateralized mortgage obligations of U.S. government corporations and agencies	—	63,774	—	63,774
Residential mortgage-backed securities of U.S. government corporations and agencies	—	48,669	—	48,669
Commercial mortgage-backed securities of U.S. government corporations and agencies	—	39,052	—	39,052
Obligations of states and political subdivisions	—	114,264	—	114,264
Marketable equity securities	202	8,713	—	8,915
Total securities available-for-sale	202	509,223	—	509,425
Trading securities held in a Rabbi Trust	2,864	—	—	2,864
Total securities	3,066	509,223	—	512,289
Derivative financial assets:				
Interest rate swaps	—	13,698	—	13,698
Interest rate lock commitments	—	85	—	85
Forward sale contracts	—	34	—	34
Total Assets	\$3,066	\$523,040	\$—	\$526,106
<b>LIABILITIES</b>				
Derivative financial liabilities:				
Interest rate swaps	\$—	\$13,647	\$—	\$13,647
Total Liabilities	\$—	\$13,647	\$—	\$13,647

We classify financial instruments as Level 3 when valuation models are used because significant inputs are not observable in the market. The following table presents the changes in assets measured at fair value on a recurring basis for which we have utilized Level 3 inputs to determine the fair value:

(dollars in thousands)	Three Months Ended June 30,		Six Months Ended June 30,	
	2014	2013	2014	2013
Balance at beginning of period	\$—	\$312	\$—	\$300
Total gains included in other comprehensive income <sup>(1)</sup>	—	32	—	44
Net purchases, sales, issuances and settlements	—	—	—	—
Transfers out of Level 3	—	(344)	—	(344)
Balance at end of period	\$—	\$—	\$—	\$—

<sup>(1)</sup> Changes in estimated fair value of available-for-sale investments are recorded in accumulated other comprehensive income (loss), while realized gains and losses from sales are recorded in security gains (losses), net in the Consolidated Statements of Comprehensive Income.

We may be required to measure certain assets and liabilities on a nonrecurring basis. The following table presents our assets that were measured at fair value on a nonrecurring basis by the fair value hierarchy level at June 30, 2014 and December 31, 2013. There were no liabilities measured at fair value on a nonrecurring basis during these periods.





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## S&amp;T BANCORP, INC. AND SUBSIDIARIES

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS – continued

## NOTE 3. FAIR VALUE MEASUREMENT – continued

(dollars in thousands)	June 30, 2014				December 31, 2013			
	Level 1	Level 2	Level 3	Total	Level 1	Level 2	Level 3	Total
<b>ASSETS</b>								
Loans held for sale	\$—	\$—	\$1,300	\$1,300	\$—	\$—	\$1,516	\$1,516
Impaired loans	—	—	14,483	14,483	—	—	19,197	19,197
Other real estate owned	—	—	317	317	—	—	317	317
Mortgage servicing rights	—	—	1,211	1,211	—	—	1,025	1,025
Total Assets	\$—	\$—	\$17,311	\$17,311	\$—	\$—	\$22,055	\$22,055

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## S&amp;T BANCORP, INC. AND SUBSIDIARIES

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS – continued

## NOTE 3. FAIR VALUE MEASUREMENT – continued

The carrying values and fair values of our financial instruments at June 30, 2014 and December 31, 2013 are presented in the following tables:

(dollars in thousands)	Carrying Value <sup>(1)</sup>	Fair Value Measurements at June 30, 2014			
		Total	Level 1	Level 2	Level 3
<b>ASSETS</b>					
Cash and due from banks, including interest-bearing deposits	\$ 130,235	\$ 130,235	\$ 130,235	\$—	\$—
Securities available-for-sale	588,488	588,488	179	588,309	—
Loans held for sale	3,102	3,121	—	—	3,121
Portfolio loans, net of unearned income	3,725,079	3,691,807	—	—	3,691,807
Bank owned life insurance	61,348	61,348	—	61,348	—
FHLB and other restricted stock	15,818	15,818	—	—	15,818
Trading securities held in a Rabbi Trust	3,117	3,117	3,117	—	—
Mortgage servicing rights	2,743	2,890	—	—	2,890
Interest rate swaps	14,082	14,082	—	14,082	—
Interest rate lock commitments	292	292	—	292	—
<b>LIABILITIES</b>					
Deposits	\$ 3,865,246	\$ 3,867,540	\$—	\$—	\$ 3,867,540
Securities sold under repurchase agreements	25,269	25,269	—	—	25,269
Short-term borrowings	185,000	185,000	—	—	185,000
Long-term borrowings	20,636	21,779	—	—	21,779
Junior subordinated debt securities	45,619	45,619	—	—	45,619
Interest rate swaps	14,050	14,050	—	14,050	—
Forward sale contracts	59	59	—	59	—

<sup>(1)</sup> As reported in the Consolidated Balance Sheets

(dollars in thousands)	Carrying Value <sup>(1)</sup>	Fair Value Measurements at December 31, 2013			
		Total	Level 1	Level 2	Level 3
<b>ASSETS</b>					
Cash and due from banks, including interest-bearing deposits	\$ 108,356	\$ 108,356	\$ 108,356	\$—	\$—
Securities available-for-sale	509,425	509,425	202	509,223	—
Loans held for sale	2,136	2,139	—	—	2,139
Portfolio loans, net of unearned income	3,566,199	3,538,072	—	—	3,538,072
Bank owned life insurance	60,480	60,480	—	60,480	—
FHLB and other restricted stock	13,629	13,629	—	—	13,629
Trading securities held in a Rabbi Trust	2,864	2,864	2,864	—	—
Mortgage servicing rights	2,919	3,143	—	—	3,143
Interest rate swaps	13,698	13,698	—	13,698	—
Interest rate lock commitments	85	85	—	85	—
Forward sale contracts	34	34	—	34	—
<b>LIABILITIES</b>					
Deposits	\$ 3,672,308	\$ 3,673,624	\$—	\$—	\$ 3,673,624

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Securities sold under repurchase agreements	33,847	33,847	—	—	33,847
Short-term borrowings	140,000	140,000	—	—	140,000
Long-term borrowings	21,810	22,924	—	—	22,924
Junior subordinated debt securities	45,619	45,619	—	—	45,619
Interest rate swaps	13,647	13,647	—	13,647	—

(1) As reported in the Consolidated Balance Sheets

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## S&amp;T BANCORP, INC. AND SUBSIDIARIES

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS – continued

## NOTE 4. SECURITIES AVAILABLE-FOR-SALE

The following table indicates the composition of the securities available-for-sale portfolio as of the dates presented:

(dollars in thousands)	June 30, 2014				December 31, 2013			
	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
Obligations of U.S. government corporations and agencies	\$268,614	\$2,733	\$(1,099)	)\$270,248	\$235,181	\$2,151	\$(2,581)	)\$234,751
Collateralized mortgage obligations of U.S. government corporations and agencies	93,787	1,035	(218)	)94,604	63,776	601	(603)	)63,774
Residential mortgage-backed securities of U.S. government corporations and agencies	44,900	1,720	(231)	)46,389	47,934	1,420	(685)	)48,669
Commercial mortgage-backed securities of U.S. government corporations and agencies	40,098	224	(402)	)39,920	40,357	—	(1,305)	)39,052
Obligations of states and political subdivisions	124,648	4,017	(352)	)128,313	115,572	1,294	(2,602)	)114,264
Debt Securities	572,047	9,729	(2,302)	)579,474	502,820	5,466	(7,776)	)500,510
Marketable equity securities	7,579	1,435	—	9,014	7,579	1,336	—	8,915
Total	\$579,626	\$11,164	\$(2,302)	)\$588,488	\$510,399	\$6,802	\$(7,776)	)\$509,425

Realized gains and losses on the sale of securities are determined using the specific-identification method. The following table shows the composition of gross and net realized gains and losses for the periods presented:

(dollars in thousands)	Three Months Ended June 30,		Six Months Ended June 30,	
	2014	2013	2014	2013
Gross realized gains	\$40	\$—	\$41	\$2
Gross realized losses	—	—	—	—
Net Realized Gains	\$40	\$—	\$41	\$2



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## S&amp;T BANCORP, INC. AND SUBSIDIARIES

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS – continued

## NOTE 4. SECURITIES AVAILABLE-FOR-SALE – continued

The following tables indicate the fair value and the age of gross unrealized losses by investment category as of the dates presented:

(dollars in thousands)	June 30, 2014		12 Months or More		Total		Number of Securities	Unrealized Losses	
	Less Than 12 Months	Number of Securities	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses			
Obligations of U.S. government corporations and agencies	2	\$19,741	\$(78)	8	\$63,265	\$(1,021)	\$83,006	10	\$(1,099)
Collateralized mortgage obligations of U.S. government corporations and agencies	1	11,420	(218)	—	—	—	11,420	1	(218)
Residential mortgage-backed securities of U.S. government corporations and agencies	—	—	—	1	9,414	(231)	9,414	1	(231)
Commercial mortgage-backed securities of U.S. government corporations and agencies	1	10,009	(16)	2	20,837	(386)	30,846	3	(402)
Obligations of states and political subdivisions	1	264	(1)	3	15,975	(351)	16,239	4	(352)
Debt Securities	5	41,434	(313)	14	109,491	(1,989)	150,925	19	(2,302)
Marketable equity securities	—	—	—	—	—	—	—	—	—
Total Temporarily Impaired Securities	5	\$41,434	\$(313)	14	\$109,491	\$(1,989)	\$150,925	19	\$(2,302)
	December 31, 2013		12 Months or More		Total				
(dollars in thousands)	Less Than 12 Months	Number of Securities	Fair Value	Unrealized Losses	Number of Securities	Fair Value	Unrealized Losses	Number of Securities	Unrealized Losses
Obligations of U.S. government	16	\$126,017	\$(2,581)	—	—	—	—	16	\$(2,581)

corporations and agencies									
Collateralized mortgage obligations of U.S. government corporations and agencies	3	39,522	(603 )	—	—	—	39,522	3	(603 )
Residential mortgage-backed securities of U.S. government corporations and agencies	2	22,822	(685 )	—	—	—	22,822	2	(685 )
Commercial mortgage-backed securities of U.S. government corporations and agencies	4	39,052	(1,305 )	—	—	—	39,052	4	(1,305 )
Obligations of states and political subdivisions	16	47,529	(1,739 )	2	10,088	(863 )	57,617	18	(2,602 )
Debt Securities	41	274,942	(6,913 )	2	10,088	(863 )	285,030	43	(7,776 )
Marketable equity securities	—	—	—	—	—	—	—	—	—
Total Temporarily Impaired Securities	41	\$274,942	\$(6,913 )	2	\$10,088	\$(863 )	\$285,030	43	\$(7,776 )



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## S&amp;T BANCORP, INC. AND SUBSIDIARIES

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS – continued

## NOTE 4. SECURITIES AVAILABLE-FOR-SALE – continued

We do not believe any individual unrealized loss as of June 30, 2014 represents an other than temporary impairment, or OTTI. As of June 30, 2014, the unrealized losses on 19 debt securities were attributable to changes in interest rates and not related to the credit quality of these securities. All debt securities are determined to be investment grade and are paying principal and interest according to the contractual terms of the security. There were no unrealized losses on marketable equity securities as of June 30, 2014. We do not intend to sell and it is not more likely than not that we will be required to sell any of the securities, referenced in the table above, in an unrealized loss position before recovery of their amortized cost.

The following table displays net unrealized gains and losses, net of tax on securities available for sale included in accumulated other comprehensive income/(loss) for the periods presented.

(dollars in thousands)	June 30, 2014			December 31, 2013		
	Gross Unrealized Gains	Gross Unrealized Losses	Net Unrealized Gains/ (Losses)	Gross Unrealized Gains	Gross Unrealized Losses	Net Unrealized Gains/ (Losses)
Total unrealized gains/(losses) on securities available-for-sale	\$ 11,164	\$(2,302)	)\$8,862	\$ 6,802	\$(7,776)	)\$ (974)
Income tax expense/(benefit)	3,907	(806)	)3,101	2,381	(2,722)	) (341)
Net unrealized gains/(losses), net of tax included in accumulated other comprehensive income/(loss)	\$ 7,257	\$(1,496)	)\$5,761	\$ 4,421	\$(5,054)	)\$ (633)

The amortized cost and fair value of securities available-for-sale at June 30, 2014, by contractual maturity, are included in the table below. Actual maturities may differ from contractual maturities because borrowers may have the right to call or prepay obligations with or without call or prepayment penalties.

(dollars in thousands)	June 30, 2014 Amortized Cost	Fair Value
Obligations of U.S. government corporations and agencies, and obligations of states and political subdivisions		
Due in one year or less	\$ 24,049	\$ 24,289
Due after one year through five years	182,816	184,074
Due after five years through ten years	98,068	99,420
Due after ten years	88,329	90,778
	393,262	398,561
Collateralized mortgage obligations of U.S. government corporations and agencies	93,787	94,604
Residential mortgage-backed securities of U.S. government corporations and agencies	44,900	46,389
Commercial mortgage-backed securities of U.S. government corporations and agencies	40,098	39,920
Debt Securities	572,047	579,474
Marketable equity securities	7,579	9,014
Total	\$ 579,626	\$ 588,488

At June 30, 2014 and December 31, 2013, securities with carrying values of \$273.5 million and \$243.2 million were pledged for various regulatory and legal requirements.



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## S&amp;T BANCORP, INC. AND SUBSIDIARIES

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS – continued

## NOTE 5. LOANS AND LOANS HELD FOR SALE

Loans are presented net of unearned income of \$1.8 million and \$1.3 million at June 30, 2014 and December 31, 2013. The following table indicates the composition of the loans as of the dates presented:

(dollars in thousands)	June 30, 2014	December 31, 2013
Commercial		
Commercial real estate	\$1,636,383	\$1,607,756
Commercial and industrial	922,191	842,449
Commercial construction	188,311	143,675
Total Commercial Loans	2,746,885	2,593,880
Consumer		
Residential mortgage	492,589	487,092
Home equity	416,226	414,195
Installment and other consumer	65,838	67,883
Consumer construction	3,541	3,149
Total Consumer Loans	978,194	972,319
Total Portfolio Loans	3,725,079	3,566,199
Loans held for sale	3,102	2,136
Total Loans	\$3,728,181	\$3,568,335

We attempt to limit our exposure to credit risk by diversifying our loan portfolio and actively managing concentrations. When concentrations exist in certain segments, we mitigate this risk by monitoring the relevant economic indicators and internal risk rating trends and through stress testing of the loans in these segments. Total commercial loans represented 74 percent of total portfolio loans at June 30, 2014 and 73 percent of total portfolio loans at December 31, 2013. Within our commercial portfolio, the commercial real estate, or CRE, and commercial construction portfolios combined comprised 66 percent of total commercial loans and 49 percent of total portfolio loans at June 30, 2014 and 68 percent of total commercial loans and 49 percent of total portfolio loans at December 31, 2013. Further segmentation of the CRE and commercial construction portfolios by industry and collateral type revealed no concentration in excess of nine percent of total loans at either June 30, 2014 or December 31, 2013. The majority of both commercial and consumer loans are made to businesses and individuals in Western Pennsylvania resulting in a geographic concentration. The conditions of the local and regional economies are monitored closely through publicly available data as well as information supplied by our customers. Management believes underwriting guidelines, active monitoring of economic conditions and ongoing review by credit administration mitigates the concentration risk present in the loan portfolio. Only the CRE and commercial construction portfolios combined have any significant out-of-state exposure, with 26 percent of the combined portfolio and 13 percent of total loans being out-of-state loans at June 30, 2014 and 23 percent of the combined portfolio and 11 percent of total loans being out-of-state loans at December 31, 2013. Our CRE and commercial construction portfolios combined out-of-state exposure, excluding the contiguous states of Ohio, West Virginia, New York and Maryland, was 7.2 percent of the combined portfolio and 3.6 percent of total loans at June 30, 2014 and 7.9 percent of the combined portfolio and 3.9 percent of total loans at December 31, 2013.

Troubled debt restructurings, or TDRs, are loans where we, for economic or legal reasons related to a borrower's financial difficulties, grant a concession to the borrower that we would not otherwise grant. We strive to identify borrowers in financial difficulty early and work with them to modify the terms before their loan reaches nonaccrual status. These modified terms generally include extensions of maturity dates at a stated interest rate lower than the current market rate for a new loan with similar risk characteristics, reductions in contractual interest rates or principal deferment. While unusual, there may be instances of principal forgiveness. These modifications are generally for longer term periods that would not be considered insignificant. Additionally, we classify loans where the debt

obligation has been discharged through a Chapter 7 Bankruptcy and not reaffirmed as TDRs.

We individually evaluate all substandard commercial loans that have experienced a forbearance or change in terms agreement, as well as all substandard consumer and residential mortgage loans that entered into an agreement to modify their existing loan to determine if they should be designated as TDRs. All TDRs are considered to be impaired loans and will be reported as impaired loans for the remaining life of the loan, unless the restructuring agreement specifies an interest rate equal

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## S&amp;T BANCORP, INC. AND SUBSIDIARIES

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS – continued

## NOTE 5. LOANS AND LOANS HELD FOR SALE – continued

to or greater than the rate that would be accepted at the time of the restructuring for a new loan with comparable risk and it is fully expected that the remaining principal and interest will be collected according to the restructured agreement. Further, all impaired loans are reported as nonaccrual loans unless the loan is a TDR that has met the requirements to be returned to accruing status. TDRs can be returned to accruing status if the ultimate collectability of all contractual amounts due, according to the restructured agreement, is not in doubt and there is a period of a minimum of six months of satisfactory payment performance by the borrower either immediately before or after the restructuring.

The following table summarizes the restructured loans as of the dates presented:

(dollars in thousands)	June 30, 2014			December 31, 2013		
	Accruing TDRs	Nonaccruing TDRs	Total TDRs	Accruing TDRs	Nonaccruing TDRs	Total TDRs
Commercial real estate	\$16,934	\$1,431	\$18,365	\$19,711	\$3,898	\$23,609
Commercial and industrial	7,390	1,170	8,560	7,521	1,884	9,405
Commercial construction	6,310	1,869	8,179	5,338	2,708	8,046
Residential mortgage	2,647	645	3,292	2,581	1,356	3,937
Home equity	3,712	125	3,837	3,924	218	4,142
Installment and other consumer	127	1	128	154	3	157
Total	\$37,120	\$5,241	\$42,361	\$39,229	\$10,067	\$49,296

We returned four TDRs for \$1.4 million to accruing status during the three months ended June 30, 2014 and five TDRs for \$1.5 million to accruing status during the six months ended June 30, 2014. There were no TDRs returned to accruing status during the three months ended June 30, 2013 and one TDR for \$0.2 million was returned to accruing status during the six months ended June 30, 2013.

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## S&amp;T BANCORP, INC. AND SUBSIDIARIES

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS – continued

## NOTE 5. LOANS AND LOANS HELD FOR SALE – continued

The following tables present the restructured loans for the three and six month periods ended June 30, 2014 and June 30, 2013:

(dollars in thousands)	Three Months Ended June 30, 2014				Three Months Ended June 30, 2013			
	Number of Loans	Pre-Modification Outstanding Recorded Investment <sup>(1)</sup>	Post-Modification Outstanding Recorded Investment <sup>(1)</sup>	Total Difference in Recorded Investment	Number of Loans	Pre-Modification Outstanding Recorded Investment <sup>(1)</sup>	Post-Modification Outstanding Recorded Investment <sup>(1)</sup>	Total Difference in Recorded Investment
Commercial real estate								
Principal forgiveness <sup>(3)</sup>	—	\$ —	\$ —	\$ —	1	\$ 4,339	\$ 4,339	\$ —
Principal deferral	1	129	127	(2 )	—	—	—	—
Chapter 7 bankruptcy <sup>(2)</sup>	—	—	—	—	4	53	51	(2 )
Commercial and industrial								
Maturity date extension	—	—	—	—	1	751	751	—
Residential mortgage								
Chapter 7 bankruptcy <sup>(2)</sup>	1	52	52	—	2	84	75	(9 )
Home equity								
Chapter 7 bankruptcy <sup>(2)</sup>	4	43	41	(2 )	17	486	478	(8 )
Installment and other consumer								
Chapter 7 bankruptcy <sup>(2)</sup>	1	9	9	—	—	—	—	—
Total by Concession Type								
Principal forgiveness <sup>(3)</sup>	—	—	—	—	1	4,339	4,339	—
Principal deferral	1	129	127	(2 )	—	—	—	—
Chapter 7 bankruptcy <sup>(2)</sup>	6	104	102	(2 )	23	623	604	(19 )
Maturity date extension	—	—	—	—	1	751	751	—
Total	7	\$ 233	\$ 229	\$ 4	25	5,713	5,694	(19 )

(1) Excludes loans that were fully paid off or fully charged-off by period end. The pre-modification balance represents the balance outstanding prior to modification. The post-modification balance represents the outstanding balance at period end.

(2) Chapter 7 bankruptcy loans where the debt has been legally discharged through the bankruptcy court and not reaffirmed.

(3) This loan had debt forgiveness of \$0.1 million to the customer; however, the loan was previously charged off to a balance below the actual contractual balance.



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## S&amp;T BANCORP, INC. AND SUBSIDIARIES

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS – continued

## NOTE 5. LOANS AND LOANS HELD FOR SALE – continued

(dollars in thousands)	Six Months Ended June 30, 2014				Six Months Ended June 30, 2013			
	Number of Loans	Pre-Modification Outstanding Recorded Investment <sup>(1)</sup>	Post-Modification Outstanding Recorded Investment <sup>(1)</sup>	Total Difference in Recorded Investment	Number of Loans	Pre-Modification Outstanding Recorded Investment <sup>(1)</sup>	Post-Modification Outstanding Recorded Investment <sup>(1)</sup>	Total Difference in Recorded Investment
Commercial real estate								
Principal deferral	1	\$ 129	\$ 127	\$(2 )	3	\$ 1,541	\$ 1,288	\$(253 )
Principal forgiveness <sup>(3)</sup>	—	—	—	—	1	4,339	4,339	—
Chapter 7 bankruptcy <sup>(2)</sup>	—	—	—	—	7	258	255	(3 )
Commercial and industrial								
Principal deferral	—	—	—	—	1	392	387	(5 )
Maturity date extension	—	—	—	—	1	751	751	—
Chapter 7 bankruptcy <sup>(2)</sup>	1	287	286	(1 )	1	3	3	—
Commercial Construction								
Maturity date extension	1	1,019	1,019	—	—	—	—	—
Residential mortgage								
Principal deferral	—	—	—	—	2	153	153	—
Chapter 7 bankruptcy <sup>(2)</sup>	5	329	327	(2 )	8	353	344	(9 )
Home equity								
Principal deferral	—	—	—	—	1	174	45	(129 )
Chapter 7 bankruptcy <sup>(2)</sup>	10	269	251	(18 )	23	648	640	(8 )
Installment and other consumer								
Chapter 7 bankruptcy <sup>(2)</sup>	1	9	9	—	6	73	73	—
Total by Concession Type								
Principal deferral	1	129	127	(2 )	7	2,260	1,873	(387 )
Principal forgiveness <sup>(3)</sup>	—	—	—	—	1	4,339	4,339	—
Maturity date extension	1	1,019	1,019	—	1	751	751	—
Chapter 7 bankruptcy <sup>(2)</sup>	17	894	873	(21 )	45	1,335	1,315	(20 )
Total	19	\$ 2,042	\$ 2,019	\$(23 )	54	\$ 8,685	8,278	(407 )

(1) Excludes loans that were fully paid off or fully charged-off by period end. The pre-modification balance represents the balance outstanding prior to modification. The post-modification balance represents the outstanding balance at period end.

(2) Chapter 7 bankruptcy loans where the debt has been legally discharged through the bankruptcy court and not reaffirmed.

(3) This loan had debt forgiveness of \$0.1 million to the customer; however, the loan was previously charged off to a balance below the actual contractual balance.

For the three months ended June 30, 2014, we modified two CRE loans totaling \$1.2 million that were not considered to be TDRs. For the six months ended June 30, 2014, we modified three loans that were not considered to be TDRs, including a \$0.4 million commercial and industrial, or C&I, loan and two CRE loans for \$1.2 million. The



modifications primarily represented instances where we were adequately compensated through additional collateral and a higher interest rate or there was an insignificant delay in payment. As of June 30, 2014 we have no commitments to lend additional funds on any TDRs.

Defaulted TDRs are defined as loans having a payment default of 90 days or more after the restructuring takes place. The following tables present a summary of TDRs which defaulted during the periods presented that had been restructured within the last twelve months prior to defaulting:

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## S&amp;T BANCORP, INC. AND SUBSIDIARIES

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS – continued

## NOTE 5. LOANS AND LOANS HELD FOR SALE – continued

(dollars in thousands)	Defaulted TDRs			
	For the Three Months ended June 30, 2014		For the Three Months ended June 30, 2013	
	Number of Defaults	Recorded Investment	Number of Defaults	Recorded Investment
Commercial real estate	—	\$—	\$—	\$—
Commercial and Industrial	—	—	—	—
Commercial construction	—	—	—	—
Residential real estate	—	—	2	46
Home equity	—	—	2	33
Total	—	\$—	\$4	\$79

(dollars in thousands)	Defaulted TDRs			
	For the Six Months Ended June 30, 2014		For the Six Months Ended June 30, 2013	
	Number of Defaults	Recorded Investment	Number of Defaults	Recorded Investment
Commercial real estate	—	\$—	\$—	\$—
Commercial and Industrial	—	—	—	—
Commercial construction	—	—	—	—
Residential real estate	1	72	3	64
Home equity	—	—	4	151
Total	1	\$72	\$7	\$215

The following table is a summary of nonperforming assets as of the dates presented:

(dollars in thousands)	Nonperforming Assets	
	June 30, 2014	December 31, 2013
Nonperforming Assets		
Nonaccrual loans	\$9,698	\$12,387
Nonaccrual TDRs	5,241	10,067
Total nonaccrual loans	14,939	22,454
OREO	431	410
Total Nonperforming Assets	\$15,370	\$22,864

OREO consists of eight properties and is included in other assets in the Consolidated Balance Sheets. It is our policy to obtain OREO appraisals on an annual basis.

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS – continued

NOTE 6. ALLOWANCE FOR LOAN LOSSES

We maintain an allowance for loan losses, or ALL, at a level determined to be adequate to absorb estimated probable credit losses inherent in the loan portfolio as of the balance sheet date. We develop and document a systematic ALL methodology based on the following portfolio segments: 1) CRE, 2) C&I, 3) Commercial Construction, 4) Consumer Real Estate and 5) Other Consumer.

The following are key risks within each portfolio segment:

CRE—Loans secured by commercial purpose real estate, including both owner occupied properties and investment properties, for various purposes such as hotels, strip malls and apartments. Operations of the individual projects as well as global cash flows of the debtors are the primary sources of repayment for these loans. The condition of the local economy is an important indicator of risk, but there are also more specific risks depending on the collateral type as well as the business prospects of the lessee, if the project is not owner occupied.

C&I—Loans made to operating companies or manufacturers for the purpose of production, operating capacity, accounts receivable, inventory or equipment financing. Cash flow from the operations of the company is the primary source of repayment for these loans. The condition of the local economy is an important indicator of risk, but there are also more specific risks depending on the industry of the company. Collateral for these types of loans often do not have sufficient value in a distressed or liquidation scenario to satisfy the outstanding debt.

Commercial Construction—Loans made to finance construction of buildings or other structures, as well as to finance the acquisition and development of raw land for various purposes. While the risk of these loans is generally confined to the construction period, if there are problems, the project may not be complete, and as such, may not provide sufficient cash flow on its own to service the debt or have sufficient value in a liquidation to cover the outstanding principal. The condition of the local economy is an important indicator of risk, but there are also more specific risks depending on the type of project and the experience and resources of the developer.

Consumer Real Estate—Loans secured by first and second liens such as home equity loans, home equity lines of credit and 1-4 family residences, including purchase money mortgages. The primary source of repayment for these loans is the income and assets of the borrower. The condition of the local economy, in particular the unemployment rate, is an important indicator of risk for this segment. The state of the local housing market can also have a significant impact on this segment because low demand and/or declining home values can limit the ability of borrowers to sell a property and satisfy the debt.

Other Consumer—Loans made to individuals that may be secured by assets other than 1-4 family residences, as well as unsecured loans. This segment includes auto loans, unsecured loans and lines and credit cards. The primary source of repayment for these loans is the income and assets of the borrower. The condition of the local economy, in particular the unemployment rate, is an important indicator of risk for this segment. The value of the collateral, if there is any, is less likely to be a source of repayment due to less certain collateral values.

We further assess risk within each portfolio segment by pooling loans with similar risk characteristics. For the commercial loan classes, the most important indicator of risk is the internally assigned risk rating, including pass, special mention and substandard. Consumer loans are pooled by type of collateral, lien position and loan to value ratio for consumer real estate loans. Historical loss rates are applied to these loan pools to determine the reserve for loans collectively evaluated for impairment.

We continually monitor our ALL methodology to ensure that it is responsive to the current economic environment. No changes were made to our ALL methodology for the six months ended June 30, 2014.

Management monitors various credit quality indicators for both the commercial and consumer loan portfolios, including delinquency, nonperforming status and changes in risk ratings on a monthly basis.

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## S&amp;T BANCORP, INC. AND SUBSIDIARIES

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS – continued

## NOTE 6. ALLOWANCE FOR LOAN LOSSES

The following tables present the age analysis of past due loans segregated by class of loans as of June 30, 2014 and December 31, 2013:

(dollars in thousands)	June 30, 2014					Total Past Due	Total Loans
	Current	30-59 Days Past Due	60-89 Days Past Due	Nonaccrual			
Commercial real estate	\$1,629,928	\$753	\$44	\$5,658	\$6,455	\$1,636,383	
Commercial and industrial	918,846	559	249	2,537	3,345	922,191	
Commercial construction	185,428	—	1,014	1,869	2,883	188,311	
Residential mortgage	488,551	1,022	898	2,118	4,038	492,589	
Home equity	412,851	1,466	478	1,431	3,375	416,226	
Installment and other consumer	65,380	364	68	26	458	65,838	
Consumer construction	3,541	—	—	—	—	3,541	
Loans held for sale	1,802	—	—	1,300	1,300	3,102	
Totals	\$3,706,327	\$4,164	\$2,751	\$14,939	\$21,854	\$3,728,181	

(dollars in thousands)	December 31, 2013					Total Past Due	Total Loans
	Current	30-59 Days Past Due	60-89 Days Past Due	Nonaccrual			
Commercial real estate	\$1,595,590	\$1,209	\$207	\$10,750	\$12,166	\$1,607,756	
Commercial and industrial	836,276	2,599	278	3,296	6,173	842,449	
Commercial construction	139,133	1,049	751	2,742	4,542	143,675	
Residential mortgage	481,260	828	1,666	3,338	5,832	487,092	
Home equity	408,777	2,468	659	2,291	5,418	414,195	
Installment and other consumer	67,420	382	44	37	463	67,883	
Consumer construction	3,149	—	—	—	—	3,149	
Loans held for sale	2,136	—	—	—	—	2,136	
Totals	\$3,533,741	\$8,535	\$3,605	\$22,454	\$34,594	\$3,568,335	

We continually monitor the commercial loan portfolio through an internal risk rating system. Loan risk ratings are assigned based upon the creditworthiness of the borrower and are reviewed on an ongoing basis according to our internal policies. Loans within the pass rating generally have a lower risk of loss than loans risk rated as special mention or substandard.

Our risk ratings are consistent with regulatory guidance and are as follows:

Pass—The loan is currently performing and is of high quality.

Special Mention—A special mention loan has potential weaknesses that warrant management's close attention. If left uncorrected, these potential weaknesses may result in deterioration of the repayment prospects or in the strength of our credit position at some future date. Economic and market conditions, beyond the borrower's control, may in the future necessitate this classification.

Substandard—A substandard loan is not adequately protected by the net worth and/or paying capacity of the borrower or by the collateral pledged, if any. Substandard loans have a well-defined weakness or weaknesses that jeopardize the liquidation of the debt. These loans are characterized by the distinct possibility that we will sustain some loss if the deficiencies are not corrected.



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## S&amp;T BANCORP, INC. AND SUBSIDIARIES

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS – continued

## NOTE 6. ALLOWANCE FOR LOAN LOSSES

The following tables summarize the recorded investment in commercial loan classes by internally assigned risk ratings as of the dates presented:

June 30, 2014											
(dollars in thousands)	Commercial Real Estate	% of Total	Commercial and Industrial	% of Total	Commercial Construction	% of Total	Total	% of Total			
Pass	\$1,563,882	95.6	% \$872,686	94.6	% \$167,267	88.8	% \$2,603,835	94.8	%		
Special mention	45,275	2.8	% 33,966	3.7	% 12,882	6.8	% 92,123	3.4	%		
Substandard	27,226	1.6	% 15,539	1.7	% 8,162	4.4	% 50,927	1.8	%		
Total	\$1,636,383	100	% \$922,191	100.0	% \$188,311	100.0	% \$2,746,885	100.0	%		

December 31, 2013											
(dollars in thousands)	Commercial Real Estate	% of Total	Commercial and Industrial	% of Total	Commercial Construction	% of Total	Total	% of Total			
Pass	\$1,519,720	94.5	% \$792,029	94.0	% \$119,177	82.9	% \$2,430,926	93.7	%		
Special mention	57,073	3.6	% 34,085	4.1	% 15,621	10.9	% 106,779	4.1	%		
Substandard	30,963	1.9	% 16,335	1.9	% 8,877	6.2	% 56,175	2.2	%		
Total	\$1,607,756	100.0	% \$842,449	100.0	% \$143,675	100.0	% \$2,593,880	100.0	%		

We monitor the delinquent status of the consumer portfolio on a monthly basis. Loans are considered nonperforming when interest and principal are 90 days or more past due or management has determined that a material deterioration in the borrower's financial condition exists. The risk of loss is generally highest for nonperforming loans.

The following tables indicate the recorded investment in consumer loan classes by performing and nonperforming status as of the dates presented:

June 30, 2014											
(dollars in thousands)	Residential Mortgage	% of Total	Home Equity	% of Total	Installment and other consumer	% of Total	Consumer Construction	% of Total	Total	% of Total	
Performing	\$490,471	99.6	% \$414,795	99.7	% \$65,812	99.9	% \$3,541	100.0	% \$974,619	99.6	%
Nonperforming	2,118	0.4	% 1,431	0.3	% 26	0.1	% —	—	% 3,575	0.4	%
Total	\$492,589	100.0	% \$416,226	100.0	% \$65,838	100.0	% \$3,541	100.0	% \$978,194	100.0	%

December 31, 2013											
(dollars in thousands)	Residential Mortgage	% of Total	Home Equity	% of Total	Installment and other consumer	% of Total	Consumer Construction	% of Total	Total	% of Total	
Performing	\$483,754	99.3	% \$411,904	99.4	% \$67,846	99.9	% \$3,149	100.0	% \$966,653	99.4	%
Nonperforming	3,338	0.7	% 2,291	0.6	% 37	0.1	% —	—	% 5,666	0.6	%
Total	\$487,092	100.0	% \$414,195	100.0	% \$67,883	100.0	% \$3,149	100.0	% \$972,319	100.0	%

We individually evaluate all substandard and nonaccrual commercial loans greater than \$0.5 million for impairment. Loans are considered to be impaired when based upon current information and events it is probable that we will be unable to collect all principal and interest payments due according to the original contractual terms of the loan agreement. All TDRs are considered to be impaired loans and will be reported as an impaired loan for the remaining life of the loan, unless the restructuring agreement specifies an interest rate equal to or greater than the rate that would

be accepted at the time of the restructuring for a new loan with comparable risk and it is expected that the remaining principal and interest will be fully collected according to the restructured agreement. For all TDRs, regardless of size, as well as all other impaired loans, we conduct further analysis to determine the probable loss and assign a specific reserve to the loan if deemed appropriate.

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## S&amp;T BANCORP, INC. AND SUBSIDIARIES

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS – continued

## NOTE 6. ALLOWANCE FOR LOAN LOSSES

The following table presents investments in loans considered to be impaired and related information on those impaired loans for the periods presented:

(dollars in thousands)	June 30, 2014			December 31, 2013		
	Recorded Investment	Unpaid Principal Balance	Related Allowance	Recorded Investment	Unpaid Principal Balance	Related Allowance
Without a related allowance recorded:						
Commercial real estate	\$21,228	\$28,296	\$—	\$26,968	\$35,474	\$—
Commercial and industrial	9,545	9,660	—	9,580	9,703	—
Commercial construction	8,179	11,866	—	7,391	12,353	—
Consumer real estate	7,082	7,629	—	8,026	9,464	—
Other consumer	107	109	—	124	128	—
Total without a Related Allowance Recorded	46,141	57,560	—	52,089	67,122	—
With a related allowance recorded:						
Commercial real estate	—	—	—	—	—	—
Commercial and industrial	—	—	—	—	—	—
Commercial construction	—	—	—	681	1,383	25
Consumer real estate	47	47	47	53	53	53
Other consumer	21	21	11	33	33	19
Total with a Related Allowance Recorded	68	68	58	767	1,469	97
Total:						
Commercial real estate	21,228	28,296	—	26,968	35,474	—
Commercial and industrial	9,545	9,660	—	9,580	9,703	—
Commercial construction	8,179	11,866	—	8,072	13,736	25
Consumer real estate	7,129	7,676	47	8,079	9,517	53
Other consumer	128	130	11	157	161	19
Total	\$46,209	\$57,628	\$58	\$52,856	\$68,591	\$97

As of June 30, 2014, CRE loans of \$21.2 million comprised 46 percent of the total impaired loans of \$46.2 million. These impaired loans are collateralized primarily by commercial real estate properties such as retail or strip malls, office buildings and various other types of commercial purpose properties. These loans are generally considered collateral dependent and charge-offs are recorded when a confirmed loss exists. Approximately \$7.9 million of charge-offs have been recorded relating to these CRE loans over the life of these loans. It is our policy to order appraisals on an annual basis on impaired loans or sooner if facts and circumstances warrant. As of June 30, 2014, an estimated fair value less cost to sell of approximately \$34.7 million existed for CRE impaired loans. We have current appraisals on all but \$0.6 million of the \$21.2 million of impaired CRE loans. We have not ordered an appraisal on this loan due to an outstanding settlement agreement with the borrower which would result in the collection of the remaining recorded investment in the loan.



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## S&amp;T BANCORP, INC. AND SUBSIDIARIES

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS – continued

## NOTE 6. ALLOWANCE FOR LOAN LOSSES

The following tables summarize investments in loans considered to be impaired and related information on those impaired loans for the periods presented:

(dollars in thousands)	For the Three Months Ended									
	June 30, 2014		June 30, 2013							
	Average Recorded Investment	Interest Income Recognized	Average Recorded Investment	Interest Income Recognized						
Without a related allowance recorded:										
Commercial real estate	\$21,382	\$ 159	\$ 30,956	\$ 174						
Commercial and industrial	9,317	57	12,452	66						
Commercial construction	8,279	57	16,376	87						
Consumer real estate	7,166	100	8,708	156						
Other consumer	109	1	114	2						
Total without a Related Allowance Recorded	46,253	374	68,606	485						
With a related allowance recorded:										
Commercial real estate	—	—	226	(2,501)	(824)	(3,126)				
(Loss) income from operating affiliates	(614)	)	—	12,580	—	—				
Net operating (loss) income (b)	(99,809)	)	31,077	335,265	74,138	322,763				
Gain on bargain purchase, net of expenses (c)	21,485	)	—	17,701	—	—				
Net realized (losses) gains on investments	(4,516)	)	5,355	18,233	28,532	32,498				
Net unrealized (losses) gains on investments	(35,857)	)	2,159	17,585	(19,991)	45,952				
(Loss) from investment affiliate	(406)	)	—	(964)	)	—				
Foreign exchange gains (losses)	1,181	)	266	4,798	(22,124)	1,351				
Transaction expenses (d)	—	)	(3,850)	—	(17,433)	—				
Net (loss) income	(117,922)	)	35,007	392,618	43,122	402,564				
Net loss (income) attributable to noncontrolling interest	27,206	)	(7,683)	15,820	(21,793)	—				
Net (loss) income (attributable) available to Validus	\$ (90,716)	)	\$27,324	\$408,438	\$21,329	\$402,564				
Selected ratios:										
	88.6	%	94.1	%	85.8	%	86.4	%	88.5	%

Net premiums written / Gross premiums written										
Losses and loss expenses	91.8	%	68.6	%	53.4	%	69.1	%	56.1	%
Policy acquisition costs	16.4	%	16.6	%	17.9	%	17.4	%	16.6	%
General and administrative expenses (e)	14.5	%	12.2	%	15.5	%	12.9	%	13.5	%
Expense ratio	30.9	%	28.8	%	33.4	%	30.3	%	30.1	%
Combined ratio	122.7	%	97.4	%	86.8	%	99.4	%	86.2	%

- (a) The results of operations for Flagstone are consolidated only from the November 30, 2012 date of acquisition.
- Non-GAAP Financial Measures. In presenting the Company's results, management has included and discussed underwriting income and operating income that are not calculated under standards or rules that comprise U.S. GAAP. Such measures are referred to as non-GAAP. Non-GAAP measures may be defined or calculated differently by other companies. These measures should not be viewed as a substitute for those determined in accordance with U.S. GAAP. Reconciliations of these measures to the most comparable U.S. GAAP financial measure, are presented in the section below entitled "Underwriting Income."
- (b) The gain on bargain purchase, net of expenses, arises from the acquisition of Flagstone on November 30, 2012 and is net of transaction related expenses.
- (c) The transaction expenses relate to costs incurred in connection with the Company's proposed acquisition of Transatlantic. Transaction expenses are primarily comprised of legal, financial advisory and audit related services.
- (d) The general and administrative expense ratio includes share compensation expenses.
- (e)
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(Dollars in thousands)	Three Months Ended December 31,		Years Ended December 31,		
	2012 (a)	2011	2012 (a)	2011	2010
<b>Validus Re</b>					
Gross premiums written	\$79,233	\$55,851	\$1,131,959	\$1,114,493	\$1,089,443
Reinsurance premiums ceded	(7,074 )	(49 )	(144,578 )	(150,718 )	(63,147 )
Net premiums written	72,159	55,802	987,381	963,775	1,026,296
Change in unearned premiums	213,105	196,679	35,890	2,150	13,822
Net premiums earned	285,264	252,481	1,023,271	965,925	1,040,118
Losses and loss expenses	331,130	215,903	575,416	749,305	601,610
Policy acquisition costs	40,703	39,227	154,362	154,582	159,527
General and administrative expenses	14,716	11,716	63,048	44,663	45,613
Share compensation expenses	1,849	2,191	7,763	9,309	7,181
Total underwriting deductions	388,398	269,037	800,589	957,859	813,931
Underwriting (loss) income (b)	(103,134 )	(16,556 )	222,682	8,066	226,187
<b>AlphaCat</b>					
Gross premiums written	\$(4 )	\$(1,323 )	\$21,603	\$75,727	\$11,796
Reinsurance premiums ceded	—	—	—	—	—
Net premiums written	(4 )	(1,323 )	21,603	75,727	11,796
Change in unearned premiums	5,895	27,834	(3,937 )	(9,761 )	(714 )
Net premiums earned	5,891	26,511	17,666	65,966	11,082
Losses and loss expenses	—	10,000	—	10,000	—
Policy acquisition costs	589	3,331	1,774	7,946	1,072
General and administrative expenses	2,011	6,807	7,532	10,929	5,327
Share compensation expenses	84	33	279	107	594
Total underwriting deductions	2,684	20,171	9,585	28,982	6,993
Underwriting income (b)	3,207	6,340	8,081	36,984	4,089
<b>Legal Entity adjustments</b>					
Gross premiums written	\$7	\$—	\$7	\$—	\$—
Reinsurance premiums ceded	—	—	—	—	—
Net premiums written	7	—	7	—	—
Change in unearned premiums	(3,833 )	—	(3,833 )	—	—
Net premiums earned	(3,826 )	—	(3,826 )	—	—
Losses and loss expenses	—	—	—	—	—
Policy acquisition costs	(365 )	(1,093 )	(390 )	(2,394 )	—
General and administrative expenses	1,673	(5,438 )	5,130	(1,658 )	15,927
Share compensation expenses	115	196	561	982	80
Total underwriting deductions	1,423	(6,335 )	5,301	(3,070 )	16,007
Underwriting (loss) income (b)	(5,249 )	6,335	(9,127 )	3,070	(16,007 )
<b>Talbot</b>					
Gross premiums written	\$241,100	\$235,242	\$1,078,636	\$1,014,122	\$981,073
Reinsurance premiums ceded	(37,067 )	(27,931 )	(228,686 )	(218,174 )	(258,081 )
Net premiums written	204,033	207,311	849,950	795,948	722,992
Change in unearned premiums	4,098	2,043	(17,671 )	(25,696 )	(13,069 )
Net premiums earned	208,131	209,354	832,279	770,252	709,923
Losses and loss expenses	127,180	108,926	424,030	485,096	385,976
Policy acquisition costs	41,745	41,160	183,926	157,334	143,769
General and administrative expenses	32,371	29,676	133,281	112,072	107,557
Share compensation expenses	2,442	1,934	7,789	8,582	6,923
Total underwriting deductions	203,738	181,696	749,026	763,084	644,225

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Underwriting income (b)	4,393	27,658	83,253	7,168	65,698
Corporate & Eliminations					
Gross premiums written	\$(8,489 )	\$(11,491 )	\$(65,765 )	\$(79,651 )	\$(91,746 )
Reinsurance premiums ceded	8,482	11,491	65,758	79,651	91,746
Net premiums written	(7 )	—	(7 )	—	—
Change in unearned premiums	3,833	—	3,833	—	—
Net premiums earned	3,826	—	3,826	—	—
Losses and loss expenses	—	—	—	—	—
Policy acquisition costs	(858 )	(1,372 )	(4,974 )	(3,284 )	(11,469 )
General and administrative expenses	14,324	9,492	54,661	31,491	34,866
Share compensation expenses	2,636	2,883	10,317	15,316	14,133
Total underwriting deductions	16,102	11,003	60,004	43,523	37,530
Underwriting (loss) (b)	(12,276 )	(11,003 )	(56,178 )	(43,523 )	(37,530 )
Total underwriting (loss) income (b)	\$(113,059 )	\$12,774	\$248,711	\$11,765	\$242,437

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- (a) The results of operations for Flagstone are consolidated only from the November 30, 2012 date of acquisition. Non-GAAP Financial Measures. In presenting the Company's results, management has included and discussed underwriting income that is not calculated under standards or rules that comprise U.S. GAAP. Such measures are referred to as non-GAAP. Non-GAAP measures may be defined or calculated differently by other companies.
- (b) These measures should not be viewed as a substitute for those determined in accordance with U.S. GAAP. A reconciliation of this measure to net income, the most comparable U.S. GAAP financial measure, is presented in the section below entitled "Underwriting Income."

Three Months Ended December 31, 2012 compared to Three Months Ended December 31, 2011

Net loss attributable to Validus for the three months ended December 31, 2012 was \$(90.7) million compared to net income available to Validus of \$27.3 million for the three months ended December 31, 2011, a decrease of \$118.0 million or 432.0%.

The primary factors driving the net loss attributable to Validus were:

• Decrease in underwriting income of \$125.8 million primarily due to:

• A \$123.5 million increase in loss and loss expenses;

• A \$12.8 million increase in general and administrative expenses; and

• Offset by a \$10.9 million increase in net premiums earned.

• Unfavorable movements in net realized and unrealized losses on investments of \$9.9 million and \$38.0 million, respectively.

The above items were partially offset by the following factors:

• Gain on bargain purchase, net of expenses and transaction expenses of \$21.5 million; and

• Net loss attributable to noncontrolling interest which resulted in an increase to net income attributable to Validus of \$34.9 million.

The change in net income available to Validus for the three months ended December 31, 2012 of \$118.0 million as compared to the three months ended December 31, 2011 is described in the following table:

Three Months Ended December 31, 2012  
Increase (Decrease) Over the Three Months Ended December 31, 2011 (a)

(Dollars in thousands)	Validus Re (a)	AlphaCat	Talbot	Corporate and Eliminations (b)	Total
Notable losses—(increase) in net loss and loss expenses (c)	\$ (259,639 )	\$ —	\$ (47,249 )	\$ —	\$ (306,888 )
Less: Notable losses—increase in net reinstatement premium (c)	33,177	—	4,540	—	37,717
Other underwriting income (loss)	139,884	(3,133 )	19,444	(12,857 )	143,338
Underwriting (loss) income (d)	(86,578 )	(3,133 )	(23,265 )	(12,857 )	(125,833 )
Net investment income	(535 )	528	(1,132 )	1,861	722
Other income	(2,311 )	(5,076 )	(1,291 )	5,348	(3,330 )
Finance expenses	(462 )	(1,043 )	75	440	(990 )
Operating (loss) income before taxes and (loss) from operating affiliates	(89,886 )	(8,724 )	(25,613 )	(5,208 )	(129,431 )
Tax (expense) benefit	(152 )	—	(1,776 )	1,087	(841 )
(Loss) from operating affiliates	—	(614 )	—	—	(614 )
Net operating (loss) income	(90,038 )	(9,338 )	(27,389 )	(4,121 )	(130,886 )
Gain on bargain purchase, net of expenses	—	—	—	21,485	21,485
Net realized (losses) on investments	(9,367 )	—	(504 )	—	(9,871 )
Net unrealized (losses) gains on investments	(4,266 )	(31,819 )	(1,932 )	1	(38,016 )

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(Loss) from investment affiliate	(406 )	—	—	—	(406 )
Foreign exchange gains (losses)	413	136	749	(383 )	915
Transaction expenses	—	—	—	3,850	3,850
Net (loss) income	(103,664 )	(41,021 )	(29,076 )	20,832	(152,929 )
Net loss (income) attributable to noncontrolling interest	—	34,889	—	—	34,889
Net (loss) income (attributable) available to Validus	\$(103,664 )	\$(6,132 )	\$(29,076 )	\$20,832	\$(118,040 )

(a) The results of operations for Flagstone are consolidated only from the November 30, 2012 date of acquisition.

(b) The Corporate and Eliminations column includes legal entity adjustments.

Notable losses for the three months ended December 31, 2012 include: Hurricane Sandy. Notable losses for the

(c) three months ended December 31, 2011 include: the Thai floods and excludes the reserve for potential development on 2011 notable loss events. The AlphaCat segment's non-consolidated

affiliates incurred loss and loss expenses of \$8.4 million related to Hurricane Sandy for the three months ended December 31, 2012. These losses are not included in the table above as the entities are accounted for as investments in operating affiliates.

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

#### Gross Premiums Written

Gross premiums written for the three months ended December 31, 2012 were \$311.8 million compared to \$278.3 million for the three months ended December 31, 2011, an increase of \$33.6 million or 12.1%. The property and marine lines increased by \$37.4 million and \$5.1 million, respectively, while the specialty lines decreased by \$8.9 million. Details of gross premiums written by line of business are provided below.

(Dollars in thousands)	Three Months Ended December 31, 2012 (a)		Three Months Ended December 31, 2011		% Change	
	Gross Premiums Written	Gross Premiums Written (%)	Gross Premiums Written	Gross Premiums Written (%)		
Property	\$110,561	35.4	% \$73,200	26.3	% 51.0	%
Marine	89,394	28.7	% 84,247	30.3	% 6.1	%
Specialty	111,892	35.9	% 120,832	43.4	% (7.4)	)%
Total	\$311,847	100.0	% \$278,279	100.0	% 12.1	%

(a) The results of operations for Flagstone are consolidated only from the November 30, 2012 date of acquisition.

Validus Re. Validus Re gross premiums written for the three months ended December 31, 2012 were \$79.2 million compared to \$55.9 million for the three months ended December 31, 2011, an increase of \$23.4 million or 41.9%.

Details of Validus Re gross premiums written by line of business are provided below.

(Dollars in thousands)	Three Months Ended December 31, 2012 (a)		Three Months Ended December 31, 2011		% Change	
	Gross Premiums Written	Gross Premiums Written (%)	Gross Premiums Written	Gross Premiums Written (%)		
Property	\$54,878	69.2	% \$34,053	61.0	% 61.2	%
Marine	8,621	10.9	% 9,742	17.4	% (11.5)	)%
Specialty	15,734	19.9	% 12,056	21.6	% 30.5	%
Total	\$79,233	100.0	% \$55,851	100.0	% 41.9	%

(a) The results of operations for Flagstone are consolidated only from the November 30, 2012 date of acquisition.

The increase in gross premiums written in the property lines of \$20.8 million was due primarily to an increase in reinstatement premiums of \$28.0 million primarily due to Hurricane Sandy and a \$7.4 million increase in premiums relating to the Flagstone acquisition, slightly offset by a decrease in per risk excess of loss treaties of \$5.1 million. The decrease in gross premiums written of \$1.1 million in the marine lines was due primarily to a \$6.8 million decrease in premium adjustments on proportional treaties, partially offset by an increase in reinstatement premiums of \$4.1 million primarily on Hurricane Sandy. The increase in gross premiums written in the specialty lines of \$3.7 million was due primarily to a \$3.1 million increase in premiums relating to the Flagstone acquisition and a \$2.5 million increase in per risk excess of loss treaties and premium adjustments on proportional treaties, slightly offset by a \$2.2 million decrease in premium adjustments relating to non-proportional treaties.

Gross premiums written under the quota share, surplus treaty and excess of loss contracts with Talbot for the three months ended December 31, 2012 were \$8.5 million compared to \$11.5 million for the three months ended December 31, 2011, a decrease of by \$3.0 million as compared to the three months ended December 31, 2011. These reinsurance transactions with Talbot are eliminated upon consolidation.

AlphaCat. AlphaCat gross premiums written for the three months ended December 31, 2012 were \$0.0 million compared to \$(1.3) million for the three months ended December 31, 2011, an increase of \$1.3 million or 99.7%. The AlphaCat segment generally does not write premiums in the fourth quarter.

The increase in gross premiums written in the property lines of \$1.3 million was due primarily to the change in accounting treatment for AlphaCat Re 2011 which occurred as at December 31, 2011, when the individual assets and liabilities and corresponding noncontrolling interest of AlphaCat Re 2011 were derecognized from the consolidated Balance Sheet of the

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Company. AlphaCat Re 2011 was consolidated in 2011 whereas in 2012, AlphaCat Re 2011 is accounted for as an equity method operating affiliate.

Managed gross premiums written from our non-consolidated affiliates, AlphaCat Re 2011 and AlphaCat Re 2012, for the three months ended December 31, 2012 were \$0.0 million compared to \$(1.4) million for the three months ended December 31, 2011, an increase of \$1.3 million or 97.3%. Gross premiums written from our consolidated AlphaCat entities for the three months ended December 31, 2012 were \$0.0 million compared to \$0.1 million for the three months ended December 31, 2011, a decrease of \$0.1 million or 106.5%.

Talbot. Talbot gross premiums written for the three months ended December 31, 2012 were \$241.1 million compared to \$235.2 million for the three months ended December 31, 2011, an increase of \$5.9 million or 2.5%. The \$241.1 million of gross premiums written translated at 2011 rates of exchange would have been \$240.9 million during the three months ended December 31, 2012, giving an effective increase of \$5.7 million or 2.4%. Details of Talbot gross premiums written by line of business are provided below.

(Dollars in thousands)	Three Months Ended December 31, 2012			Three Months Ended December 31, 2011			% Change
	Gross Premiums Written	Gross Premiums Written (%)		Gross Premiums Written	Gross Premiums Written (%)		
Property	\$62,258	25.8	%	\$51,793	22.0	%	20.2
Marine	81,540	33.8	%	74,235	31.6	%	9.8
Specialty	97,302	40.4	%	109,214	46.4	%	(10.9)
Total	\$241,100	100.0	%	\$235,242	100.0	%	2.5

The increase in gross premiums written in the property lines of \$10.5 million was due primarily to a \$6.4 million increase in premiums written in the direct property lines and a \$4.2 million increase in the construction lines, partially offset by a \$1.0 million decrease in property treaty lines. The increase in gross premiums written in the marine lines of \$7.3 million was due primarily to a \$5.1 million increase in premiums written in the cargo lines and a \$5.1 million increase in the other treaty lines, \$3.5 million of which relates to reinstatement premiums on Hurricane Sandy. These were partially offset by a \$2.5 million decrease in yachts lines. The decrease in gross premiums written in the specialty lines of \$11.9 million was due primarily to a \$12.2 million decrease in premiums written in the direct aviation and aviation treaty lines. This decrease primarily relates to a premium reassessment of \$8.2 million which has no net earned impact on the direct aviation and aviation treaty lines. In addition, there was a \$2.9 million decrease in the war lines, partially offset by a \$3.7 million increase in the political violence lines.

#### Reinsurance Premiums Ceded

Reinsurance premiums ceded for the three months ended December 31, 2012 were \$35.7 million compared to \$16.5 million for the three months ended December 31, 2011, an increase of \$19.2 million or 116.3%. Details of reinsurance premiums ceded by line of business are provided below.

(Dollars in thousands)	Three Months Ended December 31, 2012 (a)		Three Months Ended December 31, 2011		% Change		
	Reinsurance Premiums Ceded	Reinsurance Premiums Ceded (%)	Reinsurance Premiums Ceded	Reinsurance Premiums Ceded (%)			
Property	\$19,644	55.1	%	\$11,979	72.7	%	64.0
Marine	4,890	13.7	%	(1,363)	(8.3)	%	458.8
Specialty	11,125	31.2	%	5,873	35.6	%	89.4
Total	\$35,659	100.0	%	\$16,489	100.0	%	116.3

(a) The results of operations for Flagstone are consolidated only from the November 30, 2012 date of acquisition.

Validus Re. Validus Re reinsurance premiums ceded for the three months ended December 31, 2012 were \$7.1 million compared to \$0.0 million for the three months ended December 31, 2011, an increase of \$7.0 million. Details of Validus Re reinsurance premiums ceded by line of business are provided below.

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(Dollars in thousands)	Three Months Ended December 31, 2012 (a)			Three Months Ended December 31, 2011			% Change
	Reinsurance Premiums Ceded	Reinsurance Premiums Ceded (%)		Reinsurance Premiums Ceded	Reinsurance Premiums Ceded (%)		
Property	\$4,275	60.5	%	\$980	2,000.0	%	336.2
Marine	2,803	39.6	%	(931	) (1,900.0	)%	401.1
Specialty	(4	) (0.1	)%	—	—	%	NM
Total	\$7,074	100.0	%	\$49	100.0	%	NM

(a) The results of operations for Flagstone are consolidated only from the November 30, 2012 date of acquisition. NM: Not meaningful

Reinsurance premiums ceded in the property lines increased by \$3.3 million, due primarily to increases in ceded reinstatement premiums and non-proportional coverage of \$2.2 million and \$1.4 million, respectively. The increase in reinsurance premiums of \$3.7 million ceded in the marine lines was primarily due to a \$1.4 million increase in non-proportional coverage and \$1.3 million of adjustments to coverage from prior periods.

AlphaCat. AlphaCat did not cede reinsurance premiums for the three months ended December 31, 2012 and 2011.

Talbot. Talbot reinsurance premiums ceded for the three months ended December 31, 2012 were \$37.1 million compared to \$27.9 million for the three months ended December 31, 2011, an increase of \$9.1 million or 32.7%.

Details of Talbot reinsurance premiums ceded by line of business are provided below.

(Dollars in thousands)	Three Months Ended December 31, 2012			Three Months Ended December 31, 2011			% Change
	Reinsurance Premiums Ceded	Reinsurance Premiums Ceded (%)		Reinsurance Premiums Ceded	Reinsurance Premiums Ceded (%)		
Property	\$21,940	59.2	%	\$22,322	79.9	%	(1.7
Marine	2,854	7.7	%	(702	) (2.5	)%	506.6
Specialty	12,273	33.1	%	6,311	22.6	%	94.5
Total	\$37,067	100.0	%	\$27,931	100.0	%	32.7

The increase in reinsurance premiums ceded in the marine lines of \$3.6 million was due primarily to a \$5.5 million increase in premiums ceded in the marine energy and cargo lines, \$5.2 million of which relates to reinstatement premiums, partially offset by a \$2.1 million decrease in other marine lines. The increase in reinsurance premiums ceded in the specialty lines of \$6.0 million was due primarily to a \$3.0 million increase in premiums ceded in the war, political risk and violence lines and a \$2.0 million increase in financial institution lines, mainly due to higher reinstatement premiums and prior period adjustments.

Reinsurance premiums ceded under the quota share, surplus treaty and excess of loss contracts with Validus Re for the three months ended December 31, 2012 were \$8.5 million compared to \$11.5 million for the three months ended December 31, 2011, a decrease of \$3.0 million. These reinsurance agreements with Validus Re are eliminated upon consolidation.

#### Net Premiums Written

Net premiums written for the three months ended December 31, 2012 were \$276.2 million compared to \$261.8 million for the three months ended December 31, 2011, an increase of \$14.4 million or 5.5%. The ratios of net premiums written to gross premiums written for the three months ended December 31, 2012 and 2011 were 88.6% and 94.1%, respectively. Details of net premiums written by line of business are provided below.

(Dollars in thousands)	Three Months Ended December 31, 2012 (a)			Three Months Ended December 31, 2011			% Change
	Net Premiums Written	Net Premiums Written (%)		Net Premiums Written	Net Premiums Written (%)		
Property	\$90,917	32.9	%	\$61,221	23.4	%	48.5
Marine	84,504	30.6	%	85,610	32.7	%	(1.3
Specialty	100,767	36.5	%	114,959	43.9	%	(12.3

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Total	\$276,188	100.0	%	\$261,790	100.0	%	5.5	%
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(a) The results of operations for Flagstone are consolidated only from the November 30, 2012 date of acquisition.

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Validus Re. Validus Re net premiums written for the three months ended December 31, 2012 were \$72.2 million compared to \$55.8 million for the three months ended December 31, 2011, an increase of \$16.4 million or 29.3%.

Details of Validus Re net premiums written by line of business are provided below.

(Dollars in thousands)	Three Months Ended December 31, 2012 (a)		Three Months Ended December 31, 2011		% Change	
	Net Premiums Written	Net Premiums Written (%)	Net Premiums Written	Net Premiums Written (%)		
Property	\$50,603	70.1 %	\$33,073	59.3 %	53.0	%
Marine	5,818	8.1 %	10,673	19.1 %	(45.5)	)%
Specialty	15,738	21.8 %	12,056	21.6 %	30.5	%
Total	\$72,159	100.0 %	\$55,802	100.0 %	29.3	%

(a) The results of operations for Flagstone are consolidated only from the November 30, 2012 date of acquisition.

The increase in Validus Re net premiums written was driven by the factors highlighted above in respect of gross premiums written and reinsurance premiums ceded. The ratios of net premiums written to gross premiums written were 91.1% and 99.9% for the three months ended December 31, 2012 and 2011, respectively.

AlphaCat. AlphaCat net premiums written for the three months ended December 31, 2012 were \$0.0 million compared to \$(1.3) million for the three months ended December 31, 2011, an increase of \$1.3 million or 99.7%.

The increase in AlphaCat net premiums written was driven by the factors highlighted above in respect of gross premiums written. The ratios of net premiums written to gross premiums written were 100.0% for the three months ended December 31, 2012 and 2011.

Talbot. Talbot net premiums written for the three months ended December 31, 2012 were \$204.0 million compared to \$207.3 million for the three months ended December 31, 2011, a decrease of \$3.3 million or 1.6%. Details of Talbot net premiums written by line of business are provided below.

(Dollars in thousands)	Three Months Ended December 31, 2012		Three Months Ended December 31, 2011		% Change	
	Net Premiums Written	Net Premiums Written (%)	Net Premiums Written	Net Premiums Written (%)		
Property	\$40,318	19.8 %	\$29,471	14.2 %	36.8	%
Marine	78,686	38.5 %	74,937	36.1 %	5.0	%
Specialty	85,029	41.7 %	102,903	49.7 %	(17.4)	)%
Total	\$204,033	100.0 %	\$207,311	100.0 %	(1.6)	)%

The decrease in net premiums written was driven by the factors highlighted above in respect of gross premiums written and reinsurance premiums ceded. The ratios of net premiums written to gross premiums written for the three months ended December 31, 2012 and 2011 were 84.6% and 88.1%, respectively.

Net Change in Unearned Premiums

Net change in unearned premiums for the three months ended December 31, 2012 was \$223.1 million compared to \$226.6 million for the three months ended December 31, 2011, a decrease of \$3.5 million or 1.5%.

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(Dollars in thousands)	Three Months Ended December 31, 2012 (a)	Three Months Ended December 31, 2011	% Change	
	Net Change in Unearned Premiums	Net Change in Unearned Premiums		
Change in gross unearned premium	\$140,243	\$286,211	(51.0	)%
Less change due to Flagstone acquisition	139,389	—	NM	
Deconsolidation of AlphaCat Re 2011	—	(9,405	)	NM
Net change in gross unearned premium	279,632	276,806	1.0	%
Change in prepaid reinsurance premium	(45,195	) (50,250	)	(10.1
Less change due to Flagstone acquisition	(11,339	) —	)	NM
Net change in prepaid reinsurance premiums	(56,534	) (50,250	)	12.5
Net change in unearned premium	\$223,098	\$226,556	(1.5	)%

(a) The results of operations for Flagstone are consolidated only from the November 30, 2012 date of acquisition.

NM: Not meaningful

Validus Re. Validus Re's net change in unearned premiums for the three months ended December 31, 2012 was \$213.1 million compared to \$196.7 million for the three months ended December 31, 2011, an increase of \$16.4 million or 8.4%.

(Dollars in thousands)	Three Months Ended December 31, 2012 (a)	Three Months Ended December 31, 2011	% Change	
	Net Change in Unearned Premiums	Net Change in Unearned Premiums		
Change in gross unearned premium	\$110,621	\$228,747	(51.6	)%
Less change due to Flagstone acquisition	139,389	—	NM	
Deconsolidation of AlphaCatRe 2011	—	(9,405	)	NM
Net change in gross unearned premium	250,010	219,342	14.0	%
Change in prepaid reinsurance premium	(25,566	) (22,663	)	(12.8
Less change due to Flagstone acquisition	(11,339	) —	)	NM
Net change in prepaid reinsurance premiums	(36,905	) (22,663	)	(62.8
Net change in unearned premium	\$213,105	\$196,679	8.4	%

(a) The results of operations for Flagstone are consolidated only from the November 30, 2012 date of acquisition.

NM: Not meaningful

Validus Re net change in unearned premiums has increased for the three months ended December 31, 2012 due to the earnings pattern of gross premiums written and reinsurance premiums ceded.

AlphaCat. AlphaCat's net change in unearned premiums for the three months ended December 31, 2012 was \$5.9 million compared to \$27.8 million for the three months ended December 31, 2011, a decrease of \$21.9 million or 78.8%.

(Dollars in thousands)	Three Months Ended December 31, 2012	Three Months Ended December 31, 2011	% Change	
	Net Change in Unearned Premiums	Net Change in Unearned Premiums		
Change in gross unearned premiums	\$ 5,895	\$ 27,834	(78.8	)%

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Net change in unearned premiums	\$ 5,895	\$ 27,834	(78.8	)%
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AlphaCat net change in unearned premiums has decreased for the three months ended December 31, 2012 due primarily to the deconsolidation of AlphaCat Re 2011 and the earnings pattern of gross premiums written.

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Talbot. Talbot's net change in unearned premiums for the three months ended December 31, 2012 was \$4.1 million compared to \$2.0 million for the three months ended December 31, 2011, an increase of \$2.1 million or 100.6%.

(Dollars in thousands)	Three Months	Three Months	% Change
	Ended December 31, 2012	Ended December 31, 2011	
	Net	Net	
	Change in Unearned	Change in Unearned	
	Premiums	Premiums	
Change in gross unearned premiums	\$ 23,727	\$ 29,630	(19.9)%
Change in prepaid reinsurance premiums	(19,629)	(27,587)	28.8%
Net change in unearned premiums	\$ 4,098	\$ 2,043	100.6%

Talbot's net change in unearned premium has increased for the three months ended December 31, 2012 due to the earnings pattern of gross premiums written and reinsurance premiums ceded.

#### Net Premiums Earned

Net premiums earned for the three months ended December 31, 2012 were \$499.3 million compared to \$488.3 million for the three months ended December 31, 2011, an increase of \$10.9 million or 2.2%. Details of net premiums earned by line of business are provided below.

(Dollars in thousands)	Three Months Ended December 31, 2012 (a)		Three Months Ended December 31, 2011		% Change
	Net Premiums Earned	Net Premiums Earned (%)	Net Premiums Earned	Net Premiums Earned (%)	
Property	\$250,480	50.2%	\$236,671	48.5%	5.8%
Marine	146,744	29.4%	146,953	30.1%	(0.1)%
Specialty	102,062	20.4%	104,722	21.4%	(2.5)%
Total	\$499,286	100.0%	\$488,346	100.0%	2.2%

(a) The results of operations for Flagstone are consolidated only from the November 30, 2012 date of acquisition. Validus Re. Validus Re net premiums earned for three months ended December 31, 2012 were \$285.3 million compared to \$252.5 million for the three months ended December 31, 2011, an increase of \$32.8 million or 13.0%. Details of Validus Re net premiums earned by line of business are provided below.

(Dollars in thousands)	Three Months Ended December 31, 2012 (a)		Three Months Ended December 31, 2011		% Change
	Net Premiums Earned	Net Premiums Earned (%)	Net Premiums Earned	Net Premiums Earned (%)	
Property	\$198,002	69.4%	\$169,052	67.0%	17.1%
Marine	60,163	21.1%	57,524	22.8%	4.6%
Specialty	27,099	9.5%	25,905	10.2%	4.6%
Total	\$285,264	100.0%	\$252,481	100.0%	13.0%

(a) The results of operations for Flagstone are consolidated only from the November 30, 2012 date of acquisition. The overall increase in net premiums earned was due primarily to the increase in reinstatement premiums relating to Hurricane Sandy and an increase in net premiums earned relating to the acquisition of Flagstone. The increase in premiums earned in the property lines of \$29.0 million is due primarily to the increase in earned reinstatement premiums of \$25.7 million relating primarily to Hurricane Sandy and a \$20.9 million increase in premiums earned relating to the acquisition of Flagstone. These items are partially offset by a \$10.3 million decrease in intercompany premiums with Talbot which are eliminated upon consolidation and a \$6.0 million decrease in assumed earned premium. The increase in premiums earned in the marine lines of \$2.6 million is due primarily to an increase in earned reinstatement premiums of \$3.1 million relating primarily to Hurricane Sandy and a \$1.6 million premiums earned relating to the Flagstone acquisition, partially offset by a \$3.6 million decrease in premium adjustments on proportional business. These increases are consistent with the relevant pattern of net premiums written influencing the earned premiums for the three months ended December 31, 2012 compared to the three months ended December 31, 2011.

AlphaCat. AlphaCat net premiums earned for the three months ended December 31, 2012 were \$5.9 million compared to \$26.5 million for the three months ended December 31, 2011, a decrease of \$20.6 million or 77.8%. Details of AlphaCat net premiums earned by line of business are provided below.

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(Dollars in thousands)	Three Months Ended December 31, 2012		Three Months Ended December 31, 2011		% Change
	Net Premiums Earned	Net Premiums Earned (%)	Net Premiums Earned	Net Premiums Earned (%)	
Property	\$5,891	100.0 %	\$26,511	100.0 %	(77.8)%
Total	\$5,891	100.0 %	\$26,511	100.0 %	(77.8)%

The decrease in net premiums earned is consistent with the relevant pattern of net premiums written and the deconsolidation of AlphaCatRe 2011, influencing the earned premiums for the three months ended December 31, 2012 compared to the three months ended December 31, 2011.

Talbot. Talbot net premiums earned for the three months ended December 31, 2012 were \$208.1 million compared to \$209.4 million for the three months ended December 31, 2011, a decrease of \$1.2 million or 0.6%. Details of Talbot net premiums earned by line of business are provided below.

(Dollars in thousands)	Three Months Ended December 31, 2012		Three Months Ended December 31, 2011		% Change
	Net Premiums Earned	Net Premiums Earned (%)	Net Premiums Earned	Net Premiums Earned (%)	
Property	\$46,587	22.4 %	\$41,108	19.6 %	13.3 %
Marine	86,581	41.6 %	89,429	42.8 %	(3.2)%
Specialty	74,963	36.0 %	78,817	37.6 %	(4.9)%
Total	\$208,131	100.0 %	\$209,354	100.0 %	(0.6)%

The decrease in net premiums earned is consistent with the relevant patterns of net premiums written influencing the earned premiums for the three months ended December 31, 2012, as compared to the three months ended December 31, 2011.

#### Losses and Loss Expenses

Losses and loss expenses for the three months ended December 31, 2012 were \$458.3 million compared to \$334.8 million for the three months ended December 31, 2011, an increase of \$123.5 million or 36.9%. The loss ratios, defined as losses and loss expenses divided by net premiums earned, for the three months ended December 31, 2012 and 2011 were 91.8% and 68.6%, respectively. Details of loss ratios by line of business are provided below.

	Three Months Ended December 31, 2012 (a)	Three Months Ended December 31, 2011	Percentage Point Change
Property	126.0	% 90.0	% 36.0
Marine	76.2	% 53.0	% 23.2
Specialty	30.2	% 42.0	% (11.8)
All lines	91.8	% 68.6	% 23.2

(a) The results of operations for Flagstone are consolidated only from the November 30, 2012 date of acquisition.

For the three months ended December 31, 2012, the Company incurred \$361.0 million of losses from notable loss events, which represented 72.3 percentage points of the overall loss ratio. Net of \$36.4 million of reinstatement premiums, the effect of these events on net income was a decrease of \$324.6 million. For the three months ended December 31, 2011, the Company incurred \$54.1 million of losses from notable loss events, which represented 11.1 percentage points of the overall loss ratio, excluding the reserve for potential development on notable loss events. Including the impact of \$(1.3) million of reinstatement premiums, the effect of these events on net income was a decrease of \$55.5 million. The Company's loss ratio, excluding notable loss events, reserve for potential development on notable loss events and prior year loss reserve development for the three months ended December 31, 2012 and 2011 was 31.0% and 50.3%, respectively.

		Three Months Ended December 31, 2012 (b) (Dollars in thousands)							
Fourth Quarter 2012 Notable Loss Events (a) (b)		Validus Re (b)		Talbot		Total			
(Dollars in thousands)	Description	Net Losses and Loss Expenses(c)	% of NPE	Net Losses and Loss Expenses(c)	% of NPE	Net Losses and Loss Expenses(c)	% of NPE	Net Losses and Loss Expenses(c)	% of NPE
Hurricane Sandy (d)	Windstorm	\$282,603	99.1 %	\$78,433	37.7 %	\$361,036	72.3 %		
Total		\$282,603	99.1 %	\$78,433	37.7 %	\$361,036	72.3 %		

		Three Months Ended December 31, 2011 (Dollars in thousands)							
Fourth Quarter 2011 Notable Loss Events (a)		Validus Re		Talbot		Total			
(Dollars in thousands)	Description	Net Losses and Loss Expenses(c)	% of NPE	Net Losses and Loss Expenses(c)	% of NPE	Net Losses and Loss Expenses(c)	% of NPE	Net Losses and Loss Expenses(c)	% of NPE
Thailand floods	Multiple flooding events	\$22,964	9.1 %	\$31,184	14.9 %	\$54,148	11.1 %		
Total		\$22,964	9.1 %	\$31,184	14.9 %	\$54,148	11.1 %		

These notable loss event amounts exclude the reserve for potential development on 2011 notable loss events and are based on management's estimates following a review of the Company's potential exposure and discussions with certain clients and brokers. Given the magnitude and recent occurrence of these events in relation to the corresponding period end date, and other uncertainties inherent in loss estimation, meaningful uncertainty exists at the relevant reporting date regarding losses from these events and the Company's actual ultimate net losses from these events can vary materially from these estimates.

(b) The results of operations for Flagstone are consolidated only from the November 30, 2012 date of acquisition.

(c) Net of reinsurance but not of reinstatement premiums. Total reinstatement premiums were \$36.4 million and \$(1.3) million for the three months ended December 31, 2012 and December 31, 2011, respectively.

(d) The AlphaCat segment's non-consolidated affiliates incurred loss and loss expenses of \$8.4 million related to Hurricane Sandy for the three months ended December 31, 2012. These losses are not included in the table above as the entities are accounted for as investments in operating affiliates.

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Details of loss ratios by line of business and period of occurrence are provided below.

	Three Months Ended December 31,		
	2012 (a)	2011	Percentage Point Change
Property—current period—excluding items below	21.0	% 46.9	% (25.9 )
Property—current period—notable losses	113.2	% 20.3	% 92.9
Property—current period—reserve for potential development on notable loss events	0.0	% 30.8	% (30.8 )
Property—change in prior accident years	(8.2)	)% (8.0)	)% (0.2 )
Property—loss ratio	126.0	% 90.0	% 36.0
Marine—current period—excluding items below	42.8	% 53.8	% (11.0 )
Marine—current period—notable losses	47.5	% 2.9	% 44.6
Marine—current period—reserve for potential development on notable loss events	0.0	% 3.4	% (3.4 )
Marine—change in prior accident years	(14.1)	)% (7.1)	)% (7.0 )
Marine—loss ratio	76.2	% 53.0	% 23.2
Specialty—current period—excluding items below	38.2	% 53.0	% (14.8 )
Specialty—current period—notable losses	7.7	% 1.8	% 5.9
Specialty—change in prior accident years	(15.7)	)% (12.8)	)% (2.9 )
Specialty—loss ratio	30.2	% 42.0	% (11.8 )
All lines—current period—excluding items below	31.0	% 50.3	% (19.3 )
All lines—current period—notable losses	72.3	% 11.1	% 61.2
All lines—current period—reserve for potential development on notable loss events	0.0	% 16.0	% (16.0 )
All lines—change in prior accident years	(11.5)	)% (8.8)	)% (2.7 )
All lines—loss ratio	91.8	% 68.6	% 23.2

(a) The results of operations for Flagstone are consolidated only from the November 30, 2012 date of acquisition.

Validus Re. Validus Re losses and loss expenses for the three months ended December 31, 2012 were \$331.1 million compared to \$215.9 million for the three months ended December 31, 2011, an increase of \$115.2 million or 53.4%. The loss ratio, defined as losses and loss expenses divided by net premiums earned, was 116.1% and 85.5% for the three months ended December 31, 2012 and 2011, respectively. For the three months ended December 31, 2012, Validus Re incurred losses of \$350.9 million related to current year losses and \$19.8 million of favorable loss reserve development relating to prior accident years. For three months ended December 31, 2012, favorable loss reserve development on prior accident years benefited the Validus Re loss ratio by 6.9 percentage points. For the three months ended December 31, 2011, Validus Re incurred losses of \$223.0 million related to current year losses and \$7.1 million of favorable loss reserve development relating to prior accident years. For the three months ended December 31, 2011, favorable loss reserve development on prior years benefited the Validus Re loss ratio by 2.8 percentage points.

For the three months ended December 31, 2012, Validus Re incurred \$282.6 million of losses from notable loss events, which represented 99.1 percentage points of the overall loss ratio. Net of \$34.8 million of reinstatement premiums, the effect of these events on net income was a decrease of \$247.8 million. For the three months ended December 31, 2011, Validus Re incurred \$23.0 million of losses from notable loss events, which represented 9.1 percentage points of the overall loss ratio, excluding the reserve for potential development on notable loss events. Net of reinstatement premiums of \$1.6 million, the effect of these events on Validus Re segment income was a decrease of \$21.4 million. Validus Re segment loss ratios excluding notable loss events, reserve for potential development on notable loss events and prior year loss reserve development for the three months ended December 31, 2012 and 2011 were 23.9% and 48.3%, respectively. Details of Validus Re loss ratios by line of business and period of occurrence are provided below.



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	Three Months Ended December 31,		Percentage Point Change
	2012 (a)	2011	
Property—current period excluding items below	18.7	% 39.3	% (20.6 )
Property—current period—notable losses	120.2	% 11.7	% 108.5
Property—current period—reserves for potential development on notable loss events	0.0	% 43.2	% (43.2 )
Property—change in prior accident years	(3.2)	)% (2.8)	)% (0.4 )
Property—loss ratio	135.7	% 91.4	% 44.3
Marine—current period excluding items below	39.3	% 62.5	% (23.2 )
Marine—current period—notable losses	72.3	% 5.6	% 66.7
Marine—current period—reserves for potential development on notable loss events	0.0	% 8.7	% (8.7 )
Marine—change in prior accident years	(7.0)	)% (0.5)	)% (6.5 )
Marine—loss ratio	104.6	% 76.3	% 28.3
Specialty—current period excluding items below	28.4	% 75.6	% (47.2 )
Specialty—current period—notable losses	4.2	% 0.0	% 4.2
Specialty—change in prior accident years	(34.4)	)% (8.1)	)% (26.3 )
Specialty—loss ratio	(1.8)	)% 67.5	% (69.3 )
All lines—current period excluding items below	23.9	% 48.3	% (24.4 )
All lines—current period—notable losses	99.1	% 9.1	% 90.0
All lines—current period—reserves for potential development on notable loss events	0.0	% 30.9	% (30.9 )
All lines—change in prior accident years	(6.9)	)% (2.8)	)% (4.1 )
All lines—loss ratio	116.1	% 85.5	% 30.6

(a) The results of operations for Flagstone are consolidated only from the November 30, 2012 date of acquisition.

For the three months ended December 31, 2012, Validus Re property lines losses and loss expenses included \$274.9 million related to current year losses and \$6.3 million of favorable loss reserve development relating to prior accident years. The favorable loss reserve development was due to a decrease in loss estimates on prior year notable loss events, as well as a reduction in loss estimates on attritional losses. For the three months ended December 31, 2011, Validus Re property lines losses and loss expenses included \$159.3 million related to current year losses and \$4.7 million of favorable loss reserve development relating to prior accident years.

For the three months ended December 31, 2012, Validus Re property lines incurred \$237.9 million of losses from notable loss events, which represented 120.2 percentage points of the property lines loss ratio. Net of \$29.5 million of reinstatement premiums, the effect of these events on net income was a decrease of \$208.4 million. For the three months ended December 31, 2011, Validus Re property lines incurred \$19.8 million of losses from notable loss events, which represented 11.7 percentage points of the property lines loss ratio, excluding reserve for potential development on notable loss events. Validus Re property lines loss ratios, excluding notable loss events, reserve for potential development on notable loss events and prior year loss reserve development, for the three months ended December 31, 2012 and 2011 were 18.7% and 39.3%, respectively.

For the three months ended December 31, 2012, Validus Re marine lines losses and loss expenses included \$67.2 million related to current year losses and \$4.2 million of favorable loss reserve development relating to prior accident years. The favorable loss reserve development was due primarily to a reduction in loss estimates on attritional losses, which was partially offset by an increase in prior year notable loss events. For the three months ended December 31, 2011, Validus Re marine lines losses and loss expenses included \$44.2 million related to current year losses and \$0.3 million of favorable loss reserve development relating to prior accident years.

For the three months ended December 31, 2012, Validus Re marine lines incurred \$43.5 million of losses from notable loss events, which represented 72.3 percentage points of the marine lines loss ratio. Net of \$5.2 million of

reinstatement premiums, the effect of these events on net income was a decrease of \$38.3 million. For the three months ended December 31, 2011, Validus Re marine lines incurred \$3.2 million of losses from notable loss events, which represented 5.6 percentage points of the marine

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lines loss ratio, excluding reserve for potential development on notable loss events. Validus Re marine lines loss ratios, excluding notable loss events, reserve for potential development on notable loss events and prior year loss reserve development, for the three months ended December 31, 2012 and 2011 were 39.3% and 62.5%, respectively. For the three months ended December 31, 2012, Validus Re specialty lines losses and loss expenses included \$8.8 million related to current year losses and \$9.3 million of favorable loss reserve development relating to prior accident years. The favorable loss reserve development was due primarily to a reduction in loss estimates on attritional losses. For the three months ended December 31, 2011, Validus Re specialty lines losses and loss expenses included \$19.6 million related to current year losses and \$2.1 million of favorable loss reserve development relating to prior accident years.

For the three months ended December 31, 2012 and 2011, Validus Re specialty lines incurred \$1.1 million of losses from notable loss events which represented 4.2 percentage points of the specialty lines loss ratio. Validus Re specialty lines loss ratios, excluding prior year loss reserve development, for the three months ended December 31, 2012 and 2011 were 28.4% and 75.6%, respectively.

The net negative financial impact from Hurricane Sandy to Flagstone for the year ended December 31, 2012 was \$39.1 million. The financial impact to Flagstone did not impact Validus' results of operations in the fourth quarter 2012 as the loss event took place prior to the date of Validus' acquisition of Flagstone which was completed on November 30, 2012.

**AlphaCat.** AlphaCat contributed \$nil to the losses and loss expenses for the three months ended December 31, 2012 compared to \$10.0 million for the three months ended December 31, 2011, a decrease of \$10.0 million or 100.0%. The loss ratio defined as losses and loss expenses divided by net premiums earned, was nil% and 37.7% for the three months ended December 31, 2012 and 2011, respectively. For the three months ended December 31, 2012, AlphaCat Re 2011 and AlphaCat Re 2012 incurred Hurricane Sandy net losses of \$25.0 million and \$7.5 million, respectively. The AlphaCat segment's portion of incurred losses and loss expenses related to Hurricane Sandy was \$8.4 million for the year ended December 31, 2012 and are included in 'income from operating affiliates'.

**Talbot.** Talbot losses and loss expenses for the three months ended December 31, 2012 were \$127.2 million compared to \$108.9 million for the three months ended December 31, 2011, an increase of \$18.3 million or 16.8%. The loss ratio defined as losses and loss expenses divided by net premiums earned, was 61.1% and 52.0% for the three months ended December 31, 2012 and 2011, respectively. For the three months ended December 31, 2012, Talbot incurred losses of \$164.6 million related to current year losses and \$37.4 million of favorable loss reserve development relating to prior accident years. For the three months ended December 31, 2012, favorable loss reserve development on prior accident years benefited the Talbot loss ratio by 18.0 percentage points. For the three months ended December 31, 2011, Talbot incurred losses of \$144.6 million related to current year losses and \$35.7 million in favorable loss reserve development relating to prior accident years. For the three months ended December 31, 2011, favorable loss reserve development on prior accident years benefited the Talbot loss ratio by 17.0 percentage points. For the three months ended December 31, 2012, Talbot incurred \$78.4 million of losses from notable loss events, which represented 37.7 percentage points of the overall loss ratio. Net of \$1.6 million of reinstatement premiums, the effect of these events on net income was a decrease of \$76.8 million. For the three months ended December 31, 2011, Talbot incurred \$31.2 million of losses from notable loss events, which represented 14.9 percentage points of the overall loss ratio. Talbot loss ratios, excluding notable loss events and prior year loss reserve development, for the three months ended December 31, 2012 and 2011 were 41.4% and 54.1%, respectively. Details of Talbot loss ratios by line of business and period of occurrence are provided below.

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	Three Months Ended December 31,		Percentage Point Change
	2012	2011	
Property—current period excluding items below	33.5	% 83.8	% (50.3 )
Property—current period—notable losses	97.8	% 68.9	% 28.9
Property—change in prior accident years	(30.5)	)% (34.8)	)% 4.3
Property—loss ratio	100.8	% 117.9	% (17.1 )
Marine—current period excluding items below	45.3	% 48.2	% (2.9 )
Marine—current period—notable losses	30.2	% 1.1	% 29.1
Marine—change in prior accident years	(19.0)	)% (11.3)	)% (7.7 )
Marine—loss ratio	56.5	% 38.0	% 18.5
Specialty—current period excluding items below	41.8	% 45.6	% (3.8 )
Specialty—current period—notable losses	8.9	% 2.3	% 6.6
Specialty—change in prior accident years	(8.9)	)% (14.3)	)% 5.4
Specialty—loss ratio	41.8	% 33.6	% 8.2
All lines—current period excluding items below	41.4	% 54.1	% (12.7 )
All lines—current period—notable losses	37.7	% 14.9	% 22.8
All lines—change in prior accident years	(18.0)	)% (17.0)	)% (1.0 )
All lines—loss ratio	61.1	% 52.0	% 9.1

For the three months ended December 31, 2012, Talbot property lines losses and loss expenses included \$61.2 million related to current year losses and \$14.2 million of favorable loss reserve development relating to prior accident years.

The prior year favorable loss reserve development was due to lower than expected claims development on attritional and large losses. For the three months ended December 31, 2011, Talbot property lines losses and loss expenses included \$62.8 million related to current year losses and \$14.3 million of favorable loss reserve development relating to prior accident years. The prior year favorable loss reserve development was attributable to lower than expected claims development on large losses.

For the three months ended December 31, 2012, Talbot property lines incurred \$45.6 million of losses from notable loss events, which represented 97.8 percentage points of the property lines loss ratio. Net of \$1.2 million of reinstatement premiums, the effect of these events on net income was a decrease of \$44.3 million. For the three months ended December 31, 2011, Talbot's property lines incurred \$28.3 million of losses from notable loss events, which represented 68.9 percentage points of the property lines loss ratio. Talbot property line loss ratio, excluding notable loss events and prior year loss reserve development for the three months ended December 31, 2012 and 2011 were 33.5% and 83.8%, respectively.

For the three months ended December 31, 2012, Talbot marine lines losses and loss expenses included \$65.4 million related to current year losses and \$16.5 million of favorable loss reserve development relating to prior accident years. The prior year favorable loss reserve development was due primarily to lower than expected claims development on attritional losses. For the three months ended December 31, 2011, Talbot marine lines losses and loss expenses included \$44.1 million related to current year losses and \$10.1 million of favorable loss reserve development relating to prior accident years. The prior year favorable loss reserve development was primarily due to favorable development on attritional losses.

For the three months ended December 31, 2012, Talbot marine lines incurred \$26.2 million of losses from notable loss events, which represented 30.2 percentage points of the marine lines loss ratio. Net of \$0.9 million of reinstatement premiums, the effect of these events on net income was a decrease of \$25.2 million. For the three months ended December 31, 2011, Talbot's marine lines incurred \$1.0 million of losses from notable loss events, which represented 1.1 percentage points of the marine lines loss ratio. Talbot marine lines loss ratios, excluding notable loss events and prior year loss reserve development for the three months ended December 31, 2012 and 2011 were 45.3% and 48.2%, respectively.

For the three months ended December 31, 2012, Talbot specialty lines losses and loss expenses included \$38.0 million relating to current year losses and \$6.7 million of favorable loss reserve development relating to prior accident years.



The prior year favorable loss reserve development was attributable to lower than expected claims development on attritional losses. For the three months ended December 31, 2011, Talbot specialty lines losses and loss expenses included \$37.8 million relating to current year losses and \$11.3 million of favorable loss reserve development relating to prior accident years. The prior year favorable loss reserve development was primarily due to favorable development on attritional losses.

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For the three months ended December 31, 2012, Talbot specialty lines incurred \$6.7 million of losses from notable loss events, which represented 8.9 percentage points of the specialty lines loss ratio. Net of \$(0.5) million of reinstatement premiums, the effect of these events on net income was a decrease of \$7.2 million. For the three months ended December 31, 2011, Talbot's specialty lines incurred \$1.9 million of losses from notable loss events, which represented 2.3 percentage points of the specialty lines loss ratio. Talbot specialty lines loss ratios, excluding notable loss events and prior year loss reserve development for the three months ended December 31, 2012 and 2011 were 41.8% and 45.6%, respectively.

Reserves for Losses and Loss Expenses

At December 31, 2012 and 2011, gross and net reserves for losses and loss expenses were estimated using the methodology as outlined in the Critical Accounting Policies and Estimates as discussed above. The Company did not make any significant changes in assumptions or methodology used in its reserving process for the year ended December 31, 2012.

(Dollars in thousands)	As at December 31, 2012		Total Gross Reserve for Losses and Loss Expenses
	Gross Case Reserves	Gross IBNR	
Property	\$930,553	\$892,227	\$1,822,780
Marine	522,907	477,948	1,000,855
Specialty	265,638	428,300	693,938
Total	\$1,719,098	\$1,798,475	\$3,517,573

  

(Dollars in thousands)	As at December 31, 2012		Total Net Reserve for Losses and Loss Expenses
	Net Case Reserves	Net IBNR	
Property	\$768,722	\$803,182	\$1,571,904
Marine	465,080	438,009	903,089
Specialty	230,584	372,029	602,613
Total	\$1,464,386	\$1,613,220	\$3,077,606

The following table sets forth a reconciliation of gross and net reserves for losses and loss expenses by segment for the three months ended December 31, 2012:

(Dollars in thousands)	Three Months Ended December 31, 2012				
	Validus Re Segment	AlphaCat Segment	Talbot Segment	Eliminations	Total
Gross reserves at period beginning	\$1,216,560	\$10,000	\$1,422,568	\$(86,524)	\$2,562,604
Losses recoverable	(38,371)	—	(365,405)	86,524	(317,252)
Net reserves at period beginning	1,178,189	10,000	1,057,163	—	2,245,352
Net reserves acquired in Flagstone acquisition	639,641	—	—	—	639,641
Incurred losses—current year	350,926	—	164,605	—	515,531
Change in prior accident years	(19,796)	—	(37,425)	—	(57,221)
Incurred losses	331,130	—	127,180	—	458,310
Foreign exchange	(1,804)	—	2,747	—	943
Paid losses	(172,907)	(5,000)	(88,733)	—	(266,640)
Net reserves at period end	1,974,249	5,000	1,098,357	—	3,077,606
Losses recoverable	148,646	—	381,950	(90,629)	439,967
Gross reserves at period end	\$2,122,895	\$5,000	\$1,480,307	\$(90,629)	\$3,517,573

The amount of recorded reserves represents management's best estimate of expected losses and loss expenses on premiums earned. For the three months ended December 31, 2012, favorable loss reserve development on prior

accident years was \$57.2 million of which, \$19.8 million of the favorable loss reserve development related to the Validus Re segment and \$37.4 million related to the Talbot segment. Favorable loss reserve development benefited the Company's loss ratio by 11.5 percentage points for the three months ended December 31, 2012. For the three months ended December 31, 2011, favorable loss reserve development

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on prior accident years was \$42.8 million, of which, \$7.1 million related to the Validus Re segment and \$35.7 million related to the Talbot segment. Favorable loss reserve development benefited the Company's loss ratio by 8.8 percentage points for the three months ended December 31, 2011.

Management of insurance and reinsurance companies use significant judgment in the estimation of reserves for losses and loss expenses. Given the magnitude of recent loss events and other uncertainties inherent in loss estimation, meaningful uncertainty remains regarding the estimation for recent notable loss events. The Company's actual ultimate net loss may vary materially from these estimates. Ultimate losses for notable loss events are estimated through detailed review of contracts which are identified by the Company as potentially exposed to the specific notable loss event. However, there can be no assurance that the ultimate loss amount estimated for a specific contract will be accurate, or that all contracts with exposure to a specific notable loss event will be identified in a timely manner. Potential losses in excess of the estimated ultimate loss assigned to a contract on the basis of a specific review, or loss amounts from contracts not specifically included in the detailed review are reserved for in the reserve for potential development on notable loss events. The reserve for potential development on notable loss events (or "RDE") is included as part of the Company's overall reserve requirement as defined and disclosed in the Critical Accounting Policies and Estimates section above. As at September 30, 2012, the reserve for potential development on 2010 and 2011 notable loss events was \$nil and \$51.3 million, respectively. During the three months ended December 31, 2012, the Company increased certain loss estimates and allocated \$9.1 million of 2011 RDE to the Christchurch earthquake, the Thailand floods and the Gryphon Alpha mooring failure. As at December 31, 2012, the reserve for potential development on 2010 and 2011 notable loss events was \$nil and \$42.2 million, respectively. No RDE was established for 2012 notable losses.

#### Policy Acquisition Costs

Policy acquisition costs for the three months ended December 31, 2012 were \$81.8 million compared to \$81.3 million for the three months ended December 31, 2011, an increase of \$0.6 million or 0.7%. Policy acquisition costs as a percent of net premiums earned for the three months ended December 31, 2012 and 2011 were 16.4% and 16.6%, respectively. The changes in policy acquisition costs are due to the factors provided below.

(Dollars in thousands)	Three Months Ended December 31, 2012 (a)			Three Months Ended December 31, 2011			% Change
	Policy Acquisition Costs	Policy Acquisition Costs (%)	Acquisition Cost Ratio	Policy Acquisition Costs	Policy Acquisition Costs (%)	Acquisition Cost Ratio	
Property	\$29,237	35.8	% 11.7	% \$26,753	32.9	% 11.3	% 9.3
Marine	29,429	36.0	% 20.1	% 31,603	38.9	% 21.5	% (6.9)
Specialty	23,148	28.3	% 22.7	% 22,897	28.2	% 21.9	% 1.1
Total	\$81,814	100.1	% 16.4	% \$81,253	100.0	% 16.6	% 0.7

(a) The results of operations for Flagstone are consolidated only from the November 30, 2012 date of acquisition.

**Validus Re.** Validus Re policy acquisition costs for the three months ended December 31, 2012 were \$40.7 million compared to \$39.2 million for the three months ended December 31, 2011, an increase of \$1.5 million or 3.8%.

(Dollars in thousands)	Three Months Ended December 31, 2012 (a)			Three Months Ended December 31, 2011			% Change
	Policy Acquisition Costs	Policy Acquisition Costs (%)	Acquisition Cost Ratio	Policy Acquisition Costs	Policy Acquisition Costs (%)	Acquisition Cost Ratio	
Property	\$25,820	63.4	% 13.0	% \$24,734	63.0	% 14.6	% 4.4
Marine	10,526	25.9	% 17.5	% 11,165	28.5	% 19.4	% (5.7)
Specialty	4,357	10.7	% 16.1	% 3,328	8.5	% 12.8	% 30.9
Total	\$40,703	100.0	% 14.3	% \$39,227	100.0	% 15.5	% 3.8

(a) The results of operations for Flagstone are consolidated only from the November 30, 2012 date of acquisition.

Policy acquisition costs include brokerage, commission and excise tax, are generally driven by contract terms, are normally a set percentage of premiums and are also net of ceding commission income on retrocessions. Items such as

ceded premium, earned premium adjustments and reinstatement premiums that are recognized in the period have an effect on the policy acquisition costs ratio. Validus Re policy acquisition costs as a percent of net premiums earned (the policy acquisition cost ratio) for the three months ended December 31, 2012 and 2011 were 14.3% and 15.5%, respectively. The policy acquisition cost ratio on the specialty line has increased by 3.3 percentage points due to certain large proportional contracts that have higher policy acquisition cost ratios.

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AlphaCat. AlphaCat policy acquisition costs for the three months ended December 31, 2012 were \$0.6 million compared to \$3.3 million for the three months ended December 31, 2011, a decrease of \$2.7 million or 82.3%.

(Dollars in thousands)	Three Months Ended December 31, 2012			Three Months Ended December 31, 2011			% Change
	Policy Acquisition Costs	Policy Acquisition Costs (%)	Acquisition Cost Ratio	Policy Acquisition Costs	Policy Acquisition Costs (%)	Acquisition Cost Ratio	
Property	\$589	100.0	% 10.0	\$3,331	100.0	% 12.6	(82.3)%
Total	\$589	100.0	% 10.0	\$3,331	100.0	% 12.6	(82.3)%

Policy acquisition costs as a percent of net premiums earned for the three months ended December 31, 2012 and 2011 were 10.0% and 12.6%, respectively.

Talbot. Talbot policy acquisition costs for the three months ended December 31, 2012 were \$41.7 million compared to \$41.2 million for the three months ended December 31, 2011, an increase of \$0.6 million or 1.4%.

(Dollars in thousands)	Three Months Ended December 31, 2012			Three Months Ended December 31, 2011			% Change
	Policy Acquisition Costs	Policy Acquisition Costs (%)	Acquisition Cost Ratio	Policy Acquisition Costs	Policy Acquisition Costs (%)	Acquisition Cost Ratio	
Property	\$4,648	11.1	% 10.0	\$1,053	2.5	% 2.6	341.4%
Marine	18,269	43.8	% 21.1	20,523	49.9	% 22.9	(11.0)%
Specialty	18,828	45.1	% 25.1	19,584	47.6	% 24.8	(3.9)%
Total	\$41,745	100.0	% 20.1	\$41,160	100.0	% 19.7	1.4%

Policy acquisition costs as a percent of net premiums earned for the three months ended December 31, 2012 and 2011 were 20.1% and 19.7%, respectively. The policy acquisition ratio on the property line increased by 7.4 percentage points primarily due to a decrease in the ceding acquisition rates on the onshore energy lines.

#### General and Administrative Expenses

General and administrative expenses for the three months ended December 31, 2012 were \$65.1 million compared to \$52.3 million for the three months ended December 31, 2011, an increase of \$12.8 million or 24.6%.

(Dollars in thousands)	Three Months Ended December 31, 2012 (a)		Three Months Ended December 31, 2011		% Change
	General and Administrative Expenses	General and Administrative Expenses (%)	General and Administrative Expenses	General and Administrative Expenses (%)	
Validus Re	\$14,716	22.6	\$11,716	22.4	25.6%
AlphaCat	2,011	3.1	6,807	13.0	(70.5)%
Talbot	32,371	49.7	29,676	56.8	9.1%
Corporate & Eliminations(b)	15,997	24.6	4,054	7.8	294.6%
Total	\$65,095	100.0	\$52,253	100.0	24.6%

(a) The results of operations for Flagstone are consolidated only from the November 30, 2012 date of acquisition.

(b) Corporate and Eliminations includes legal entity adjustments

General and administrative expenses of \$65.1 million in the three months ended December 31, 2012 represents 13.0 percentage points of the expense ratio. Share compensation expense is discussed in the following section.

Validus Re. Validus Re general and administrative expenses for the three months ended December 31, 2012 were \$14.7 million compared to \$11.7 million for the three months ended December 31, 2011, an increase of \$3.0 million or 25.6%. General and administrative expenses have increased primarily due to the Company consolidating the general and administrative expenses as a result of the acquisition of Flagstone. General and administrative expenses include salaries and benefits, professional fees, rent and office expenses. Validus Re general and administrative expenses as a percent of net premiums earned for the three months ended December 31, 2012 and 2011 were 5.2% and 4.6%, respectively.

AlphaCat. AlphaCat general and administrative expenses for the three months ended December 31, 2012 were \$2.0 million as compared to \$6.8 million for the three months ended December 31, 2011, a decrease of \$4.8 million or 70.5%. General and administrative expenses have decreased primarily due to the deconsolidation of AlphaCat Re 2011 as at December 31, 2011.

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AlphaCat's general and administrative expenses as a percent of net premiums earned for the three months ended December 31, 2012 and 2011 were 34.1% and 25.7%, respectively. The AlphaCat segment's general and administrative ratio has been impacted by the reduction in net premiums earned as a greater proportion of the segment's revenues are generated in equity earnings from operating affiliates which is not included in the ratio calculation.

Talbot. Talbot general and administrative expenses for the three months ended December 31, 2012 were \$32.4 million compared to \$29.7 million for the three months ended December 31, 2011, an increase of \$2.7 million or 9.1%. General and administrative expenses have increased primarily due to an increase in performance bonus expense for the three months ended December 31, 2012 as compared to the three months ended December 31, 2011. Talbot's general and administrative expenses as a percent of net premiums earned for the three months ended December 31, 2012 and 2011 were 15.6% and 14.2%, respectively.

Corporate & Eliminations. Corporate general and administrative expenses for the three months ended December 31, 2012 were \$16.0 million compared to \$4.1 million for the three months ended December 31, 2011, an increase of \$11.9 million or 294.6%. General and administrative expenses have increased primarily due to an increase in performance bonus expense as well as a decrease in eliminations between segments. Corporate general and administrative expenses are comprised of executive and board expenses, internal and external audit expenses and other costs relating to the Company as a whole.

#### Share Compensation Expenses

Share compensation expenses for the three months ended December 31, 2012 were \$7.1 million compared to \$7.2 million for the three months ended December 31, 2011, a decrease of \$0.1 million or 1.5%. This expense is non-cash and has no net effect on total shareholders' equity, as it is balanced by an increase in additional paid-in capital.

(Dollars in thousands)	Three Months Ended December 31, 2012 (a)		Three Months Ended December 31, 2011		% Change
	Share Compensation Expenses	Share Compensation Expenses (%)	Share Compensation Expenses	Share Compensation Expenses (%)	
Validus Re	\$1,849	25.9 %	\$2,191	30.3 %	(15.6) %
AlphaCat	84	1.2 %	33	0.5 %	154.5 %
Talbot	2,442	34.3 %	1,934	26.7 %	26.3 %
Corporate & Eliminations (b)	2,751	38.6 %	3,079	42.5 %	(10.7) %
Total	\$7,126	100.0 %	\$7,237	100.0 %	(1.5) %

(a) The results of operations for Flagstone are consolidated only from the November 30, 2012 date of acquisition.

(b) Corporate and Eliminations includes legal entity adjustments.

Share compensation expenses of \$7.1 million in the three months ended December 31, 2012 represents 1.5 percentage points of the general and administrative expense ratio.

Validus Re. Validus Re share compensation expenses for the three months ended December 31, 2012 were \$1.8 million compared to \$2.2 million for the three months ended December 31, 2011, a decrease of \$0.3 million or 15.6%. Share compensation expense as a percent of net premiums earned for the three months ended December 31, 2012 and 2011 were 0.6% and 0.9%, respectively.

AlphaCat. AlphaCat share compensation expense as a percent of net premiums earned for the three months ended December 31, 2012 and 2011 were 1.5% and 0.1%, respectively.

Talbot. Talbot share compensation expenses for the three months ended December 31, 2012 was \$2.4 million compared to \$1.9 million for the three months ended December 31, 2011, an increase of \$0.5 million or 26.3%. Share compensation expense as a percent of net premiums earned for the three months ended December 31, 2012 and 2011 were 1.1% and 0.9%, respectively.

Corporate & Eliminations. Corporate share compensation expenses for the three months ended December 31, 2012 were \$2.8 million compared to \$3.1 million for the three months ended December 31, 2011, a decrease of \$0.3 million or 10.7%.

#### Selected Ratios



The underwriting results of an insurance or reinsurance company are often measured by reference to its combined ratio, which is the sum of the loss ratio and the expense ratio. The net loss ratio is calculated by dividing losses and loss expenses incurred (including estimates for incurred but not reported losses) by net premiums earned. The expense ratio is calculated by dividing policy acquisition costs combined with general and administrative expenses (including share compensation expenses)

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by net premiums earned. The following table presents the losses and loss expense ratio, policy acquisition cost ratio, general and administrative expense ratio, expense ratio and combined ratio for the three months ended December 31, 2012 and 2011.

	Three Months Ended December 31, 2012 (a)	Three Months Ended December 31, 2011	Percentage Point Change
<b>Consolidated</b>			
Losses and loss expense ratio	91.8	% 68.6	% 23.2
Policy acquisition cost ratio	16.4	% 16.6	% (0.2)
General and administrative expense ratio (b)	14.5	% 12.2	% 2.3
Expense ratio	30.9	% 28.8	% 2.1
Combined ratio	122.7	% 97.4	% 25.3
<b>Validus Re</b>			
Losses and loss expense ratio	116.1	% 85.5	% 30.6
Policy acquisition cost ratio	14.3	% 15.5	% (1.2)
General and administrative expense ratio (b)	5.8	% 5.5	% 0.3
Expense ratio	20.1	% 21.0	% (0.9)
Combined ratio	136.2	% 106.5	% 29.7
<b>AlphaCat</b>			
Losses and loss expense ratio	0.0	% 37.7	% (37.7)
Policy acquisition cost ratio	10.0	% 12.6	% (2.6)
General and administrative expense ratio (b)	35.6	% 25.8	% 9.8
Expense ratio	45.6	% 38.4	% 7.2
Combined ratio	45.6	% 76.1	% (30.5)
<b>Talbot</b>			
Losses and loss expense ratio	61.1	% 52.0	% 9.1
Policy acquisition cost ratio	20.1	% 19.7	% 0.4
General and administrative expense ratio (b)	16.7	% 15.1	% 1.6
Expense ratio	36.8	% 34.8	% 2.0
Combined ratio	97.9	% 86.8	% 11.1

(a) The results of operations for Flagstone are consolidated only from the November 30, 2012 date of acquisition.

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

General and administrative expense ratios for the three months ended December 31, 2012 and 2011 were 14.5% and 12.2%, respectively. General and administrative expense ratio is the sum of general and administrative expenses and share compensation expense divided by net premiums earned.

(Dollars in thousands)	Three Months Ended December 31, 2012 (a)		Three Months Ended December 31, 2011	
	Expenses	Expenses as % of Net Earned Premiums	Expenses	Expenses as % of Net Earned Premiums
General and administrative expenses	\$65,095	13.0	% \$52,253	10.7
Share compensation expenses	7,126	1.5	% 7,237	1.5
Total	\$72,221	14.5	% \$59,490	12.2

(a) The results of operations for Flagstone are consolidated only from the November 30, 2012 date of acquisition.

**Underwriting (Loss) Income**

Underwriting loss for the three months ended December 31, 2012 was \$(113.1) million compared to income of \$12.8 million for the three months ended December 31, 2011, a decrease of \$125.8 million, or 985.1%.

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(Dollars in thousands)	Three Months		Three Months		% Change	
	Ended December 31, 2012 (a)	% of Sub-total	Ended December 31, 2011	% of Sub-total		
Validus Re	\$(103,134)	) 108.0	% \$(16,556	) (94.9	)% (522.9	)%
AlphaCat	3,207	(3.4	)% 6,340	36.3	% (49.4	)%
Talbot	4,393	(4.6	)% 27,658	158.6	% (84.1	)%
Sub-total	(95,534	) 100.0	% 17,442	100.0	% (647.7	)%
Corporate & Eliminations (b)	(17,525	)	(4,668	)	(275.4	)%
Total	\$(113,059	)	\$12,774		(985.1	)%

(a) The results of operations for Flagstone are consolidated only from the November 30, 2012 date of acquisition.

(b) Corporate and Eliminations include legal entity adjustments.

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

(Dollars in thousands)	Three Months	Three Months
	Ended December 31, 2012 (a)	Ended December 31, 2011
Underwriting (loss) income	\$(113,059	) \$12,774
Net investment income	28,802	28,080
Other income	187	3,517
Finance expenses	(14,510	) (13,520
Net realized (losses) gains on investments	(4,516	) 5,355
Net unrealized (losses) gains on investments	(35,857	) 2,159
Gain on bargain purchase, net of expenses	21,485	—
Transaction expenses	—	(3,850
(Loss) from investment affiliate	(406	) —
Foreign exchange gains	1,181	266
Tax (expense) benefit	(615	) 226
(Loss) from operating affiliates	(614	) —
Net (loss) income	\$(117,922	) \$35,007

(a) The results of operations for Flagstone are consolidated only from the November 30, 2012 date of acquisition.

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

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

management analyzes the Company's underlying business performance. The Company uses underwriting income as a primary measure of underwriting results in its analysis of historical financial information and when performing its budgeting and forecasting processes. Analysts, investors and rating agencies who follow the Company

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request this non-GAAP financial information on a regular basis. In addition, underwriting income is one of the factors considered by the compensation committee of our Board of Directors in determining the total annual incentive compensation.

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

#### Net Investment Income

Net investment income for the three months ended December 31, 2012 was \$28.8 million compared to \$28.1 million for the three months ended December 31, 2011, an increase of \$0.7 million or 2.6%. Net investment income increased due to the Flagstone acquisition. Net investment income is comprised of accretion of premium or discount on fixed maturities, interest on coupon-paying bonds, short-term investments and cash and cash equivalents, partially offset by investment management fees. The components of net investment income for the three months ended December 31, 2012 and 2011 are as provided below.

(Dollars in thousands)	Three Months Ended December 31, 2012 (a)	Three Months Ended December 31, 2011	% Change	
Fixed maturities and short-term investments	\$26,487	\$27,740	(4.5	)%
Other investments	2,790	—	NM	
Cash and cash equivalents	1,723	2,153	(20.0	)%
Securities lending income	5	27	(81.5	)%
Total gross investment income	31,005	29,920	3.6	%
Investment expenses	(2,203	) (1,840	) (19.7	)%
Net investment income	\$28,802	\$28,080	2.6	%

(a) The results of operations for Flagstone are consolidated only from the November 30, 2012 date of acquisition.

NM: Not meaningful

Annualized investment yield is calculated by dividing net investment income (excluding other investments) by the average balance of the assets managed by our portfolio managers (excluding other investments). Average assets is the average of the beginning, ending and intervening quarter end asset balances. Percentages for the quarter periods are annualized. The Company's annualized effective investment yield was 1.53% and 1.84% for the three months ended December 31, 2012 and 2011 respectively, and the average duration of the portfolio at December 31, 2012 was 1.34 years (December 31, 2011—1.63 years).

The annualized effective investment yield decreased for the three months ended December 31, 2012 due to the consolidation of the Flagstone investment portfolio which included \$1,060.4 million in cash and short term investments, or 72.4% of Flagstone's total investments and cash as at December 31, 2012. Excluding the effect of the consolidation of the Flagstone investment portfolio, the annualized effective investment yield would have been 1.69% for the three months ended December 31, 2012. Overall yield has decreased due to falling yields on fixed maturity investments.

#### Other Income

Other income for the three months ended December 31, 2012 was \$0.2 million compared to \$3.5 million for the three months ended December 31, 2011, a decrease of \$3.3 million or 94.7%. The decrease was due primarily to a reduction in Talbot third party income and the deconsolidation of AlphaCat Re 2011 as at December 31, 2011. AlphaCat Re 2011 was a consolidated subsidiary during the three months ended December 31, 2011. The balance sheet of AlphaCat Re 2011 was deconsolidated as at December 31, 2011.

#### Finance Expenses

Finance expenses for the three months ended December 31, 2012 were \$14.5 million compared to \$13.5 million for the three months ended December 31, 2011, an increase of \$1.0 million or 7.3%. Finance expenses also include the amortization of debt offering costs and discounts, and fees related to our credit facilities.

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(Dollars in thousands)	Three Months Ended December 31,		
	2012 (a)	2011	% Change
2006 Junior Subordinated Deferrable Debentures	\$2,235	\$1,496	49.4 %
2007 Junior Subordinated Deferrable Debentures	1,850	3,029	(38.9) %
2010 Senior Notes due 2040	5,596	5,597	0.0 %
Flagstone 2006 Junior Subordinated Deferrable Interest Notes	459	—	NM
Flagstone 2007 Junior Subordinated Deferrable Interest Notes	327	—	NM
Credit facilities	1,469	1,671	(12.1) %
Bank charges	138	218	22.9 %
AlphaCat Re 2011 fees (b)	—	1,497	(100.0) %
AlphaCat ILS Funds fees (c)	2,432	—	NM
Talbot FAL Facility	4	12	(66.7) %
Finance expenses	\$14,510	\$13,520	7.3 %

(a) The results of operations for Flagstone are consolidated only from the November 30, 2012 date of acquisition.

(b) Includes preferred share dividends and finance expenses attributable to AlphaCat Re 2011.

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

NM: Not Meaningful

The increase in finance expenses of \$1.0 million for the three months ended December 31, 2012 was due primarily to placements fees incurred by AlphaCat for its investments in ILS Funds of \$2.4 million, partially offset by a \$1.5 million decrease in the preferred dividends and finance expenses attributable to AlphaCat Re 2011.

Tax (Expense) Benefit

Tax expense for the three months ended December 31, 2012 was \$(0.6) million compared to a benefit of \$0.2 million for the three months ended December 31, 2011, an increase in expense of \$0.8 million. The increase was primarily due to higher profit commission, UK taxable profit and Canadian tax charge, partially offset by a higher bonus deduction.

The Company provides for income taxes based upon amounts reported in the financial statements and the provisions of currently enacted tax laws. The Company is registered in Bermuda and is subject to Bermuda law with respect to taxation. Under current Bermuda law, the Company is not taxed on any Bermuda income or capital gains and has received an undertaking from the Bermuda Minister of Finance that, in the event of any Bermuda income or capital gains taxes being imposed, the Company will be exempt from those taxes until March 31, 2035.

Within the segment information contained in the Financial Statements, gross premiums written allocated to the territory of coverage exposure are presented for the periods indicated. Gross premiums written allocated to the United States are written primarily through Validus Reinsurance, Ltd., a Bermuda Registered Reinsurance Company. As noted, under current Bermuda law, the Company is not taxed on any Bermuda income and therefore the premium disclosed in the segment information does not correlate to pre-tax income generated in the United States.

(Loss) Income From Operating Affiliates

Loss from operating affiliates for the three months ended December 31, 2012 was \$(0.6) million, compared to \$nil for the three months ended December 31, 2011, a decrease of \$(0.6) million. For the three months ended December 31, 2012, loss from operating affiliates of \$(0.6) million relates to equity losses relating to AlphaCat Re 2011 and AlphaCat Re 2012.

In the second quarter of 2011, AlphaCat Re 2011 was included in the consolidated results of the Company, therefore there was no comparative information for the three months ended December 31, 2011. As at December 31, 2012, the Company owned 22.3% of AlphaCat Re 2011, therefore loss from operating affiliates reflects the Company's share of AlphaCat Re 2011's net loss for the three months ended December 31, 2012.

AlphaCat Re 2012 was formed on May 29, 2012 therefore there was no comparative information for the three months ended December 31, 2011. As at December 31, 2012, the Company owned 37.9% of AlphaCat Re 2012, therefore loss from operating affiliates reflects the Company's share of AlphaCat Re 2012's net loss for the three months ended December 31, 2012.





#### Gain on Bargain Purchase, Net of Expenses

On November 30, 2012, the Company acquired all of the outstanding shares of Flagstone. Pursuant to the Merger Agreement, the Company acquired all of Flagstone's outstanding common shares in exchange for the Company's common shares and cash. The purchase price paid by the Company was \$646.0 million for net assets acquired of \$695.7 million. The Company expensed as incurred \$2.0 million of transaction expenses, \$20.2 million of termination expenses and \$6.0 million for amortization of intangibles related to the acquisition for the three months ended December 31, 2012, resulting in a gain on bargain purchase of \$21.5 million. Transaction expenses are comprised of primarily legal and corporate advisory services.

#### Net Realized (Losses) Gains on Investments

Net realized losses on investments for the three months ended December 31, 2012 were \$(4.5) million compared to gains of \$5.4 million for the three months ended December 31, 2011, a decrease of \$9.9 million or 184.3%.

#### Net Unrealized (Losses) Gains on Investments

Net unrealized losses on fixed maturities and short term investments for the three months ended December 31, 2012 were \$(3.1) million compared to gains of \$1.9 million for the three months ended December 31, 2011, a decrease of \$5.0 million or 263.2%.

Net unrealized losses on other investments for the three months ended December 31, 2012 were \$(32.8) million compared to gains of \$0.3 million for the three months ended December 31, 2011. Net unrealized losses for the three months ended December 31, 2012 were driven primarily by a \$(31.3) million unrealized loss relating to the Paulson & Co. hedge fund investments held by PaCRE. The amount of net unrealized losses attributable to noncontrolling interest was \$(28.2) million for the three months ended December 31, 2012, leaving a net impact to the Company of \$(3.1) million.

Net unrealized gains (losses) on investments are recorded as a component of net income. The Company has adopted all authoritative guidance on U.S. GAAP fair value measurements in effect as of the balance sheet date. Consistent with these standards, certain market conditions allow for fair value measurements that incorporate unobservable inputs where active market transaction based measurements are unavailable.

#### Loss From Investment Affiliate

The loss from investment affiliate for the three months ended December 31, 2012 was \$(0.4) million compared to \$nil for the three months ended December 31, 2011, a decrease of \$(0.4) million. The loss from investment affiliate relates to the loss incurred in the Company's investment in the Aquiline Financial Services Fund II L.P. for the three months ended December 31, 2012. As at December 31, 2011, the investment in the Aquiline Financial Services Fund II L.P. was included in other investments.

#### Foreign Exchange Gains

Foreign exchange gains for the three months ended December 31, 2012 were \$1.2 million compared to \$0.3 million for the three months ended December 31, 2011, a favorable movement of \$0.9 million or 344.0%. For the three months ended December 31, 2012, Validus Re recognized foreign exchange gains of \$0.2 million and Talbot recognized foreign exchange gains of \$1.2 million.

For the three months ended December 31, 2012, Validus Re segment foreign exchange gains were \$0.2 million compared to foreign exchange losses of \$(0.2) million for the three months ended December 31, 2011, a favorable movement of \$0.4 million or 196.7%. Validus Re currently hedges foreign currency exposure by balancing assets (primarily cash and premium receivables) with liabilities (primarily case reserves and event IBNR) for certain major non-USD currencies. Consequently, Validus Re aims to have a limited exposure to foreign exchange fluctuations. For the three months ended December 31, 2012, Talbot segment foreign exchange gains were \$1.2 million compared to \$0.4 million for the three months ended December 31, 2011, a favorable movement of \$0.7 million or 168.7%. The favorable movement in Talbot foreign exchange was due primarily to a \$0.6 million gain due to the revaluation of assets held in Euros and other currencies.

As at December 31, 2012, Talbot's balance sheet includes net unearned premiums and deferred acquisition costs denominated in foreign currencies of approximately \$107.4 million and \$21.5 million, respectively. These balances consisted of British pound sterling and Canadian dollars of \$78.0 million and \$7.9 million, respectively. Net unearned premiums and deferred acquisition costs are classified as non-monetary items and are translated at historic exchange rates. All of Talbot's other balance sheet items are classified as monetary items and are translated at period end

exchange rates. Additional foreign exchange gains (losses) may be incurred on the translation of net unearned premiums and deferred acquisition costs arising from insurance and reinsurance premiums written in future periods.

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#### Net Loss (Income) Attributable to Noncontrolling Interest

On April 2, 2012, the Company capitalized PaCRe, a new Class 4 Bermuda reinsurer formed for the purpose of writing high excess property catastrophe reinsurance. PaCRe was funded with \$500.0 million of contributed capital. Validus invested \$50.0 million in PaCRe's common equity and therefore owns 10.0% of PaCRe. The net loss attributable to noncontrolling interest of \$27.2 million for the three months ended December 31, 2012 was calculated as 90.0% of the net loss in PaCRe for the quarter.

On May 25, 2011, the Company joined with other investors in capitalizing AlphaCat Re 2011, a new special purpose reinsurer formed for the purpose of writing collateralized reinsurance and retrocessional reinsurance. Validus Re has an equity interest in AlphaCat Re 2011 and Validus Re held a majority of AlphaCat Re 2011's outstanding voting rights up to December 23, 2011 when AlphaCat Re 2011 completed a secondary offering of its common shares to third party investors, along with a partial sale of Validus Re common shares to one of the third party investors. As a result of these transactions, the Company's outstanding voting rights decreased to 43.7%. As a result of the Company's voting interest falling below 50%, the individual assets and liabilities and corresponding noncontrolling interest of AlphaCat Re 2011 were derecognized from the consolidated balance sheet of the Company as at December 31, 2011 and the remaining investment in AlphaCat Re 2011 is treated as an equity method investment as at December 31, 2012. For the three months ended December 31, 2011, the Company recorded \$(7.7) million in net income attributable to noncontrolling interest relating to AlphaCat Re 2011.

#### Transaction Expenses

During the three months ended December 31, 2012, the Company incurred \$nil in transaction expenses compared to \$3.9 million for the three months ended December 31, 2011. For the three months ended December 31, 2011, the Company incurred transaction expenses related to its proposed acquisition of Transatlantic Holdings, Inc. ("Transatlantic"). The transaction expenses related to the November 30, 2012 acquisition of Flagstone are netted against the gain on bargain purchase. Refer to the section above entitled "Gain on Bargain Purchase, Net of Expenses." Transaction expenses are primarily comprised of legal, financial advisory and audit related services.

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The following table presents results of operations for the three months ended December 31, 2012 and 2011 and years ended December 31, 2012, 2011 and 2010:

(Dollars in thousands)	Three Months Ended December 31,		Years Ended December 31,			
	2012 (a)	2011	2012 (a)	2011	2010	
Gross premiums written	\$311,847	\$278,279	\$2,166,440	\$2,124,691	1,990,566	
Reinsurance premiums ceded	(35,659 )	(16,489 )	(307,506 )	(289,241 )	(229,482 )	
Net premiums written	276,188	261,790	1,858,934	1,835,450	1,761,084	
Change in unearned premiums	223,098	226,556	14,282	(33,307 )	39	
Net premiums earned	499,286	488,346	1,873,216	1,802,143	1,761,123	
Losses and loss expenses	458,310	334,829	999,446	1,244,401	987,586	
Policy acquisition costs	81,814	81,253	334,698	314,184	292,899	
General and administrative expenses	65,095	52,253	263,652	197,497	209,290	
Share compensation expenses	7,126	7,237	26,709	34,296	28,911	
Total underwriting deductions	612,345	475,572	1,624,505	1,790,378	1,518,686	
Underwriting (loss) income (b)	(113,059 )	12,774	248,711	11,765	242,437	
Net investment income	28,802	28,080	107,936	112,296	134,103	
Other income	187	3,517	22,396	5,718	5,219	
Finance expenses	(14,510 )	(13,520 )	(53,857 )	(54,817 )	(55,870 )	
Operating (loss) income before taxes and (loss) income from operating affiliates (b)	(98,580 )	30,851	325,186	74,962	325,889	
Tax (expense) benefit	(615 )	226	(2,501 )	(824 )	(3,126 )	
(Loss) income from operating affiliates	(614 )	—	12,580	—	—	
Net operating (loss) income (b)	(99,809 )	31,077	335,265	74,138	322,763	
Gain on bargain purchase, net of expenses (c)	21,485	—	17,701	—	—	
Net realized (losses) gains on investments	(4,516 )	5,355	18,233	28,532	32,498	
Net unrealized (losses) gains on investments	(35,857 )	2,159	17,585	(19,991 )	45,952	
(Loss) from investment affiliate	(406 )	—	(964 )	—	—	
Foreign exchange gains (losses)	1,181	266	4,798	(22,124 )	1,351	
Transaction expenses (d)	—	(3,850 )	—	(17,433 )	—	
Net (loss) income	(117,922 )	35,007	392,618	43,122	402,564	
Net loss (income) attributable to noncontrolling interest	27,206	(7,683 )	15,820	(21,793 )	—	
Net (loss) income (attributable) available to Validus	\$(90,716 )	\$27,324	\$408,438	\$21,329	\$402,564	
Selected ratios:						
Net premiums written / Gross premiums written	88.6	% 94.1	% 85.8	% 86.4	% 88.5	%
Losses and loss expenses	91.8	% 68.6	% 53.4	% 69.1	% 56.1	%
Policy acquisition costs	16.4	% 16.6	% 17.9	% 17.4	% 16.6	%
General and administrative expenses (e)	14.5	% 12.2	% 15.5	% 12.9	% 13.5	%
Expense ratio	30.9	% 28.8	% 33.4	% 30.3	% 30.1	%
Combined ratio	122.7	% 97.4	% 86.8	% 99.4	% 86.2	%

(a) The results of operations for Flagstone are consolidated only from the November 30, 2012 date of acquisition.

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

accordance with U.S. GAAP. Reconciliations of these measures to the most comparable U.S. GAAP financial measure, are presented in the section below entitled "Underwriting Income"

- (c) The gain on bargain purchase, net of expenses, arises from the acquisition of Flagstone Reinsurance Holdings S.A. on November 30, 2012 and is net of transaction related expenses.
  - (d) The transaction expenses relate to costs incurred in connection with the Company's proposed acquisition of Transatlantic. Transaction expenses are primarily comprised of legal, financial advisory and audit related services.
  - (e) The general and administrative expense ratio includes share compensation expenses.
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(Dollars in thousands)	Three Months Ended December 31,		Years Ended December 31,		
	2012 (a)	2011	2012 (a)	2011	2010
<b>Validus Re</b>					
Gross premiums written	\$79,233	\$55,851	\$1,131,959	\$1,114,493	\$1,089,443
Reinsurance premiums ceded	(7,074 )	(49 )	(144,578 )	(150,718 )	(63,147 )
Net premiums written	72,159	55,802	987,381	963,775	1,026,296
Change in unearned premiums	213,105	196,679	35,890	2,150	13,822
Net premiums earned	285,264	252,481	1,023,271	965,925	1,040,118
Losses and loss expenses	331,130	215,903	575,416	749,305	601,610
Policy acquisition costs	40,703	39,227	154,362	154,582	159,527
General and administrative expenses	14,716	11,716	63,048	44,663	45,613
Share compensation expenses	1,849	2,191	7,763	9,309	7,181
Total underwriting deductions	388,398	269,037	800,589	957,859	813,931
Underwriting (loss) income (b)	(103,134 )	(16,556 )	222,682	8,066	226,187
<b>AlphaCat</b>					
Gross premiums written	\$(4 )	\$(1,323 )	\$21,603	\$75,727	\$11,796
Reinsurance premiums ceded	—	—	—	—	—
Net premiums written	(4 )	(1,323 )	21,603	75,727	11,796
Change in unearned premiums	5,895	27,834	(3,937 )	(9,761 )	(714 )
Net premiums earned	5,891	26,511	17,666	65,966	11,082
Losses and loss expenses	—	10,000	—	10,000	—
Policy acquisition costs	589	3,331	1,774	7,946	1,072
General and administrative expenses	2,011	6,807	7,532	10,929	5,327
Share compensation expenses	84	33	279	107	594
Total underwriting deductions	2,684	20,171	9,585	28,982	6,993
Underwriting income (b)	3,207	6,340	8,081	36,984	4,089
<b>Legal Entity adjustments</b>					
Gross premiums written	\$7	\$—	\$7	\$—	\$—
Reinsurance premiums ceded	—	—	—	—	—
Net premiums written	7	—	7	—	—
Change in unearned premiums	(3,833 )	—	(3,833 )	—	—
Net premiums earned	(3,826 )	—	(3,826 )	—	—
Losses and loss expenses	—	—	—	—	—
Policy acquisition costs	\$(365 )	\$(1,093 )	\$(390 )	\$(2,394 )	\$—
General and administrative expenses	1,673	(5,438 )	5,130	(1,658 )	15,927
Share compensation expenses	115	196	561	982	80
Total underwriting deductions	1,423	(6,335 )	5,301	(3,070 )	16,007
Underwriting (loss) income(b)	(5,249 )	6,335	(9,127 )	3,070	(16,007 )
<b>Talbot</b>					
Gross premiums written	\$241,100	\$235,242	\$1,078,636	\$1,014,122	\$981,073
Reinsurance premiums ceded	(37,067 )	(27,931 )	(228,686 )	(218,174 )	(258,081 )
Net premiums written	204,033	207,311	849,950	795,948	722,992
Change in unearned premiums	4,098	2,043	(17,671 )	(25,696 )	(13,069 )
Net premiums earned	208,131	209,354	832,279	770,252	709,923
Losses and loss expenses	127,180	108,926	424,030	485,096	385,976
Policy acquisition costs	41,745	41,160	183,926	157,334	143,769
General and administrative expenses	32,371	29,676	133,281	112,072	107,557
Share compensation expenses	2,442	1,934	7,789	8,582	6,923

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Total underwriting deductions	203,738	181,696	749,026	763,084	644,225
Underwriting income (b)	4,393	27,658	83,253	7,168	65,698
Corporate & Eliminations					
Gross premiums written	\$(8,489 )	\$(11,491 )	\$(65,765 )	\$(79,651 )	\$(91,746 )
Reinsurance premiums ceded	8,482	11,491	65,758	79,651	91,746
Net premiums written	(7 )	—	(7 )	—	—
Change in unearned premiums	3,833	—	3,833	—	—
Net premiums earned	3,826	—	3,826	—	—
Losses and loss expenses	—	—	—	—	—
Policy acquisition costs	(858 )	(1,372 )	(4,974 )	(3,284 )	(11,469 )
General and administrative expenses	14,324	9,492	54,661	31,491	34,866
Share compensation expenses	2,636	2,883	10,317	15,316	14,133
Total underwriting deductions	16,102	11,003	60,004	43,523	37,530
Underwriting (loss) (b)	(12,276 )	(11,003 )	(56,178 )	(43,523 )	(37,530 )
Total underwriting (loss) income (b)	\$(113,059 )	\$12,774	\$248,711	\$11,765	\$242,437

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- (a) The results of operations for Flagstone are consolidated only from the November 30, 2012 date of acquisition. Non-GAAP Financial Measures. In presenting the Company's results, management has included and discussed underwriting income that is not calculated under standards or rules that comprise U.S. GAAP. Such measures are referred to as non-GAAP. Non-GAAP measures may be defined or calculated differently by other companies.
- (b) These measures should not be viewed as a substitute for those determined in accordance with U.S. GAAP. A reconciliation of this measure to net income, the most comparable U.S. GAAP financial measure, is presented in the section below entitled "Underwriting Income."

Year Ended December 31, 2012 compared to Year Ended December 31, 2011

Net income available to Validus for the year ended December 31, 2012 was \$408.4 million compared to \$21.3 million for the year ended December 31, 2011, an increase of \$387.1 million. The primary factors driving the increase in net income were:

• Increase in underwriting income of \$236.9 million due primarily to:

• A \$245.0 million decrease in loss and loss expenses and a \$71.1 million increase in net premiums earned;

• Offset by the following factors:

• A \$20.5 million increase in policy acquisition costs; and

• A \$66.2 million increase in general and administrative expenses, partially offset by a \$7.6 million decrease in share compensation expenses;

• Increases in other income of \$16.7 million and income from operating affiliates of \$12.6 million;

• Increase in net unrealized gains on investments and foreign exchange of \$37.6 million and \$26.9 million, respectively;

• Decrease in transaction expenses of \$17.4 million (\$nil in the current year) and a \$17.7 million gain on bargain purchase, net of expenses; and

• Net loss attributable to controlling interest which resulted in an increase to net income attributable to Validus of \$37.6 million.

The above items were partially offset by the following factors:

• Unfavorable movement in net investment income and net realized gains on investments of \$4.4 million and \$10.3 million, respectively.

The change in net income available to Validus for the year ended December 31, 2012 of \$387.1 million as compared to the year ended December 31, 2011 is described in the following table:

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(Dollars in thousands)	Year Ended December 31, 2012				
	Decrease (increase) over the year ended December 31, 2011				
	Validus Re	AlphaCat	Talbot	Corporate and	Total
	(a)			Eliminations(b)	
Notable losses—decrease in net losses and loss expenses (c)	\$72,055	\$—	\$61,240	\$ —	\$ 133,295
Less: Notable losses— increase in net reinstatement premiums (c)	6,932	—	5,898	—	12,830
Other underwriting (loss) income	135,629	(28,903 )	8,947	(24,852 )	90,821
Underwriting income (loss) (d)	214,616	(28,903 )	76,085	(24,852 )	236,946
Net investment income	(4,521 )	503	(4,070 )	3,728	(4,360 )
Other income	(2,305 )	11,763	(1,452 )	8,672	16,678
Finance expenses	(1,166 )	598	65	1,463	960
Operating income (loss) before taxes and income from operating affiliates	206,624	(16,039 )	70,628	(10,989 )	250,224
Tax (expense)	(150 )	—	(1,578 )	51	(1,677 )
Income from operating affiliates	—	12,580	—	—	12,580
Net operating income (loss)	206,474	(3,459 )	69,050	(10,938 )	261,127
Gain on bargain purchase, net of expenses	—	—	—	17,701	17,701
Net realized gains on investments	(9,112 )	(315 )	(872 )	—	(10,299 )
Net unrealized gains (losses) on investments	49,731	(18,168 )	6,013	—	37,576
(Loss) from investment affiliate	(964 )	—	—	—	(964 )
Foreign exchange gains (losses)	22,188	508	4,715	(489 )	26,922
Transaction expenses	—	—	—	17,433	17,433
Net income (loss)	268,317	(21,434 )	78,906	23,707	349,496
Net loss (income) attributable to noncontrolling interest	—	37,613	—	—	37,613
Net income (loss) available (attributable) to Validus	\$268,317	\$16,179	\$78,906	\$ 23,707	\$387,109

(a) The results of operations for Flagstone are consolidated only from the November 30, 2012 date of acquisition.

(b) The Corporate and Eliminations column includes legal entity adjustments.

Notable losses for the year ended December 31, 2012 include: Costa Concordia, Cat 67, U.S. drought, Hurricane Isaac and Hurricane Sandy. Notable losses for the year ended December 31, 2011 include: Tohoku earthquake,

(c) Gryphon Alpha mooring failure, Christchurch earthquake, Brisbane floods, CNRL Horizon, Cat 46, Cat 48, Jupiter 1, Danish floods, Hurricane Irene and the Thai floods. Excludes the reserve for potential development on 2011 notable loss events.

Non-GAAP Financial Measures. In presenting the Company's results, management has included and discussed underwriting income (loss) that is not calculated under standards or rules that comprise U.S. GAAP. Such measures are referred to as non-GAAP. Non-GAAP measures may be defined or calculated differently by other companies. These measures should not be viewed as a substitute for those determined in accordance with U.S. GAAP. A reconciliation of this measure to net income, the most comparable U.S. GAAP financial measure, is presented in the section below entitled "Underwriting Income".

#### Gross Premiums Written

Gross premiums written for the year ended December 31, 2012 were \$2,166.4 million compared to \$2,124.7 million for the year ended December 31, 2011, an increase of \$41.7 million or 2.0%. The marine and specialty lines increased by \$79.4 million and \$1.3 million, respectively, while the property lines decreased by \$39.0 million. Details of gross premiums written by line of business are provided below.

Year Ended December 31, 2012 (a)		Year Ended December 31, 2011		Year Ended December 31, 2010	
Gross	Gross	Gross	Gross	Gross	Gross

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(Dollars in thousands)	Premiums Written	Premiums Written (%)	Premiums Written	Premiums Written (%)	Premiums Written	Premiums Written (%)
Property	\$1,060,297	48.9 %	\$1,099,303	51.7 %	\$1,037,061	52.1 %
Marine	649,421	30.0 %	569,981	26.9 %	525,307	26.4 %
Specialty	456,722	21.1 %	455,407	21.4 %	428,198	21.5 %
Total	\$2,166,440	100.0 %	\$2,124,691	100.0 %	\$1,990,566	100.0 %

(a) The results of operations for Flagstone are consolidated only from the November 30, 2012 date of acquisition.

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Validus Re. Validus Re gross premiums written for the year ended December 31, 2012 were \$1,132.0 million compared to \$1,114.5 million for the year ended December 31, 2011, an increase of \$17.5 million or 1.6%. Details of Validus Re gross premiums written by line of business are provided below.

(Dollars in thousands)	Year Ended December 31, 2012 (a)		Year Ended December 31, 2011		Year Ended December 31, 2010			
	Gross Premiums Written	Gross Premiums Written (%)	Gross Premiums Written	Gross Premiums Written (%)	Gross Premiums Written	Gross Premiums Written (%)		
	Property	\$771,617	68.2 %	\$786,937	70.6 %	\$778,794		
Marine	257,469	22.7 %	232,401	20.9 %	227,135	20.8 %		
Specialty	102,873	9.1 %	95,155	8.5 %	83,514	7.7 %		
Total	\$1,131,959	100.0 %	\$1,114,493	100.0 %	\$1,089,443	100.0 %		

(a) The results of operations for Flagstone are consolidated only from the November 30, 2012 date of acquisition. The decrease in gross premiums written in the property lines of \$15.3 million was due primarily to a \$25.8 million decrease in renewing premiums written on proportional and per risk excess of loss treaties relating to reduced participation on several large contracts not meeting the Company's underwriting requirements and a \$12.4 million decrease in intercompany premiums written with Talbot. These were partially offset by a \$9.3 million increase in new business written in the Singapore branch, a \$9.1 million increase in premium adjustments and catastrophe excess of loss business and a \$7.4 million increase in premiums relating to the Flagstone acquisition. The increase in gross premiums written of \$25.1 million in the marine lines was due to a \$24.6 million increase in reinstatement premiums primarily relating to the Costa Concordia event and a \$2.8 million increase in premium adjustments on proportional business, slightly offset by a \$3.8 million decrease in premiums on new business incepting during the period. The increase in gross premiums written of \$7.7 million in the specialty lines was due primarily to a \$6.0 million increase in premium adjustments on proportional business, a \$3.1 million increase in premiums relating to the Flagstone acquisition and a \$2.8 million increase in new business written in the Singapore branch. These were slightly offset by a \$2.1 million decrease in premiums on new business incepting during the period and a \$2.0 million decrease in intercompany premiums written with Talbot.

Gross premiums written under the quota share, surplus treaty and excess of loss contracts between Validus Re and Talbot for the year ended December 31, 2012 decreased by \$14.4 million as compared to the year ended December 31, 2011. These reinsurance agreements with Talbot are eliminated upon consolidation.

AlphaCat. AlphaCat gross premiums written for the year ended December 31, 2012 were \$21.6 million compared to \$75.7 million for the year ended December 31, 2011, a decrease of \$54.1 million or 71.5%. Details of AlphaCat gross premiums written by line of business are provided below.

(Dollars in thousands)	Year Ended December 31, 2012		Year Ended December 31, 2011		Year Ended December 31, 2010			
	Gross Premiums Written	Gross Premiums Written (%)	Gross Premiums Written	Gross Premiums Written (%)	Gross Premiums Written	Gross Premiums Written (%)		
	Property	21,603	100.0 %	75,727	100.0 %	11,796		
Total	21,603	100.0 %	75,727	100.0 %	11,796	100.0 %		

The decrease in gross premiums written in the property lines of \$54.1 million was due primarily to the deconsolidation of AlphaCat Re 2011 which occurred as at December 31, 2011, when the individual assets and liabilities and corresponding noncontrolling interest of AlphaCat Re 2011 were derecognized from the consolidated Balance Sheet of the Company. AlphaCat Re 2011 was consolidated in 2011 until December 31, 2011 whereas in 2012, AlphaCat Re 2011 is accounted for as an equity method operating affiliate. Therefore the comparative renewals are not reflected in gross premiums written in 2012, but are included in gross managed premiums, a comparable measure.

Managed gross premiums written from our non-consolidated affiliates, AlphaCat Re 2011 and AlphaCat Re 2012, for the year ended December 31, 2012 were \$126.5 million compared to \$60.0 million for the year ended December 31, 2011, an increase of \$66.5 million or 110.8%. Gross premiums written from our consolidated AlphaCat entities for the

year ended December 31, 2012 were \$21.6 million compared to \$15.7 million for the year ended December 31, 2011, an increase of \$5.9 million or 37.5% .

Gross premiums written with Talbot for the year ended December 31, 2012 increased by \$0.5 million as compared to the year ended December 31, 2011. These reinsurance agreements with Talbot are eliminated upon consolidation.

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Talbot. Talbot gross premiums written for the year ended December 31, 2012 were \$1,078.6 million compared to \$1,014.1 million for the year ended December 31, 2011, an increase of \$64.5 million or 6.4%. The \$1,078.6 million of gross premiums written translated at 2011 rates of exchange would have been \$1,081.7 million for the year ended December 31, 2012, giving an effective increase of \$67.6 million or 6.7%. Details of Talbot gross premiums written by line of business are provided below.

(Dollars in thousands)	Year Ended December 31, 2012		Year Ended December 31, 2011		Year Ended December 31, 2010			
	Gross Premiums Written	Gross Premiums Written (%)	Gross Premiums Written	Gross Premiums Written (%)	Gross Premiums Written	Gross Premiums Written (%)		
Property	\$324,910	30.1 %	\$306,317	30.2 %	\$314,769	32.1 %		
Marine	396,207	36.7 %	341,821	33.7 %	315,102	32.1 %		
Specialty	357,519	33.2 %	365,984	36.1 %	351,202	35.8 %		
Total	\$1,078,636	100.0 %	\$1,014,122	100.0 %	\$981,073	100.0 %		

The increase in gross premiums written in the property lines of \$18.6 million was due primarily to a \$16.1 million increase in the direct property lines and a \$9.1 million increase in the construction lines, partially offset by an \$8.3 million decrease in the property treaty lines. During the nine months ended September 30, 2012, Talbot reassessed commission costs on underwriting years 2007 and prior, related to business on the marine class. This resulted in a \$14.8 million increase in gross premiums written and earned premium, offset by an equal increase on policy acquisition costs for the marine class, resulting in no net impact. The increase in gross premiums written in the marine lines of \$54.4 million was due primarily to a \$14.8 million increase in premium adjustments, described above, a \$29.9 million increase in premium adjustments in the cargo and offshore energy lines, an \$8.0 million increase in premiums written in the marine energy and liability lines and a \$4.9 million increase in other treaty lines mainly driven by reinstatement premiums on Hurricane Sandy. These increases were slightly offset by a \$2.3 million decrease in premiums written in the hull lines. The decrease in gross premiums written in the specialty lines of \$8.5 million was due primarily to a \$15.1 million decrease in premiums written in direct aviation and aviation treaty lines. This decrease primarily relates to a premium reassessment of \$8.2 million which has no net earned impact on the direct aviation and aviation treaty lines. In addition, there was a \$1.7 million decrease in financial institutions lines, partially offset by a \$9.3 million increase in political risk lines.

Reinsurance Premiums Ceded

Reinsurance premiums ceded for the year ended December 31, 2012 were \$307.5 million compared to \$289.2 million for the year ended December 31, 2011, an increase of \$18.3 million, or 6.3%. The marine and specialty lines increased by \$14.0 million and \$7.2 million, respectively, while the property lines decreased by \$3.0 million. Details of reinsurance premiums ceded by line of business are provided below.

(Dollars in thousands)	Year Ended December 31, 2012		Year Ended December 31, 2011		Year Ended December 31, 2010			
	Reinsurance Premiums Ceded	Reinsurance Premiums Ceded (%)	Reinsurance Premiums Ceded	Reinsurance Premiums Ceded (%)	Reinsurance Premiums Ceded	Reinsurance Premiums Ceded (%)		
Property	\$206,000	67.0 %	\$208,968	72.2 %	\$123,383	53.7 %		
Marine	46,853	15.2 %	32,847	11.4 %	38,701	16.9 %		
Specialty	54,653	17.8 %	47,426	16.4 %	67,398	29.4 %		
Total	\$307,506	100.0 %	\$289,241	100.0 %	\$229,482	100.0 %		

(a) The results of operations for Flagstone are consolidated only from the November 30, 2012 date of acquisition.

Validus Re. Validus Re reinsurance premiums ceded for the year ended December 31, 2012 were \$144.6 million compared to \$150.7 million for the year ended December 31, 2011, a decrease of \$6.1 million, or 4.1%. Details of Validus Re reinsurance premiums ceded by line of business are provided below.

	Year Ended December 31, 2012 (a)	Year Ended December 31, 2011	Year Ended December 31, 2010
Reinsurance	Reinsurance	Reinsurance	Reinsurance

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(Dollars in thousands)	Premiums Ceded	Premiums Ceded (%)	Premiums Ceded	Premiums Ceded (%)	Premiums Ceded	Premiums Ceded (%)	
Property	\$123,610	85.5	% \$136,369	90.5	% \$45,536	72.2	%
Marine	20,397	14.1	% 13,848	9.2	% 17,643	27.9	%
Specialty	571	0.4	% 501	0.3	% (32	) (0.1	)%
Total	\$144,578	100.0	% \$150,718	100.0	% \$63,147	100.0	%

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(a) The results of operations for Flagstone are consolidated only from the November 30, 2012 date of acquisition. Reinsurance premiums ceded in the property lines decreased by \$12.8 million, due primarily to a \$7.9 million decrease in non-proportional retrocessional coverage, a \$3.3 million decrease in adjustments from prior periods and a \$2.1 million decrease in proportional retrocessional coverage. These were slightly offset by a \$0.7 million increase in ceded reinstatement premiums. The reduction in both non-proportional and proportional retrocessional coverage is a result of comparatively higher purchases of this coverage in the three months ended March 31, 2011 prior to, and following, the notable loss events of that quarter. The increase in reinsurance premiums ceded in the marine lines of \$6.5 million was due primarily to a \$6.0 million increase in non-proportional coverage incepting in the year.

AlphaCat. AlphaCat did not cede reinsurance premiums during the year ended December 31, 2012 and 2011.

Talbot. Talbot reinsurance premiums ceded for the year ended December 31, 2012 were \$228.7 million compared to \$218.2 million for the year ended December 31, 2011, an increase of \$10.5 million or 4.8%. Details of Talbot reinsurance premiums ceded by line of business are provided below.

(Dollars in thousands)	Year Ended December 31, 2012		Year Ended December 31, 2011		Year Ended December 31, 2010			
	Reinsurance Premiums Ceded	Reinsurance Premiums Ceded (%)	Reinsurance Premiums Ceded	Reinsurance Premiums Ceded (%)	Reinsurance Premiums Ceded	Reinsurance Premiums Ceded (%)		
Property	\$140,223	61.3 %	\$142,277	65.2 %	\$146,145	56.6 %		%
Marine	30,711	13.4 %	23,240	10.7 %	37,988	14.7 %		%
Specialty	57,752	25.3 %	52,657	24.1 %	73,948	28.7 %		%
Total	\$228,686	100.0 %	\$218,174	100.0 %	\$258,081	100.0 %		%

The decrease in reinsurance premiums ceded in the property lines of \$2.1 million was due primarily to a \$4.1 million decrease in premium ceded in the onshore energy lines and a \$2.3 million decrease in property treaty lines, partially offset by a \$3.1 million increase in the direct property lines. The increase in reinsurance premiums ceded in the marine lines of \$7.5 million was primarily due to an increase in premiums ceded in the energy lines of \$5.6 million driven primarily by an increase in reinstatement premiums and prior period adjustments. The increase in reinsurance premiums ceded in the specialty lines of \$5.1 million was primarily due to a \$4.3 million increase in excess of loss coverage and reinstatement premiums on aviation direct lines.

Reinsurance premiums ceded under the quota share, surplus treaty and excess of loss contracts with Validus Re and AlphaCat for the year ended December 31, 2012 were \$65.8 million compared to \$79.7 million for the year ended December 31, 2011, a decrease of \$13.9 million. These reinsurance agreements with Validus Re and AlphaCat are eliminated upon consolidation.

#### Net Premiums Written

Net premiums written for the year ended December 31, 2012 were \$1,858.9 million compared to \$1,835.5 million for the year ended December 31, 2011, an increase of \$23.5 million, or 1.3%. The ratios of net premiums written to gross premiums written for the year ended December 31, 2012 and 2011 were 85.8% and 86.4%, respectively. Details of net premiums written by line of business are provided below.

(Dollars in thousands)	Year Ended December 31, 2012		Year Ended December 31, 2011		Year Ended December 31, 2010			
	Net Premiums Written	Net Premiums Written (%)	Net Premiums Written	Net Premiums Written (%)	Net Premiums Written	Net Premiums Written (%)		
Property	\$854,297	46.0 %	\$890,335	48.5 %	\$913,678	51.9 %		%
Marine	602,568	32.4 %	537,134	29.3 %	486,606	27.6 %		%
Specialty	402,069	21.6 %	407,981	22.2 %	360,800	20.5 %		%
Total	\$1,858,934	100.0 %	\$1,835,450	100.0 %	\$1,761,084	100.0 %		%

(a) The results of operations for Flagstone are consolidated only from the November 30, 2012 date of acquisition.

Validus Re. Validus Re net premiums written for the year ended December 31, 2012 were \$987.4 million compared to \$963.8 million for the year ended December 31, 2011, an increase of \$23.6 million or 2.4%. Details of Validus Re net premiums written by line of business are provided below.





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(Dollars in thousands)	Year Ended December 31, 2012		Year Ended December 31, 2011		Year Ended December 31, 2010	
	Net Premiums Written	Net Premiums Written (%)	Net Premiums Written	Net Premiums Written (%)	Net Premiums Written	Net Premiums Written (%)
Property	\$648,007	65.6 %	\$650,568	67.5 %	\$733,258	71.5 %
Marine	237,072	24.0 %	218,553	22.7 %	209,492	20.4 %
Specialty	102,302	10.4 %	94,654	9.8 %	83,546	8.1 %
Total	\$987,381	100.0 %	\$963,775	100.0 %	\$1,026,296	100.0 %

(a) The results of operations for Flagstone are consolidated only from the November 30, 2012 date of acquisition.

The increase in Validus Re net premiums written was driven by factors highlighted above in respect of gross premiums written and reinsurance premiums ceded. The ratios of net premiums written to gross premiums written were 87.2% and 86.5% for the year ended December 31, 2012 and 2011, respectively.

AlphaCat. AlphaCat net premiums written for the year ended December 31, 2012 were \$21.6 million compared to \$75.7 million for the year ended December 31, 2011, a decrease of \$54.1 million or 71.5%. Details of AlphaCat net premiums written by line of business are provided below.

(Dollars in thousands)	Year Ended December 31, 2012		Year Ended December 31, 2011		Year Ended December 31, 2010	
	Net Premiums Written	Net Premiums Written (%)	Net Premiums Written	Net Premiums Written (%)	Net Premiums Written	Net Premiums Written (%)
Property	\$21,603	100.0 %	\$75,727	100.0 %	\$11,796	100.0 %
Total	\$21,603	100.0 %	\$75,727	100.0 %	\$11,796	100.0 %

The decrease in AlphaCat net premiums written was driven by the factors highlighted above in respect of gross premiums written. The ratios of net premiums written to gross premiums written were 100.0% for the year ended December 31, 2012 and 2011.

Talbot. Talbot net premiums written for the year ended December 31, 2012 were \$850.0 million compared to \$795.9 million for the year ended December 31, 2011, an increase of \$54.0 million or 6.8%. Details of Talbot net premiums written by line of business are provided below.

(Dollars in thousands)	Year Ended December 31, 2012		Year Ended December 31, 2011		Year Ended December 31, 2010	
	Net Premiums Written	Net Premiums Written (%)	Net Premiums Written	Net Premiums Written (%)	Net Premiums Written	Net Premiums Written (%)
Property	\$184,687	21.7 %	\$164,040	20.6 %	\$168,624	23.4 %
Marine	365,496	43.0 %	318,581	40.0 %	277,114	38.3 %
Specialty	299,767	35.3 %	313,327	39.4 %	277,254	38.3 %
Total	\$849,950	100.0 %	\$795,948	100.0 %	\$722,992	100.0 %

The increase in Talbot net premiums written was driven by the factors highlighted above in respect of gross premiums written and reinsurance premiums ceded. The ratios of net premiums written to gross premiums written for the year ended December 31, 2012 and 2011 were 78.8% and 78.5%, respectively.

#### Net Change in Unearned Premiums

Net change in unearned premiums for the year ended December 31, 2012 was \$14.3 million compared to \$(33.3) million for the year ended December 31, 2011, an increase of \$47.6 million or 142.9%.

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(Dollars in thousands)	Year Ended December 31, 2012 (a)	Year Ended December 31, 2011	Year Ended December 31, 2010
	Net Change in Unearned Premiums	Net Change in Unearned Premiums	Net Change in Unearned Premiums
Change in gross unearned premium	\$(121,980 )	\$(43,866 )	\$(12,079 )
Less change due to Flagstone acquisition	139,389	—	—
Deconsolidation of AlphaCat Re 2011	—	(9,405 )	—
Net change in gross unearned premium	17,409	(53,271 )	(12,079 )
Change in prepaid reinsurance premium	8,212	19,964	12,118
Less change due to Flagstone acquisition	(11,339 )	—	—
Net change in prepaid reinsurance premium	(3,127 )	19,964	12,118
Net change in unearned premium	\$14,282	\$(33,307 )	\$39

(a) The results of operations for Flagstone are consolidated only from the November 30, 2012 date of acquisition. Validus Re. Validus Re net change in unearned premiums for the year ended December 31, 2012 was \$35.9 million compared to \$2.2 million for the year ended December 31, 2011, an increase of \$33.7 million, or 1,569.3%.

(Dollars in thousands)	Year Ended December 31, 2012(a)	Year Ended December 31, 2011	Year Ended December 31, 2010
	Net Change in Unearned Premiums	Net Change in Unearned Premiums	Net Change in Unearned Premiums
Change in gross unearned premium	\$(104,420 )	\$(7,771 )	\$16,277
Less change due to Flagstone acquisition	139,389	—	—
Deconsolidation of AlphaCat Re 2011	—	(9,405 )	—
Net change in gross unearned premium	34,969	(17,176 )	16,277
Change in prepaid reinsurance premium	12,260	19,326	(2,455 )
Less change due to Flagstone acquisition	(11,339 )	—	—
Net change in prepaid reinsurance premium	921	19,326	(2,455 )
Net change in unearned premium	\$35,890	\$2,150	\$13,822

(a) The results of operations for Flagstone are consolidated only from the November 30, 2012 date of acquisition. Validus Re net change in unearned premiums has increased for the year ended December 31, 2012 due to the earnings pattern of gross premiums written and reinsurance premiums ceded during the year ended December 31, 2012 as compared to the year ended December 31, 2011.

AlphaCat. AlphaCat net change in unearned premiums for the year ended December 31, 2012 was \$(3.9) million compared to \$(9.8) million for the year ended December 31, 2011, an increase of \$5.8 million or 59.7%.

(Dollars in thousands)	Year Ended December 31, 2012	Year Ended December 31, 2011	Year Ended December 31, 2010
	Net Change in Unearned Premiums	Net Change in Unearned Premiums	Net Change in Unearned Premiums
Change in gross unearned premium	\$(3,937 )	\$(9,761 )	\$(714 )
Net change in unearned premium	\$(3,937 )	\$(9,761 )	\$(714 )

AlphaCat net change in unearned premiums has increased for the year ended December 31, 2012 due primarily to the deconsolidation of AlphaCat Re 2011 and the earnings pattern of gross premiums written and reinsurance premiums ceded during the year ended December 31, 2012 as compared to year ended December 31, 2011.



Talbot. Talbot net change in unearned premiums for the year ended December 31, 2012 was \$(17.7) million compared to \$(25.7) million for the year ended December 31, 2011, an increase of \$8.0 million or 31.2%.

(Dollars in thousands)	Year Ended December 31, 2012	Year Ended December 31, 2011	Year Ended December 31, 2010
	Net Change in Unearned Premiums	Net Change in Unearned Premiums	Net Change in Unearned Premiums
Change in gross unearned premium	\$(13,623 )	\$(26,334 )	\$(27,642 )
Change in prepaid reinsurance premium	(4,048 )	638	14,573
Net change in unearned premium	\$(17,671 )	\$(25,696 )	\$(13,069 )

Talbot net change in unearned premiums has increased for the year ended December 31, 2012 due to the earnings pattern of gross premiums written and reinsurance premiums ceded during the year ended December 31, 2012 as compared to the year ended December 31, 2011.

#### Net Premiums Earned

Net premiums earned for the year ended December 31, 2012 were \$1,873.2 million compared to \$1,802.1 million for the year ended December 31, 2011, an increase of \$71.1 million or 3.9%. Details of net premiums earned by line of business are provided below.

(Dollars in thousands)	Year Ended December 31, 2012 (a)			Year Ended December 31, 2011		Year Ended December 31, 2010			
	Net Premiums Earned	Net Premiums Earned (%)	Net Premiums Earned (%)	Net Premiums Earned	Net Premiums Earned (%)	Net Premiums Earned	Net Premiums Earned (%)		
Property	\$866,365	46.3	%	\$891,448	49.5	%	\$923,370	52.4	%
Marine	609,012	32.5	%	517,376	28.7	%	445,426	25.3	%
Specialty	397,839	21.2	%	393,319	21.8	%	392,327	22.3	%
Total	\$1,873,216	100.0	%	\$1,802,143	100.0	%	\$1,761,123	100.0	%

(a) The results of operations for Flagstone are consolidated only from the November 30, 2012 date of acquisition.

Validus Re. Validus Re net premiums earned for the year ended December 31, 2012 were \$1,023.3 million compared to \$965.9 million for the year ended December 31, 2011, an increase of \$57.3 million or 5.9%. Details of Validus Re net premiums earned by line of business are provided below.

(Dollars in thousands)	Year Ended December 31, 2012 (a)			Year Ended December 31, 2011		Year Ended December 31, 2010			
	Net Premiums Earned	Net Premiums Earned (%)	Net Premiums Earned (%)	Net Premiums Earned	Net Premiums Earned (%)	Net Premiums Earned	Net Premiums Earned (%)		
Property	\$673,928	65.9	%	\$664,244	68.8	%	\$754,583	72.5	%
Marine	254,092	24.8	%	211,344	21.9	%	176,601	17.0	%
Specialty	95,251	9.3	%	90,337	9.3	%	108,934	10.5	%
Total	\$1,023,271	100.0	%	\$965,925	100.0	%	\$1,040,118	100.0	%

(a) The results of operations for Flagstone are consolidated only from the November 30, 2012 date of acquisition.

The increase in net premiums earned is consistent with the relevant pattern of net premiums written influencing the earned premiums for the year ended December 31, 2012 compared to the year ended December 31, 2011.

AlphaCat. AlphaCat net premiums earned for the year ended December 31, 2012 were \$17.7 million compared to \$66.0 million for the year ended December 31, 2011, a decrease of \$48.3 million or 73.2%. Details of AlphaCat net premiums earned by line of business are provided below.

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(Dollars in thousands)	Year Ended December 31, 2012		Year Ended December 31, 2011		Year Ended December 31, 2010	
	Net Premiums Earned	Net Premiums Earned (%)	Net Premiums Earned	Net Premiums Earned (%)	Net Premiums Earned	Net Premiums Earned (%)
Property	\$17,666	100.0	% \$65,966	100.0	% \$11,082	100.0
Total	\$17,666	100.0	% \$65,966	100.0	% \$11,082	100.0

The decrease in net premiums earned is consistent with the relevant pattern of net premiums written influencing the earned premiums for the year ended December 31, 2012 compared to the year ended December 31, 2011 and the deconsolidation of AlphaCat Re 2011.

Talbot. Talbot net premiums earned for the year ended December 31, 2012 were \$832.3 million compared to \$770.3 million for the year ended December 31, 2011, an increase of \$62.0 million or 8.1%. Details of Talbot net premiums earned by line of business are provided below.

(Dollars in thousands)	Year Ended December 31, 2012		Year Ended December 31, 2011		Year Ended December 31, 2010	
	Net Premiums Earned	Net Premiums Earned (%)	Net Premiums Earned	Net Premiums Earned (%)	Net Premiums Earned	Net Premiums Earned (%)
Property	\$174,771	21.0	% \$161,238	21.0	% \$157,705	22.2
Marine	354,920	42.6	% 306,032	39.7	% 268,825	37.9
Specialty	302,588	36.4	% 302,982	39.3	% 283,393	39.9
Total	\$832,279	100.0	% \$770,252	100.0	% \$709,923	100.0

During the nine months ended September 30, 2012, Talbot reassessed commission costs on underwriting years 2007 and prior, related to business on the marine class. This resulted in a \$14.8 million increase in gross premiums written and earned premium, offset by an equal increase on policy acquisition costs for the marine class, resulting in no net impact. Increases in previously written premium income also contributed to an increase in net premiums earned of \$34.1 million, driven mainly by energy, cargo, other treaty and marine energy and liability classes, offset by small decreases in other classes.

The increase in net premiums earned is consistent with the relevant patterns of net premiums written influencing the earned premiums for the year ended December 31, 2012, as compared to the year ended December 31, 2011.

#### Losses and Loss Expenses

Losses and loss expenses for the year ended December 31, 2012 were \$999.4 million compared to \$1,244.4 million for the year ended December 31, 2011, a decrease of \$245.0 million or 19.7%. The loss ratios, defined as losses and loss expenses divided by net premiums earned, for the year ended December 31, 2012 and 2011 were 53.4% and 69.1%, respectively. Details of loss ratios by line of business are provided below.

	Year Ended December 31, 2012 (a)	Year Ended December 31, 2011	Year Ended December 31, 2010
Property	54.7	% 87.1	% 60.5
Marine	60.1	% 61.7	% 50.3
Specialty	40.0	% 37.8	% 52.2
All lines	53.4	% 69.1	% 56.1

(a) The results of operations for Flagstone are consolidated only from the November 30, 2012 date of acquisition.

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	Year Ended				
	December 31,				
	2012 (a)	2011	2010		
Property—current period—excluding items below	25.5	% 28.2	% 21.7		%
Property—current period—notable losses	37.5	% 58.7	% 45.7		%
Property—current period—reserve for potential development on notable loss events	0.0	% 8.2	% 0.9		%
Property—change in prior accident years	(8.3	)% (8.0	)% (7.8		)%
Property—loss ratio	54.7	% 87.1	% 60.5		%
Marine—current period—excluding items below	44.6	% 48.4	% 44.9		%
Marine—current period—notable losses	23.9	% 20.3	% 15.5		%
Marine—current period—reserve for potential development on notable loss events	0.0	% 1.0	% 5.6		%
Marine—change in prior accident years	(8.4	)% (8.0	)% (15.7		)%
Marine—loss ratio	60.1	% 61.7	% 50.3		%
Specialty—current period—excluding items below	45.4	% 47.3	% 45.7		%
Specialty—current period—notable losses (b)	7.6	% 1.5	% 10.1		%
Specialty—current period—reserve for potential development on notable loss events	0.0	% 0.0	% 0.0		%
Specialty—change in prior accident years (b)	(13.0	)% (11.0	)% (3.6		)%
Specialty—loss ratio	40.0	% 37.8	% 52.2		%
All lines—current period—excluding items below	36.0	% 38.3	% 33.0		%
All lines—current period—notable losses (b)	26.7	% 35.2	% 30.1		%
All lines—current period—reserve for potential development on notable loss events	0.0	% 4.3	% 1.9		%
All lines—change in prior accident years (b)	(9.3	)% (8.7	)% (8.9		)%
All lines—loss ratio	53.4	% 69.1	% 56.1		%

(a) The results of operations for Flagstone are consolidated only from the November 30, 2012 date of acquisition. The financial institution loss occurred in a prior period but developed over the notable loss threshold in the three (b) months ended December 31, 2010. In 2010, this loss was included in the change in prior year development and excluded as a notable loss as presented above.

Validus Re. Validus Re losses and loss expenses for the year ended December 31, 2012 were \$575.4 million compared to \$749.3 million for the year ended December 31, 2011, a decrease of \$173.9 million or 23.2%. The loss ratio, defined as losses and loss expenses divided by net premiums earned, was 56.2% and 77.6% for the year ended December 31, 2012 and 2011, respectively. For the year ended December 31, 2012, Validus Re incurred losses of \$648.0 million related to current year losses and \$72.6 million of favorable loss reserve development relating to prior accident years. For the year ended December 31, 2012, favorable loss reserve development on prior accident years benefited the Validus Re loss ratio by 7.1 percentage points. For the year ended December 31, 2011, Validus Re incurred losses of \$817.9 million related to current year losses and \$68.6 million of favorable loss reserve development relating to prior accident years. For the year ended December 31, 2011, favorable loss reserve development relating to prior accident years benefited the Validus Re loss ratio by 7.1 percentage points. For the year ended December 31, 2012, Validus Re incurred \$402.7 million of losses from notable loss events, which represented 39.4 percentage points of the loss ratio. Net of reinstatement premiums of \$60.8 million, the effect of these events on Validus Re segment income was a decrease of \$342.0 million. For the year ended December 31, 2011, Validus Re incurred \$474.8 million of losses from notable loss events, which represented 49.2 percentage points of the loss ratio, excluding reserve for potential development on notable loss events. Net of reinstatement premiums of \$53.8 million, the effect of these events on Validus Re segment income was a decrease of \$420.9 million. Validus Re segment loss ratios excluding, notable loss events, reserve for potential development on notable loss events and prior year loss reserve development for the year ended December 31, 2012 and 2011 were 23.9% and 27.4%, respectively.

Details of Validus Re loss ratios by line of business and period of occurrence are provided below.

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	Year Ended December 31,				
	2012 (a)		2011 (b)		2010 (b)
Property—current period excluding items below	18.5	%	21.0	%	16.6
Property—current period—notable losses	41.1	%	61.1	%	46.5
Property—current period—reserve for potential development on notable loss events	0.0	%	11.0	%	1.1
Property—change in prior accident years	(6.8	)%	(7.4	)%	(6.6
Property—loss ratio	52.8	%	85.7	%	57.6
Marine—current period excluding items below	36.3	%	44.0	%	36.5
Marine—current period—notable losses	40.3	%	32.7	%	29.1
Marine—current period—reserve for potential development on notable loss events	0.0	%	2.4	%	14.2
Marine—change in prior accident years	(4.4	)%	(4.8	)%	(10.0
Marine—loss ratio	72.2	%	74.3	%	69.8
Specialty—current period excluding items below	29.9	%	36.3	%	19.2
Specialty—current period—notable losses	24.3	%	0.0	%	23.7
Specialty—current period—reserve for potential development on notable loss events	0.0	%	0.0	%	0.0
Specialty—change in prior accident years	(16.3	)%	(10.4	)%	(2.9
Specialty—loss ratio	37.9	%	25.9	%	40.0
All lines—current period excluding items below	23.9	%	27.4	%	20.3
All lines—current period—notable losses	39.4	%	49.2	%	41.1
All lines—current period—reserve for potential development on notable loss events	0.0	%	8.1	%	3.2
All lines—change in prior accident years	(7.1	)%	(7.1	)%	(6.8
All lines—loss ratio	56.2	%	77.6	%	57.8

(a) The results of operations for Flagstone are consolidated only from the November 30, 2012 date of acquisition.

(b) The prior year ratios have been represented to exclude the impact of the AlphaCat segment premiums.

For the year ended December 31, 2012, Validus Re property lines losses and loss expenses included \$401.5 million related to current year losses and \$45.7 million of favorable loss reserve development relating to prior accident years. The favorable loss reserve development was due primarily to a reduction in loss estimates on attritional losses. This movement was largely offset by an increase in loss estimates on prior year notable loss events, which led to a movement in the reserve for potential development on notable loss events during the year ended December 31, 2012. For the year ended December 31, 2011, Validus Re property lines losses and loss expenses included \$618.0 million related to current year losses and \$49.0 million of favorable loss reserve development relating to prior accident years. This favorable development was primarily due to a reduction in the loss estimates on certain large loss events and favorable development on attritional losses and various smaller loss events.

For the year ended December 31, 2012, Validus Re property lines incurred \$277.1 million of losses from notable loss events, which represented 41.1 percentage points of the property lines loss ratio. Net of \$33.0 million in reinstatement premiums, the effect of these events on net income was a decrease of \$244.1 million. For the year ended December 31, 2011, Validus Re property lines incurred \$405.6 million of losses from notable loss events, which represented 61.1 percentage points of the property lines loss ratio. Validus Re property lines loss ratios, excluding notable loss events, reserve for potential development on notable loss events and prior year loss reserve development, for the year ended December 31, 2012 and 2011 were 18.5% and 21.0%, respectively.

For the year ended December 31, 2012, Validus Re marine lines losses and loss expenses included \$194.8 million related to current year losses and \$11.3 million of favorable loss reserve development relating to prior accident years. The favorable loss reserve development is due primarily to a reduction in loss estimates on attritional losses, which was partially offset by an increase in prior year notable loss events. For the year ended December 31, 2011, Validus Re marine lines losses and loss expenses included \$167.2 million related to current year losses and \$10.2 million of



favorable loss reserve development relating to prior accident years. This favorable development was due primarily to favorable development on large loss events and attritional losses and various smaller loss events.

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For the year ended December 31, 2012, Validus Re marine lines incurred \$102.5 million of losses from notable loss events, which represented 40.3 percentage points of the loss ratio. Net of \$27.8 million in reinstatement premiums, the effect of these events on net income was a decrease of \$74.7 million. For the year ended December 31, 2011, Validus Re marine lines incurred \$69.2 million of losses from notable loss events, which represented 32.7 percentage points of the marine lines loss ratio, excluding reserve for potential development on notable loss events. Validus Re marine lines loss ratios, excluding notable loss events, reserve for potential development on notable loss events and prior year loss reserve development, for the year ended December 31, 2012 and 2011 were 36.3% and 44.0%, respectively. For the year ended December 31, 2012, Validus Re specialty lines losses and loss expenses included \$51.6 million related to current year losses and \$15.5 million of favorable loss reserve development relating to prior accident years. The favorable loss reserve development was due primarily to a reduction in loss estimates on attritional losses. For the year ended December 31, 2011, Validus Re specialty lines losses and loss expenses included \$32.7 million related to current year losses and \$9.4 million of favorable loss reserve development relating to prior accident years. This favorable development was attributable to favorable development on attritional losses partially offset by adverse development on large loss events.

For the year ended December 31, 2012, Validus Re specialty lines incurred \$23.2 million of losses from notable loss events which represented 24.3 percentage points of the loss ratio. Validus Re specialty lines loss ratios, excluding notable loss events, reserve for potential development on notable loss events and prior year loss reserve development, for the year ended December 31, 2012 and 2011 were 29.9% and 36.3%, respectively.

The net negative financial impact from Hurricane Sandy to Flagstone for the year ended December 31, 2012 was \$39.1 million. The financial impact to Flagstone did not impact Validus' results of operations in the fourth quarter 2012 as the loss event took place prior to the date of Validus' acquisition of Flagstone which was completed on November 30, 2012.

AlphaCat. AlphaCat contributed \$nil to the losses and loss expenses for the year ended December 31, 2012 compared to \$10.0 million for the year ended December 31, 2011, a decrease of \$10.0 million or 100.0%. The loss ratio defined as losses and loss expenses divided by net premiums earned, was nil% and 15.2% for the year ended December 31, 2012 and 2011, respectively. For the year ended December 31, 2012, AlphaCat Re 2011 and AlphaCat Re 2012 incurred Hurricane Sandy losses of \$25.0 million and \$7.5 million, respectively. The AlphaCat segment's portion of incurred losses and loss expenses related to Hurricane Sandy was \$8.4 million for the year ended December 31, 2012 and are included in income from operating affiliates.

Talbot. Talbot losses and loss expenses for the year ended December 31, 2012 were \$424.0 million compared to \$485.1 million for the year ended December 31, 2011, a decrease of \$61.1 million or 12.6%. The loss ratio defined as losses and loss expenses divided by net premiums earned, was 50.9% and 63.0% for the year ended December 31, 2012 and 2011, respectively. For the year ended December 31, 2012, Talbot incurred losses of \$526.4 million related to current year losses and \$102.4 million of favorable loss reserve development relating to prior accident years. For the year ended December 31, 2012, favorable loss reserve development on prior accident years benefited the Talbot loss ratio by 12.3 percentage points. For the year ended December 31, 2011, Talbot incurred losses of \$572.6 million related to current year losses and \$87.5 million in favorable loss reserve development relating to prior accident years. For the year ended December 31, 2011, favorable loss reserve development on prior accident years benefited the Talbot loss ratio by 11.4 percentage points.

For the year ended December 31, 2012, Talbot incurred \$97.8 million of losses from notable loss events, which represented 11.8 percentage points of the loss ratio. Including the impact of reinstatement premiums of \$(3.3) million, the effect of these events on Talbot segment income was a decrease of \$101.1 million. For the year ended December 31, 2011, Talbot incurred \$159.1 million of losses from notable loss events, which represented 20.7 percentage points of the Talbot loss ratio. Talbot loss ratios, excluding notable loss events and prior year loss reserve development, for the year ended December 31, 2012 and 2011 were 51.4% and 53.7%, respectively. Details of Talbot loss ratios by line of business and period of occurrence are provided below.

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	Year Ended				
	December 31,				
	2012	2011	2010		
Property—current period excluding items below	55.6	% 63.6	% 47.5		%
Property—current period—notable losses	27.2	% 72.8	% 45.3		%
Property—change in prior accident years	(15.0)	)% (13.7)	)% (14.2)		)%
Property—loss ratio	67.8	% 122.7	% 78.6		%
Marine—current period excluding items below	50.5	% 51.5	% 50.5		%
Marine—current period—notable losses	12.2	% 11.7	% 6.6		%
Marine—change in prior accident years	(11.3)	)% (10.2)	)% (19.5)		)%
Marine—loss ratio	51.4	% 53.0	% 37.6		%
Specialty—current period excluding items below	50.3	% 50.6	% 55.8		%
Specialty—current period—notable losses (a)	2.3	% 1.9	% 4.9		%
Specialty—change in prior accident years (a)	(11.9)	)% (11.2)	)% (3.9)		)%
Specialty—loss ratio	40.7	% 41.3	% 56.8		%
All lines—current period excluding items below	51.4	% 53.7	% 52.0		%
All lines—current period—notable losses (a)	11.8	% 20.7	% 14.5		%
All lines—change in prior accident years (a)	(12.3)	)% (11.4)	)% (12.1)		)%
All lines—loss ratio	50.9	% 63.0	% 54.4		%

The financial institution loss occurred in a prior period but developed over the notable loss threshold in the three (a) months ended December 31, 2010. In 2010, this loss was included in the change in prior year development and excluded as a notable loss as presented above.

For the year ended December 31, 2012, Talbot property lines losses and loss expenses include \$144.7 million related to current year losses and \$26.3 million of favorable loss reserve development relating to prior accident years. The prior year favorable loss reserve development was due to favorable experience on attritional losses. For the year ended December 31, 2011, Talbot property lines losses and loss expenses included \$220.0 million related to current year losses and \$22.2 million of favorable loss reserve development relating to prior accident years. This favorable development was attributable to lower than expected development on large losses as well as favorable development on attritional losses.

For the year ended December 31, 2012, Talbot property lines incurred \$47.5 million of losses from notable loss events, which represented 27.2 percentage points of the property lines loss ratio. Net of reinstatement premiums of \$1.2 million, the effect of these events on net income was a decrease of \$46.2 million. For the year ended December 31, 2011, Talbot's property lines incurred \$117.5 million of losses from notable loss events, which represented 72.8 percentage points of the property lines loss ratio. Talbot property lines loss ratio, excluding notable loss events and prior year loss reserve development for the year ended December 31, 2012 and 2011 were 55.6% and 63.6%, respectively.

For the year ended December 31, 2012, Talbot marine lines losses and loss expenses included \$222.4 million related to current year losses and \$40.1 million of favorable loss reserve development relating to prior accident years. The prior year favorable loss reserve development was due primarily to favorable development on attritional losses. For the year ended December 31, 2011, Talbot marine lines losses and loss expenses included \$193.5 million related to current year losses and \$31.4 million of favorable loss reserve development relating to prior accident years. The prior year favorable loss reserve development was due to favorable development on attritional losses.

For the year ended December 31, 2012, Talbot marine lines incurred \$43.3 million of losses from notable loss events, which represented 12.2 percentage points of the marine lines loss ratio. Net of reinstatement premiums of \$(3.0) million, the effect of these events on net income was a decrease of \$46.3 million. For the year ended December 31, 2011, Talbot's marine lines incurred \$35.8 million of losses from notable loss events, which represented 11.7 percentage points of the marine lines loss ratio. Talbot marine lines loss ratios, excluding notable loss events and prior year loss reserve development, for the year ended December 31, 2012 and 2011 were 50.5% and 51.5%, respectively.

For the year ended December 31, 2012, Talbot specialty lines losses and loss expenses included \$159.3 million relating to current year losses and \$36.1 million of favorable loss reserve development relating to prior accident years. The prior year favorable reserve development was due primarily to favorable development on attritional losses. For the year ended December 31, 2011, Talbot specialty lines losses and loss expenses included \$159.1 million relating to current year losses and \$34.0 million of favorable loss reserve development relating to prior accident years. The prior year favorable loss reserve development was due to favorable development on attritional losses.

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For the year ended December 31, 2012, Talbot specialty lines incurred \$7.1 million losses from notable loss events, which represented 2.3 percentage points of the specialty lines loss ratio. Net of reinstatement premiums of \$(1.5) million, the effect of these events on net income was a decrease of \$8.5 million. For the year ended December 31, 2011, Talbot's specialty lines incurred \$5.8 million of losses from notable loss events, which represented 1.9 percentage points of the specialty lines loss ratio. Talbot specialty lines loss ratios, excluding notable loss events and prior year loss reserve development for the year ended December 31, 2012 and 2011 were 50.3% and 50.6%, respectively.

Reserves for Losses and Loss Expenses

At December 31, 2012 and 2011, gross and net reserves for losses and loss expenses were estimated using the methodology as outlined in the Critical Accounting Policies and Estimates above.

(Dollars in thousands)	As at December 31, 2012		Total Gross Reserve for Losses and Loss Expenses
	Gross Case Reserves	Gross IBNR	
Property	\$930,553	\$892,227	\$1,822,780
Marine	522,907	477,948	1,000,855
Specialty	265,638	428,300	693,938
Total	\$1,719,098	\$1,798,475	\$3,517,573

(Dollars in thousands)	As at December 31, 2012		Total Net Reserve for Losses and Loss Expenses
	Net Case Reserves	Net IBNR	
Property	\$768,722	\$803,182	\$1,571,904
Marine	465,080	438,009	903,089
Specialty	230,584	372,029	602,613
Total	\$1,464,386	\$1,613,220	\$3,077,606

The following table sets forth a reconciliation of gross and net reserves for losses and loss expenses by segment for the year ended December 31, 2012.

(Dollars in thousands)	Year Ended December 31, 2012				
	Validus Re Segment	AlphaCat Segment	Talbot Segment	Eliminations	Total
Gross reserves at period beginning	\$1,350,849	\$10,000	\$1,377,561	\$(107,267)	\$2,631,143
Losses recoverable	(95,509)	—	(384,243)	107,267	(372,485)
Net reserves at period beginning	1,255,340	10,000	993,318	—	2,258,658
Net reserves acquired in purchase of Flagstone	639,641	—	—	—	639,641
Incurred losses—current year	647,977	—	526,438	—	1,174,415
Change in prior accident years	(72,561)	—	(102,408)	—	(174,969)
Incurred losses	575,416	—	424,030	—	999,446
Foreign exchange	4,203	—	11,678	—	15,881
Paid losses	(500,351)	(5,000)	(330,669)	—	(836,020)
Net reserves at period end	1,974,249	5,000	1,098,357	—	3,077,606
Losses recoverable	148,646	—	381,950	(90,629)	439,967
Gross reserves at period end	\$2,122,895	\$5,000	\$1,480,307	\$(90,629)	\$3,517,573

The amount of recorded reserves represents management's best estimate of expected losses and loss expenses on premiums earned. For the year ended December 31, 2012, favorable loss reserve development on prior accident years was \$175.0 million of which, \$72.6 million related to the Validus Re segment and \$102.4 million related to the Talbot segment. Favorable loss reserve development benefited the Company's loss ratio by 9.3 percentage points for the year

ended December 31, 2012. For the year ended December 31, 2011, favorable loss reserve development on prior accident years was \$156.1 million, of which, \$68.6 million

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related to the Validus Re segment and \$87.5 million related to the Talbot segment. Favorable loss reserve development benefited the Company's loss ratio by 8.7 percentage points for the year ended December 31, 2011. For the year ended December 31, 2012, the Company incurred \$500.6 million of losses from notable loss events, which represented 26.7 percentage points of the loss ratio. Net of \$57.5 million of reinstatement premiums, the effect of these events on net income was a decrease of \$443.0 million. For the year ended December 31, 2011, the Company incurred \$633.9 million of losses from notable loss events, which represented 35.2 percentage points of the loss ratio, excluding the reserve for potential development on notable loss events. Net of \$44.7 million of reinstatement premiums, the effect of these events on net income was a decrease of \$589.2 million. The Company's loss ratio, excluding notable loss events, reserve for potential development on notable loss events and prior year loss reserve development for the year ended December 31, 2012 and 2011 was 36.0% and 38.3%, respectively.

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

As of December 31, 2011 the reserve for potential development on 2010 and 2011 notable loss events was \$18.6 million and \$78.0 million, respectively. During the year ended December 31, 2012, the Company increased certain loss estimates and allocated \$82.4 million of the 2010 and 2011 reserve to the Deepwater Horizon, Danish flood, Thailand floods, Tohoku earthquake, Christchurch earthquake and the Gryphon Alpha mooring failure. The Company also increased the reserve for potential development on 2011 notable loss events by \$27.9 million. The 2011 notable loss events, principally the Tohoku earthquake, the Christchurch earthquake, the Thailand floods and the Gryphon Alpha continued to experience adverse development as shown in the reserves for notable loss events roll forward table. Contract complexity, the nature and number of perils arising from these events, limits and sub limits exposed, the quality, flow and timing of information received by the Company, information regarding retrocessional covers, assumptions, both explicit and implicit, regarding future paid and reported loss development patterns, frequency and severity trends, claims settlement practices and potential changes in the legal environment continue to lead to complexity and volatility in the ultimate loss estimates for these events. Given the potential that one or some of the 2011 notable loss events eligible for potential allocation from the 2011 RDE may experience adverse development, rather than all deteriorating proportionately, an addition to the 2011 RDE of \$27.9 million was made. As at December 31, 2012, the reserve for potential development on 2010 and 2011 notable loss events was \$nil and \$42.2 million, respectively. No RDE was established for 2012 notable losses.

For disclosure purposes, only those notable loss events which had an initial consolidated ultimate loss estimate above \$15.0 million are disclosed separately and included in the reserve for notable loss events and reserve for development on events tables. To the extent that there are continued complexity and volatility factors relating to notable loss events in the aggregate, additions to the RDE may be established for a specific accident year, as illustrated in the RDE roll forward table. The Company increased the consolidated threshold for disclosure for notable losses effective January 1, 2011, from \$5.0 million to \$15.0 million.





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RESERVES FOR NOTABLE LOSS EVENTS - (Dollars in thousands)

2010 NOTABLE LOSS EVENTS	Year Ended December 31, 2010				Year Ended December 31, 2011				Year Ended December 31, 2012		
	Initial Estimate (a)	Development (Favorable) / Allocations (b)	Unfavorable of RDE (f) (c)	Closing Estimate (c) 31-Dec-10	Development (Favorable) / Allocations (b)	Unfavorable of RDE (f) (c)	Closing Estimate (c) 31-Dec-11	Development (Favorable) / Allocations (b)	Unfavorable of RDE (f) (c)	Closing Estimate (c) 31-Dec-12	
Notable Loss Chilean earthquake	\$293,116	\$2,548	\$19,242	\$314,906	\$(14,449)	\$—	\$300,457	\$(15,172)	\$—	\$285,285	
Deepwater Horizon (e)	44,101	737	—	44,838	3	14,769	59,610	13,529	18,617	91,756	
New Zealand earthquake	28,685	1,167	16,614	46,466	(297 )	—	46,169	3,026	—	49,195	
Queensland floods	25,000	—	—	25,000	(17,966 )	—	7,034	(3,700 )	—	3,334	
Melbourne hailstorm	18,200	2,644	—	20,844	293	—	21,137	—	—	21,137	
Windstorm Xynthia	12,558	(11,177)	—	1,381	(220 )	—	1,161	—	—	1,161	
Political violence loss	12,500	—	—	12,500	2,195	—	14,695	—	—	14,695	
Aban Pearl Satellite failure	10,500	20	—	10,520	272	—	10,792	—	—	10,792	
Perth hailstorm	8,786	—	—	8,786	(810 )	—	7,976	—	—	7,976	
Political violence loss	8,390	—	—	8,390	1,063	—	9,453	—	—	9,453	
Oklahoma windstorm	7,677	29	—	7,706	(841 )	—	6,865	1	—	6,866	
Bangkok riots	7,500	4,159	—	11,659	1,055	—	12,714	(203 )	—	12,511	
Hurricane Karl	6,313	—	—	6,313	—	—	6,313	(4,320 )	—	1,993	
Financial institutions loss	5,487	—	—	5,487	95	—	5,582	—	—	5,582	
Political risk loss	5,000	349	—	5,349	(3,828 )	—	1,521	—	—	1,521	
Total 2010 Notable Loss Events	\$493,813	\$476	\$35,856	\$530,145	\$(33,435)	\$14,769	\$511,479	\$(6,839 )	\$18,617	\$523,257	
				Closing Paid Loss (Recovery) (d) 31-Dec-10			Closing Paid Loss (Recovery) (d) 31-Dec-11			Closing Paid Loss (Recovery) (d) 31-Dec-12	

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Notable Loss Chilean earthquake	\$120,549	\$194,357	\$103,847	\$76,061	\$25,380	\$35,509
Deepwater Horizon (e)	45,152	(314 )	(34,881 )	49,339	14,458	67,027
New Zealand earthquake	—	46,466	1,254	44,915	12,182	35,759
Queensland floods	—	25,000	—	7,034	112	3,222
Melbourne hailstorm	7,163	13,681	11,611	2,363	1,290	1,073
Windstorm Xynthia	111	1,270	369	681	53	628
Political violence loss	—	12,500	—	14,695	—	14,695
Aban Pearl Satellite failure	7,346	3,174	2,418	1,028	165	863
Perth hailstorm	5,206	3,580	2,234	536	82	454
Perth hailstorm	5,339	3,051	3,751	363	134	229
Oklahoma windstorm	4,054	3,652	2,047	764	79	686
Bangkok riots	(1 )	11,660	7,500	5,215	—	5,012
Hurricane Karl	—	6,313	—	6,313	1,637	356
Financial institutions loss	57	5,430	3,039	2,486	174	2,312
Political risk loss	7	5,342	1,514	—	—	—
Total 2010 Notable Loss Events	\$194,983	\$335,162	\$104,703	\$211,793	\$55,746	\$167,825

RESERVES FOR NOTABLE LOSS EVENTS - (Dollars in thousands) -  
CONTINUED

2011 NOTABLE LOSS EVENTS		Year Ended December 31, 2011			Year Ended December 31, 2012		
		Development (Favorable) / Allocations Unfavorable of RDE (b)	Closing Estimate (c)	31-Dec-11	Development (Favorable) / Allocations Unfavorable of RDE (b)	Closing Estimate (c)	31-Dec-12
Notable Loss	Initial Estimate (a)						
Tohoku earthquake	\$ 148,926	\$ 37,963	\$ 29,788	\$ 216,677	\$(6,652)	\$ 16,342	\$ 226,367
Thailand floods	54,148	—	—	54,148	10,704	14,262	79,114
Gryphon Alpha	52,434	9,151	—	61,585	874	5,355	67,814
Cat 46	43,806	18,553	—	62,359	\$ 118	—	62,477
Christchurch earthquake	41,881	16,854	20,212	78,947	(495)	20,121	98,573
Hurricane Irene	32,451	3	—	32,454	(10,788)	—	21,666
Cat 48	31,481	9,190	—	40,671	5,612	—	46,283
Brisbane floods	31,023	4,848	—	35,871	(1,394)	—	34,477
CNRL Horizon (g)	19,500	(8,706)	—	10,794	558	—	11,352
Danish flood	19,429	5,987	—	25,416	2,566	7,665	35,647
Jupiter 1	15,008	(73)	—	14,935	(166)	—	14,769
Total 2011 Notable Loss Events	\$ 490,087	\$ 93,770	\$ 50,000	\$ 633,857	\$ 937	\$ 63,745	\$ 698,539
				Closing Reserve (d) 31-Dec-11			Closing Reserve (d) 31-Dec-12
Notable Loss		Paid Loss (Recovery)			Paid Loss (Recovery)		
Tohoku earthquake		\$ 59,100		\$ 157,577	\$ 94,011		\$ 73,256
Thailand floods		1,748		52,400	13,017		64,349
Gryphon Alpha		8,686		52,899	19,487		39,641
Cat 46		51,429		10,930	1,700		9,348
Christchurch earthquake		(42)		78,989	5,708		92,907
Hurricane Irene		8,669		23,785	3,743		9,254
Cat 48		19,934		20,737	14,032		12,317
Brisbane floods		16,151		19,720	10,998		7,328
CNRL Horizon (g)		5,600		5,194	5,746		6
Danish flood		7,872		17,544	15,099		12,676
Jupiter 1		14,342		593	245		182
Total 2011 Notable Loss Events		\$ 193,489		\$ 440,368	\$ 183,786		\$ 321,264



RESERVES FOR NOTABLE LOSS EVENTS - (Dollars in thousands)  
CONTINUED

2012 NOTABLE LOSS EVENTS		Year Ended December 31, 2012		
	Initial Estimate	Development (Favorable) / Unfavorable (b)	Allocations of RDE	Closing Estimate (c) 30-Dec-12
Notable Loss	(a)			
Hurricane Sandy	\$361,036	\$—	\$ —	\$361,036
Costa Concordia	76,197	(2,061)	—	74,136
Cat 67	22,713	5,377	—	28,090
U.S. drought	22,021	—	—	22,021
Hurricane Isaac	15,209	67	—	15,276
Total 2012 Notable Loss Events	\$497,176	\$3,383	\$ —	\$500,559

		Year Ended December 31, 2012	
		Paid Loss	Closing Reserve (d) 31-Dec-12
Notable Loss			
Hurricane Sandy		\$ 38,515	\$322,521
Costa Concordia		13,040	61,096
Cat 67		13,432	14,658
U.S. drought		12,346	9,675
Hurricane Isaac		313	14,963
Total 2012 Notable Loss Events		\$ 77,646	\$422,913

(a) Includes paid losses, case reserves and IBNR reserves.

(b) Development other than allocation of RDE.

(c) Excludes impact of movements in foreign exchange rates.

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

(e) Net movement in 2011 impacted by recognition of recoveries under retrocessional contracts.

(f) As at December 31, 2012, the Company has allocated all of the 2010 RDE.

(g) As at December 31, 2012, the Company has concluded that CNRL Horizon and Jupiter 1 no longer remains eligible for potential allocations from the 2011 RDE.

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RESERVE FOR DEVELOPMENT ON EVENTS	Reserve for potential development on 2010 notable loss events (dollars in thousands)	Reserve for potential development on 2011 notable loss events (dollars in thousands)	Reserve for potential development on 2012 notable loss events (dollars in thousands)	Total Reserve for potential development on notable loss events (dollars in thousands)
As at December 31, 2009	\$—			\$—
Reserve for potential development additions	69,242			69,242
Reserve for potential development allocations (a)	(35,856 )			(35,856 )
Reserve for potential development releases	—			—
As at December 31, 2010 (b)	\$33,386	\$—	\$—	\$33,386
Reserve for potential development additions	—	128,000		128,000
Reserve for potential development allocations (a)	(14,769 )	(50,000 )		(64,769 )
Reserve for potential development releases	—	—		—
As at December 31, 2011 (b)	\$18,617	\$78,000	\$—	\$96,617
Reserve for potential development additions (c)	—	27,926	—	27,926
Reserve for potential development allocations (a)	(18,617 )	(63,746 )	—	(82,363 )
Reserve for potential development releases	—	—	—	—
As at December 31, 2012 (b)	\$—	\$42,180	\$—	\$42,180

(a) During the year ended December 31, 2010, \$19,242 was allocated to the Chilean earthquake and \$16,614 was allocated to the New Zealand earthquake from the 2010 reserve for development on notable loss events.

During the year ended December 31, 2011, \$14,769 was allocated to Deepwater Horizon from the 2010 reserve for development on notable loss events. During the same period \$29,788 was allocated to the Tohoku earthquake and \$20,212 was allocated to the Christchurch earthquake from the 2011 reserve for development on notable loss events.

During the year ended December 31, 2012, \$18,617 was allocated to Deepwater Horizon from the 2010 reserve for development on notable loss events. During the same period \$16,342 was allocated to the Tohoku earthquake, \$20,121 was allocated to the Christchurch earthquake, \$7,665 was allocated to the Danish flood and \$14,262 was allocated to the Thailand floods and \$5,355 was allocated to the Gryphon Alpha mooring failure.

Notable losses for the year ended December 31, 2010 included Chilean earthquake, Melbourne hailstorm, Windstorm Xynthia, Deepwater Horizon, Aban Pearl, Bangkok riots, Perth hailstorm, New Zealand earthquake, (b) Oklahoma windstorm, Political risk loss, Hurricane Karl, Queensland floods, Political violence loss, Satellite failure and Financial institution loss.

Notable losses for the year ended December 31, 2011 included Tohoku earthquake, Gryphon Alpha mooring failure, Christchurch earthquake, Brisbane floods, CNRL Horizon, Cat 46, Cat 48, Jupiter 1, Danish floods, Hurricane Irene and Thailand floods. As at September 30, 2012, the Company has concluded that CNRL Horizon and Jupiter 1 no longer remains eligible for potential allocations from the 2011 RDE.

Notable losses for the year ended December 31, 2012 included Costa Concordia, Cat 67, U.S. drought, Hurricane Isaac and Hurricane Sandy.

- The 2011 notable loss events, principally the Tohoku earthquake, the Christchurch earthquake and the Thailand floods continued to experience adverse development as shown in the notable loss roll forward table. Contract complexity, the nature and number of perils arising from these events, limits and sub limits exposed, the quality, flow and timing of information received by the Company, information regarding retrocessional covers,
- (c) assumptions, both explicit and implicit, regarding future paid and reported loss development patterns, frequency and severity trends, claims settlement practices and potential changes in the legal environment continue to lead to complexity and volatility in the ultimate loss estimates for these events. Given the potential that one or some of the 2011 notable loss events eligible for potential allocation from the 2011 RDE may experience adverse development, rather than all deteriorating proportionately, an addition to the 2011 RDE of \$27.9 million was made.
- (d) The RDE is included as part of the Company's overall reserve requirement as defined and disclosed in the Critical Accounting Policies and Estimates section above.
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## Policy Acquisition Costs

Policy acquisition costs for the year ended December 31, 2012 were \$334.7 million compared to \$314.2 million for the year ended December 31, 2011, an increase of \$20.5 million or 6.5%. Policy acquisition costs as a percent of net premiums earned for the year ended December 31, 2012 and 2011 were 17.9% and 17.4%, respectively. Details of policy acquisition costs by line of business are provided below.

(Dollars in thousands)	Year Ended December 31, 2012			Year Ended December 31, 2011			Year Ended December 31, 2010			
	Policy Acquisition Costs	Policy Acquisition Costs (%)	Acquisition Cost Ratio	Policy Acquisition Costs	Policy Acquisition Costs (%)	Acquisition Cost Ratio	Policy Acquisition Costs	Policy Acquisition Costs (%)	Acquisition Cost Ratio	
Property	\$107,062	32.0	% 12.4	% \$112,261	35.8	% 12.6	% \$119,894	40.9	% 13.0	%
Marine	140,714	42.0	% 23.1	% 113,845	36.2	% 22.0	% 92,271	31.5	% 20.7	%
Specialty	86,922	26.0	% 21.8	% 88,078	28.0	% 22.4	% 80,734	27.6	% 20.6	%
Total	\$334,698	100.0	% 17.9	% \$314,184	100.0	% 17.4	% \$292,899	100.0	% 16.6	%

(a) The results of operations for Flagstone are consolidated only from the November 30, 2012 date of acquisition. Validus Re. Validus Re policy acquisition costs for the year ended December 31, 2012 were \$154.4 million compared to \$154.6 million for the year ended December 31, 2011, a decrease of \$0.2 million or 0.1%. Details of Validus Re policy acquisition costs by line of business are provided below.

(Dollars in thousands)	Year Ended December 31, 2012			Year Ended December 31, 2011			Year Ended December 31, 2010			
	Policy Acquisition Costs	Policy Acquisition Costs (%)	Acquisition Cost Ratio	Policy Acquisition Costs	Policy Acquisition Costs (%)	Acquisition Cost Ratio	Policy Acquisition Costs	Policy Acquisition Costs (%)	Acquisition Cost Ratio	
Property	\$94,239	61.1	% 14.0	% \$95,893	62.1	% 14.4	% \$111,478	69.9	% 14.8	%
Marine	44,343	28.7	% 17.5	% 44,431	28.7	% 21.0	% 33,691	21.1	% 19.1	%
Specialty	15,780	10.2	% 16.6	% 14,258	9.2	% 15.8	% 14,358	9.0	% 13.2	%
Total	\$154,362	100.0	% 15.1	% \$154,582	100.0	% 16.0	% \$159,527	100.0	% 15.3	%

(a) The results of operations for Flagstone are consolidated only from the November 30, 2012 date of acquisition.

Policy acquisition costs include brokerage, commission and excise tax, are generally driven by contract terms, are normally a set percentage of premiums and are also net of ceding commission income on retrocessions. Items such as ceded premium, earned premium adjustments and reinstatement premiums that are recognized in the period have an effect on policy acquisition costs. Validus Re policy acquisition costs as a percentage of net premiums earned for the year ended December 31, 2012 and 2011 were 15.1% and 16.0%, respectively. The policy acquisition cost ratio on the marine line has decreased by 3.5 percentage points due to an increase in reinstatement premiums that attract little or no policy acquisition costs.

AlphaCat. AlphaCat policy acquisition costs for the year ended December 31, 2012 were \$1.8 million compared to \$7.9 million for the year ended December 31, 2011, a decrease of \$6.2 million or 77.7%.

(Dollars in thousands)	Year Ended December 31, 2012			Year Ended December 31, 2011			Year Ended December 31, 2010			
	Policy Acquisition Costs	Policy Acquisition Costs (%)	Acquisition Cost Ratio	Policy Acquisition Costs	Policy Acquisition Costs (%)	Acquisition Cost Ratio	Policy Acquisition Costs	Policy Acquisition Costs (%)	Acquisition Cost Ratio	
Property	\$1,774	100.0	% 10.0	% \$7,946	100.0	% 12.0	% \$1,072	100.0	% 9.7	%
Total	\$1,774	100.0	% 10.0	% \$7,946	100.0	% 12.0	% \$1,072	100.0	% 9.7	%

Policy acquisition costs as a percent of net premiums earned for the year ended December 31, 2012 and 2011 were 10.0% and 12.0%, respectively

Talbot. Talbot policy acquisition costs for the year ended December 31, 2012 were \$183.9 million compared to \$157.3 million for the year ended December 31, 2011, an increase of \$26.6 million or 16.9%. Details of Talbot policy acquisition costs by line of business are provided below.





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(Dollars in thousands)	Year Ended December 31, 2012				Year Ended December 31, 2011				Year Ended December 31, 2010			
	Policy Acquisition Costs	Policy Acquisition Costs (%)	Acquisition Cost Ratio		Policy Acquisition Costs	Policy Acquisition Costs (%)	Acquisition Cost Ratio		Policy Acquisition Costs	Policy Acquisition Costs (%)	Acquisition Cost Ratio	
Property	\$16,114	8.8	% 9.2	%	\$13,814	8.7	% 8.6	%	\$18,628	12.9	% 11.8	%
Marine	96,582	52.5	% 27.2	%	69,624	44.3	% 22.8	%	58,614	40.8	% 21.8	%
Specialty	71,230	38.7	% 23.5	%	73,896	47.0	% 24.4	%	66,527	46.3	% 23.5	%
Total	\$183,926	100.0	% 22.1	%	\$157,334	100.0	% 20.4	%	\$143,769	100.0	% 20.3	%

Policy acquisition costs as a percent of net premiums earned for the year ended December 31, 2012 and 2011 were 22.1% and 20.4%, respectively. During the nine months ended September 30, 2012, Talbot reassessed commission costs on underwriting years 2007 and prior, related to business on the marine class. This resulted in a \$14.8 million increase in gross premiums written and earned premium, offset by an equal increase on policy acquisition costs for the marine class, resulting in no net impact. The effect on the policy acquisition cost ratio was an increase of 9.3 percentage points for the year ended December 31, 2012. Excluding the effect of this implementation, the marine lines and total policy acquisition cost ratios would have been 23.0% and 20.3%, respectively.

General and Administrative Expenses

General and administrative expenses for the year ended December 31, 2012 were \$263.7 million compared to \$197.5 million for the year ended December 31, 2011, an increase of \$66.2 million or 33.5%. The increase was primarily due to an increase in Corporate expenses of \$30.0 million, a \$21.2 million increase in the Talbot segment and a \$18.4 million increase in the Validus Re segment. The increase was offset by a \$3.4 million decrease in the AlphaCat segment.

(Dollars in thousands)	Year Ended December 31, 2012				Year Ended December 31, 2011				Year Ended December 31, 2010			
	(a)											
	General and Administrative Expenses	General and Administrative Expenses (%)	General and Administrative Expenses	General and Administrative Expenses (%)	General and Administrative Expenses	General and Administrative Expenses (%)	General and Administrative Expenses	General and Administrative Expenses (%)				
Validus Re	\$63,048	23.9	%	\$44,663	22.6	%	\$45,613	21.8	%			
AlphaCat	7,532	2.9	%	10,929	5.5	%	5,327	2.5	%			
Talbot	133,281	50.5	%	112,072	56.7	%	107,557	51.4	%			
Corporate & Eliminations (b)	59,791	22.7	%	29,833	15.2	%	50,793	24.3	%			
Total	\$263,652	100.0	%	\$197,497	100.0	%	\$209,290	100.0	%			

(a) The results of operations for Flagstone are consolidated only from the November 30, 2012 date of acquisition.

(b) Corporate and Eliminations includes legal entity adjustments.

General and administrative expenses of \$263.7 million in the year ended December 31, 2012 represented 14.1 percentage points of the expense ratio. General and administrative expenses of \$197.5 million in the year ended December 31, 2011 represented 11.0 percentage points of the expense ratio. Share compensation expenses are discussed in the following section.

Validus Re. Validus Re general and administrative expenses for the year ended December 31, 2012 were \$63.0 million compared to \$44.7 million for the year ended December 31, 2011, an increase of \$18.4 million or 41.2%. General and administrative expenses have increased primarily due to an increase in the performance bonus expense for the year ended December 31, 2012 as compared to the year ended December 31, 2011. Other contributing factors of the increase in general and administrative expense include an increase in rent and office expenses due to the Bermuda office refurbishment, the departure of a senior executive and the Company consolidating the general and administrative expenses as a result of the acquisition of Flagstone. General and administrative expenses include salaries and benefits, professional fees, rent and office expenses. Validus Re general and administrative expenses as a percent of net premiums earned for the year ended December 31, 2012 and 2011 were 6.2% and 4.6%, respectively.

AlphaCat. AlphaCat general and administrative expenses for the year ended December 31, 2012 were \$7.5 million compared to \$10.9 million for the year ended December 31, 2011, a decrease of \$3.4 million or 31.1%. General and administrative expenses include salaries and benefits and professional fees. General and administrative expenses have

decreased primarily due to the deconsolidation of AlphaCat Re 2011 as at December 31, 2011, offset by an increase in salaries and benefits and performance bonus expense. AlphaCat's general and administrative expenses as a percent of net premiums earned for the year ended December 31, 2012 and 2011 were 42.6% and 16.5%, respectively. The AlphaCat segment general and administrative expense ratio has

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been impacted by the reduction in net premiums earned as a greater proportion of the segment's revenues are generated in equity earnings from operating affiliates which is not included in the ratio calculation.

**Talbot.** Talbot general and administrative expenses for the year ended December 31, 2012 were \$133.3 million compared to \$112.1 million for the year ended December 31, 2011, an increase of \$21.2 million or 18.9%. General and administrative expenses have increased primarily due to an increase in the performance bonus expense. This increase was partially offset by a decrease in Lloyd's syndicate costs. Talbot's general and administrative expenses as a percent of net premiums earned for the year ended December 31, 2012 and 2011 were 16.0% and 14.6%, respectively.

**Corporate & Eliminations.** Corporate general and administrative expenses for the year ended December 31, 2012 were \$59.8 million compared to \$29.8 million for the year ended December 31, 2011, an increase of \$30.0 million or 100.4%. General and administrative expenses have increased primarily due to an increase in the performance bonus expense and professional fees. Corporate general and administrative expenses are comprised of executive and board expenses, internal and external audit expenses and other costs relating to the Company as a whole.

#### Share Compensation Expenses

Share compensation expenses for the year ended December 31, 2012 were \$26.7 million compared to \$34.3 million for the year ended December 31, 2011, a decrease of \$7.6 million or 22.1%. This expense is non-cash and has no net effect on total shareholders' equity, as it is balanced by an increase in additional paid-in capital.

(Dollars in thousands)	Year Ended December 31, 2012 (a)			Year Ended December 31, 2011			Year Ended December 31, 2010		
	Share Compensation Expense	Share Compensation Expenses (%)		Share Compensation Expense	Share Compensation Expenses (%)		Share Compensation Expense	Share Compensation Expenses (%)	
Validus Re	\$7,763	29.1	%	\$9,309	27.2	%	\$7,181	24.9	%
AlphaCat	279	1.0	%	107	0.3	%	594	2.1	%
Talbot	7,789	29.2	%	8,582	25.0	%	6,923	23.9	%
Corporate & Eliminations (b)	10,878	40.7	%	16,298	47.5	%	14,213	49.1	%
<b>Total</b>	<b>\$26,709</b>	<b>100.0</b>	<b>%</b>	<b>\$34,296</b>	<b>100.0</b>	<b>%</b>	<b>\$28,911</b>	<b>100.0</b>	<b>%</b>

(a) The results of operations for Flagstone are consolidated only from the November 30, 2012 date of acquisition.

(b) Corporate and Eliminations includes legal entity adjustments.

Share compensation expenses of \$26.7 million in the year ended December 31, 2012 represented 1.4 percentage points of the general and administrative expense ratio. The decrease in share compensation expenses of \$7.6 million is due to a reversal of \$1.4 million of expenses related to performance shares based on a review of current and projected performance criteria and a reduced expense of \$1.3 million on the non-qualified options which fully vested in May 2012. In addition, the share compensation expenses of \$34.3 million for the year ended December 31, 2011 included \$2.2 million of expenses on the employee seller shares and \$1.1 million of Talbot restricted share awards which fully vested on July 2, 2011.

**Validus Re.** Validus Re share compensation expenses for the year ended December 31, 2012 were \$7.8 million compared to \$9.3 million for the year ended December 31, 2011, a decrease of \$1.5 million or 16.6%. Share compensation expense as a percent of net premiums earned for the year ended December 31, 2012 and 2011 were 0.7% and 1.0%, respectively.

**AlphaCat.** AlphaCat share compensation expense as a percent of net premiums earned for the year ended December 31, 2012 and 2011 were 1.6% and 0.2%, respectively.

**Talbot.** Talbot share compensation expenses for the year ended December 31, 2012 were \$7.8 million compared to \$8.6 million for the year ended December 31, 2011, a decrease of \$0.8 million or 9.2%. Share compensation expense as a percent of net premiums earned for the year ended December 31, 2012 and 2011 were 0.9% and 1.1%, respectively.

**Corporate & Eliminations.** Corporate share compensation expenses for the year ended December 31, 2012 were \$10.9 million compared to \$16.3 million for the year ended December 31, 2011, a decrease of \$5.4 million or 33.3%.

#### Selected Ratios

The underwriting results of an insurance or reinsurance company are often measured by reference to its combined ratio, which is the sum of the loss ratio and the expense ratio. The loss ratio is calculated by dividing losses and loss expenses incurred (including estimates for incurred but not reported losses) by net premiums earned. The expense ratio is calculated by dividing

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acquisition costs combined with general and administrative expenses by net premiums earned. The following table presents the losses and loss expenses ratio, policy acquisition cost ratio, general and administrative expense ratio, expense ratio and combined ratio for the years ended December 31, 2012, 2011 and 2010.

	Year Ended December 31, 2012 (a)	Year Ended December 31, 2011	Year Ended December 31, 2010	
<b>Consolidated</b>				
Losses and loss expenses ratio	53.4	% 69.1	% 56.1	%
Policy acquisition costs ratio	17.9	% 17.4	% 16.6	%
General and administrative expenses ratio (b)	15.5	% 12.9	% 13.5	%
Expense ratio	33.4	% 30.3	% 30.1	%
Combined ratio	86.8	% 99.4	% 86.2	%
<b>Validus Re</b>				
Losses and loss expenses ratio	56.2	% 77.6	% 57.8	%
Policy acquisition costs ratio	15.1	% 16.0	% 15.3	%
General and administrative expenses ratio (b)	6.9	% 5.6	% 5.1	%
Expense ratio	22.0	% 21.6	% 20.4	%
Combined ratio	78.2	% 99.2	% 78.2	%
<b>AlphaCat</b>				
Losses and loss expenses ratio	0.0	% 15.2	% 0.0	%
Policy acquisition costs ratio	10.0	% 12.0	% 9.7	%
General and administrative expenses ratio (b)	44.2	% 16.7	% 53.4	%
Expense ratio	54.2	% 28.7	% 63.1	%
Combined ratio	54.2	% 43.9	% 63.1	%
<b>Talbot</b>				
Losses and loss expenses ratio	50.9	% 63.0	% 54.4	%
Policy acquisition costs ratio	22.1	% 20.4	% 20.3	%
General and administrative expenses ratio (b)	16.9	% 15.7	% 16.1	%
Expense ratio	39.0	% 36.1	% 36.4	%
Combined ratio	89.9	% 99.1	% 90.7	%

(a) The results of operations for Flagstone are consolidated only from the November 30, 2012 date of acquisition.

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

General and administrative expense ratios for the year ended December 31, 2012 and 2011 were 15.5% and 12.9%, respectively. General and administrative expense ratio is the sum of general and administrative expenses and share compensation expense divided by net premiums earned.

(Dollars in thousands)	Year Ended December 31, 2012 (a)		Year Ended December 31, 2011		Year Ended December 31, 2010			
	Expenses	Expenses as % of Net Earned Premiums	Expenses	Expenses as % of Net Earned Premiums	Expenses	Expenses as % of Net Earned Premiums		
General and administrative expenses	\$263,652	14.1 %	\$197,497	11.0 %	\$209,290	11.9 %		%
Share compensation expenses	26,709	1.4 %	34,296	1.9 %	28,911	1.6 %		%
Total	\$290,361	15.5 %	\$231,793	12.9 %	\$238,201	13.5 %		%

(a) The results of operations for Flagstone are consolidated only from the November 30, 2012 date of acquisition.

## Underwriting Income

Underwriting income for the year ended December 31, 2012 was \$248.7 million compared to \$11.8 million for the year ended December 31, 2011, an increase of \$236.9 million or 2,014.0%.

(Dollars in thousands)	Year Ended December 31, 2012	% of Sub- total	Year Ended December 31, 2011	% of Sub- total	Year Ended December 31, 2010	% of Sub- total	
Validus Re (a)	\$222,682	70.9	% \$8,066	15.5	% \$226,187	76.4	%
AlphaCat	8,081	2.6	% 36,984	70.8	% 4,089	1.4	%
Talbot	83,253	26.5	% 7,168	13.7	% 65,698	22.2	%
Sub total	314,016	100.0	% 52,218	100.0	% 295,974	100.0	%
Corporate & Eliminations	(65,305 )		(40,453 )		(53,537 )		
Total	\$248,711		\$11,765		\$242,437		

(a) The results of operations for Flagstone are consolidated only from the November 30, 2012 date of acquisition. The underwriting results of an insurance or reinsurance company are also often measured by reference to its underwriting income, which is a non-GAAP measure as previously defined. Underwriting income, as set out in the table below, is reconciled to net income (the most directly comparable GAAP financial measure) by the addition or subtraction of net investment income, other income, finance expenses, gain on bargain purchase, realized gain on repurchase of debentures, net realized and unrealized gains (losses) on investments, foreign exchange gains (losses) and transaction expenses, as illustrated below.

(Dollars in thousands)	Year Ended December 31, 2012 (a)	Year Ended December 31, 2011	Year Ended December 31, 2010
Underwriting income	\$248,711	\$11,765	\$242,437
Net investment income	107,936	112,296	134,103
Other income	22,396	5,718	5,219
Finance expenses	(53,857 )	(54,817 )	(55,870 )
Gain on bargain purchase, net of expenses	17,701	—	—
Net realized gains on investments	18,233	28,532	32,498
Net unrealized gains (losses) on investments	17,585	(19,991 )	45,952
(Loss) from investment affiliate	(964 )	—	—
Foreign exchange gains (losses)	4,798	(22,124 )	1,351
Transaction expenses	—	(17,433 )	—
Tax (expense) benefit	(2,501 )	(824 )	(3,126 )
Income from operating affiliates	12,580	—	—
Net income	\$392,618	\$43,122	\$402,564

(a) The results of operations for Flagstone are consolidated only from the November 30, 2012 date of acquisition. Underwriting income indicates the performance of the Company's core underwriting function, excluding revenues and expenses such as the reconciling items in the table above. The Company believes the reporting of underwriting income enhances the understanding of our results by highlighting the underlying profitability of the Company's core insurance and reinsurance business. Underwriting profitability is influenced significantly by earned premium growth, adequacy of the Company's pricing and loss frequency and severity. Underwriting profitability over time is also influenced by the Company's underwriting discipline, which seeks to manage exposure to loss through favorable risk selection and diversification, its management of claims, its use of reinsurance and its ability to manage its expense ratio, which it accomplishes through its management of acquisition costs and other underwriting expenses. The Company believes that underwriting income provides investors with a valuable measure of profitability derived from underwriting activities.

The Company excludes the U.S. GAAP measures noted above, in particular net realized and unrealized gains and losses on investments, from its calculation of underwriting income because the amount of these gains and losses is heavily influenced by, and fluctuates in part, according to availability of investment market opportunities. The Company believes these amounts are largely independent of its underwriting business and including them distorts the

analysis of trends in its operations. In addition to presenting net income determined in accordance with U.S. GAAP, the Company believes that showing underwriting income

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enables investors, analysts, rating agencies and other users of its financial information to more easily analyze the Company's results of operations in a manner similar to how management analyzes the Company's underlying business performance. The Company uses underwriting income as a primary measure of underwriting results in its analysis of historical financial information and when performing its budgeting and forecasting processes. Analysts, investors and rating agencies who follow the Company request this non-GAAP financial information on a regular basis. In addition, underwriting income is one of the factors considered by the compensation committee of our Board of Directors in determining total annual incentive compensation.

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

#### Net Investment Income

Net investment income for the year ended December 31, 2012 was \$107.9 million compared to \$112.3 million for the year ended December 31, 2011, a decrease of \$4.4 million or 3.9%. Net investment income decreased due to falling yields on fixed maturity investments. Net investment income includes accretion of premium or discount on fixed maturities, interest on coupon-paying bonds, short-term investments and cash and cash equivalents, partially offset by investment management fees. The components of net investment income for the year ended December 31, 2012, 2011 and 2010 are as presented below.

(Dollars in thousands)	Year Ended December 31, 2012 (a)	Year Ended December 31, 2011	Year Ended December 31, 2010
Fixed maturities and short-term investments	\$ 105,937	\$ 111,983	\$ 132,669
Other investments	2,790	—	—
Cash and cash equivalents	7,259	7,285	8,180
Securities lending income	14	58	200
Total gross investment income	116,000	119,326	141,049
Investment expenses	(8,064	) (7,030	) (6,946
Net investment income	\$ 107,936	\$ 112,296	\$ 134,103

(a) The results of operations for Flagstone are consolidated only from the November 30, 2012 date of acquisition. Annualized investment yield is calculated by dividing net investment income (excluding other investments) by the average balance of the assets managed by our portfolio managers (excluding other investments). Average assets is the average of the beginning, ending and intervening quarter end asset balances. The Company's annualized effective investment yield was 1.65% and 1.87% for the years ended December 31, 2012 and 2011, respectively, and the average duration of the portfolio at December 31, 2012 was 1.34 years (December 31, 2011—1.63 years). The annualized effective investment yield decreased for the year ended December 31, 2012 due to the consolidation of the Flagstone investment portfolio which included \$1,060.4 million in cash and short term investments, or 72.4% of Flagstone's total investments and cash as at December 31, 2012. Excluding the effect of the consolidation of the Flagstone investment portfolio, the annualized effective investment yield would have been 1.72% for the year ended December 31, 2012. Overall yield has decreased due to falling yields on fixed maturity investments.

#### Other Income

Other income for the year ended December 31, 2012 was \$22.4 million compared to \$5.7 million for the year ended December 31, 2011, an increase of \$16.7 million or 291.7%. The primary component of other income for the year ended December 31, 2012 is \$23.2 million in underwriting and performance fees the AlphaCat segment earned from business written by AlphaCat Re 2011, PaCRe and AlphaCat Re 2012. AlphaCat Re 2011 was a consolidated subsidiary during the three months ended June 30, September 30 and December 31, 2011. The balance sheet of AlphaCat Re 2011 was deconsolidated as at December 31, 2011.



## Finance Expenses

Finance expenses for the year ended December 31, 2012 were \$53.9 million compared to \$54.8 million for the year ended December 31, 2011, an increase of \$1.0 million or 1.8%. Finance expenses also include the amortization of debt offering costs and discounts, and fees related to our credit facilities.

(Dollars in thousands)	Year Ended December 31,		
	2012 (a)	2011	2010
2006 Junior Subordinated Deferrable Debentures	\$6,964	\$9,768	14,354
2007 Junior Subordinated Deferrable Debentures	8,922	12,115	12,114
2010 Senior Notes due 2040	22,388	22,388	20,770
Flagstone 2006 Junior Subordinated Deferrable Interest Notes	459	—	—
Flagstone 2007 Junior Subordinated Deferrable Interest Notes	327	—	—
Credit facilities	11,999	6,492	5,246
Bank charges	269	218	246
AlphaCat Re 2011 preferred dividend(b)	—	3,609	—
AlphaCat ILS Funds fees (c)	2,432	—	—
Talbot FAL Facility	97	227	333
Talbot third party FAL facility	—	—	2,807
Finance expenses	\$53,857	\$54,817	55,870

(a) The results of operations for Flagstone are consolidated only from the November 30, 2012 date of acquisition.

(b) Includes preferred share dividends and finance expenses attributable to AlphaCat Re 2011.

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

The decrease in finance expenses of \$1.0 million for the year ended December 31, 2012 was due primarily to a \$3.2 million decrease in interest paid on the 2007 Junior Subordinated Deferrable Debentures due to the basis of repayments changing from a fixed interest rate of 8.480% per annum through June 15, 2012 to a floating rate of three month LIBOR plus 295 basis points, a \$2.8 million decrease in interest paid on the 2006 Junior Subordinated Deferrable Debentures due to the basis of repayments changing from a fixed interest rate of 9.069% per annum through June 15, 2011 to a floating rate of three month LIBOR plus 355 basis points and a \$3.6 million decrease in the preferred dividends and finance expenses attributable to AlphaCat Re 2011. These decreases were partially offset by placement fees incurred by AlphaCat for its investments in ILS Funds of \$2.4 million and a \$5.5 million increase in credit facility fees primarily due to closing fees on the renewal of the credit facilities and the acceleration of fees expensed on the credit facilities that were terminated during the year.

## Tax (Expense)

Tax expense for the year ended December 31, 2012 was \$(2.5) million compared to \$(0.8) million for the year ended December 31, 2011, an increase in expense of \$1.7 million or 203.5%. The increase was primarily due to underwriting profits in the Talbot segment for the year ended December 31, 2012 compared to underwriting losses for the year ended December 31, 2011. The increase was also due to an increase in UK taxable profits arising from higher fee income, partially offset by a higher bonus deduction and a reduction in the deferred tax liability due to a reduction in the UK tax rate from 2013.

The Company provides for income taxes based upon amounts reported in the financial statements and the provisions of currently enacted tax laws. The Company is registered in Bermuda and is subject to Bermuda law with respect to taxation. Under current Bermuda law, the Company is not taxed on any Bermuda income or capital gains and has received an undertaking from the Bermuda Minister of Finance that, in the event of any Bermuda income or capital gains taxes being imposed, the Company will be exempt from those taxes until March 31, 2035.

Within the segment information contained in the Financial Statements, gross premiums written allocated to the territory of coverage exposure are presented for the periods indicated. Gross premiums written allocated to the United States are written primarily through Validus Reinsurance, Ltd., a Bermuda Registered Reinsurance Company. As noted, under current Bermuda law, the Company is not taxed on any Bermuda income and therefore the premium disclosed in the segment information does not correlate to pre-tax income generated in the United States.



#### Income From Operating Affiliates

Income from operating affiliates for the year ended December 31, 2012, was \$12.6 million compared to \$nil for the year ended December 31, 2011, an increase of \$12.6 million. For the year ended December 31, 2012 income from operating affiliates of \$12.6 million relates to equity earnings relating to AlphaCat Re 2011 and AlphaCat Re 2012. In the second quarter of 2011, AlphaCat Re 2011 was included in the consolidated results of the Company, therefore there was no comparative information for the year ended December 31, 2011. As at December 31, 2012, the Company owned 22.3% of AlphaCat Re 2011, therefore income from operating affiliates reflects the Company's share of AlphaCat Re 2011's net income for the year ended December 31, 2012.

AlphaCat Re 2012 was formed on May 29, 2012 therefore there was no comparative information for the year ended December 31, 2011. As at December 31, 2012, the Company owned 37.9% of AlphaCat Re 2012, therefore income from operating affiliates reflects the Company's share of AlphaCat Re 2012's net income for the year ended December 31, 2012.

#### Gain on Bargain Purchase, Net of Expenses

On November 30, 2012, the Company acquired all of the outstanding shares of Flagstone. Pursuant to the Amalgamation Agreement, the Company acquired all of Flagstone's outstanding common shares in exchange for the Company's common shares and cash. The purchase price paid by the Company was \$646.0 million for net assets acquired of \$695.7 million. The Company expensed as incurred \$5.8 million of transaction expenses, \$20.2 million of termination expenses and \$6.0 million for amortization of intangibles related to the acquisition for the year ended December 31, 2012, resulting in a gain on bargain purchase, net of expenses of \$17.7 million. Transaction expenses are comprised of primarily legal and corporate advisory services.

#### Net Realized Gains on Investments

Net realized gains on investments for the year ended December 31, 2012 were \$18.2 million compared to \$28.5 million for the year ended December 31, 2011, a decrease of \$10.3 million or 36.1%.

#### Net Unrealized Gains (Losses) on Investments

Net unrealized gains on fixed maturity and short term investments for the year ended December 31, 2012 were \$17.6 million compared to losses of \$(20.0) million for the year ended December 31, 2011, an increase of \$37.6 million or 188.0%. The net unrealized gains for the year ended December 31, 2012 were a result primarily of increased market appetite for corporate credit.

Net unrealized losses on other investments for the year ended December 31, 2012 were \$(20.4) million compared to \$(1.3) million for the year ended December 31, 2011, a decrease of \$19.1 million. The net unrealized losses for the year ended December 31, 2012 were driven primarily by the \$(19.2) million unrealized loss relating to the Paulson & Co. hedge fund investments held by PaCRe. The amount of net unrealized losses attributable to noncontrolling interest was \$(17.3) million for the year ended December 31, 2012, leaving a net impact to the Company of \$(1.9) million.

Net unrealized (losses) gains on investments are recorded as a component of net income. The Company has adopted all authoritative guidance on U.S. GAAP fair value measurements in effect as of the balance sheet date. Consistent with these standards, certain market conditions allow for fair value measurements that incorporate unobservable inputs where active market transaction based measurements are unavailable.

#### Loss From Investment Affiliate

The loss from investment affiliate for the year ended December 31, 2012 was \$(1.0) million as compared to \$nil for the year ended December 31, 2011, a decrease of \$(1.0) million. The loss from investment affiliate relates to the loss incurred in the Company's investment in the Aquiline Financial Services Fund II L.P. for the year ended December 31, 2012. As at December 31, 2011, the investment in the Aquiline Financial Services Fund II L.P was included in other investments.

#### Foreign Exchange Gains (Losses)

Our reporting currency is the U.S. dollar. Our subsidiaries have one of the following functional currencies: U.S. dollar, British pound sterling, Euro, Canadian dollar, Swiss franc, Indian rupee, South African rand and Singapore dollar. As a significant portion of our operations are transacted in foreign currencies, fluctuations in foreign exchange rates may affect period-to-period comparisons. To the extent that fluctuations in foreign currency exchange rates affect comparisons, their impact has been quantified, when possible, and discussed in each of the relevant sections. See Note 3 "Significant accounting policies" to the consolidated financial statements in Item 8, "Financial Statements and

Supplementary Data.”

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U.S. dollar (weakened) strengthened against:	Year Ended December 31, 2012	Year Ended December 31, 2011	Year Ended December 31, 2010	
British Pound sterling	(4.4)	)% (0.4	)% 3.0	%
Euro	(1.7	)% 2.3	% 8.2	%
Canadian Dollar	(2.7	)% 2.1	% (4.7	)%
Swiss Franc	(2.4	)% (0.2	)% (9.4	)%
Indian Rupee	3.6	% 16.5	% (2.6	)%
South African Rand	4.7	% 21.6	% (10.4	)%
Singapore Dollar	(5.8	)% 0.4	% (8.1	)%

Foreign exchange gains for the year ended December 31, 2012 were \$4.8 million compared to losses of \$(22.1) million for the year ended December 31, 2011, a favorable movement of \$26.9 million or 121.7%. For the year ended December 31, 2012, Validus Re recognized foreign exchange gains of \$2.7 million and Talbot recognized foreign exchange gains of \$2.5 million.

For the year ended December 31, 2012, Validus Re segment foreign exchange gains were \$2.7 million compared to a foreign exchange loss of \$(19.5) million for the year ended December 31, 2011, a favorable movement of \$22.2 million or 113.6%. Validus Re currently hedges foreign currency exposure by balancing assets (primarily cash and premium receivables) with liabilities (primarily case reserves and event IBNR) for certain major non-USD currencies. Consequently, Validus Re aims to have a limited exposure to foreign exchange fluctuations. The \$2.7 million gain for the year ended December 31, 2012 primarily occurred as a result of the British pound sterling and Japanese Yen strengthening during the period. In the year ended December 31, 2011 a foreign exchange loss occurred as a result of the Company having liabilities in both New Zealand Dollars and Japanese Yen during a period when both of these currencies strengthened against the U.S. dollar.

For the year ended December 31, 2012, Talbot segment foreign exchange gains were \$2.5 million compared to losses of \$(2.2) million for the year ended December 31, 2011, a favorable movement of \$4.7 million or 215.5%. The favorable movement in Talbot foreign exchange was due primarily to a \$2.1 million translation of non U.S. dollar balances and a \$3.5 million translation of non-monetary assets, partially offset a \$1.2 million losses incurred in the revaluation of assets held in Euros and other currencies. During 2012, the U.S. dollar to British pound sterling weakened by 4.4% as compared to a weakening of the U.S. dollar to British pound sterling of 0.4% for the in 2011. At December 31, 2012, Talbot's balance sheet includes net unearned premiums and deferred acquisition costs denominated in foreign currencies of approximately \$107.4 million and \$21.5 million, respectively. These balances consisted of British pound sterling and Canadian dollars of \$78.0 million and \$7.9 million, respectively. Net unearned premiums and deferred acquisition costs are classified as non-monetary items and are translated at historic exchange rates. All of Talbot's other balance sheet items are classified as monetary items and are translated at period end exchange rates. Additional foreign exchange gains (losses) may be incurred on the translation of net unearned premiums and deferred acquisition costs arising from insurance and reinsurance premiums written in future periods.

Net Loss (Income) Attributable to Noncontrolling Interest

On April 2, 2012, the Company capitalized PaCRe, a new Class 4 Bermuda reinsurer formed for the purpose of writing high excess property catastrophe reinsurance. PaCRe was funded with \$500.0 million of contributed capital. Validus invested \$50.0 million in PaCRe's common equity and therefore owns 10.0% of PaCRe. The net loss attributable to noncontrolling interest of \$15.8 million for the period from April 2, 2012 to December 31, 2012 was calculated as 90.0% of the net loss in PaCRe for the period.

On May 25, 2011, the Company joined with other investors in capitalizing AlphaCat Re 2011, a new special purpose reinsurer formed for the purpose of writing collateralized reinsurance and retrocessional reinsurance. Validus Re has an equity interest in AlphaCat Re 2011 and Validus Re held a majority of AlphaCat Re 2011's outstanding voting rights up to December 23, 2011 when AlphaCat Re 2011 completed a secondary offering of its common shares to third party investors, along with a partial sale of Validus Re common shares to one of the third party investors. As a result of these transactions, the Company's outstanding voting rights decreased to 43.7%. As a result of the Company's voting interest falling below 50%, the individual assets and liabilities and corresponding noncontrolling interest of AlphaCat Re 2011 were derecognized from the consolidated balance sheet of the Company as at December 31, 2011

and the remaining investment in AlphaCat Re 2011 is treated as an equity method investment as at December 31, 2012. For the year ended December 31, 2011, the Company recorded \$(21.8) million in net income attributable to noncontrolling interest relating to AlphaCat Re 2011.

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Transaction Expenses

During the year ended December 31, 2012, the Company incurred \$nil in transaction expenses compared to \$17.4 million for the year ended December 31, 2011. The 2011 transaction expenses related to the Company's proposed acquisition of Transatlantic. The transaction expenses related to the November 30, 2012 acquisition of Flagstone were used in the calculation of the gain on bargain purchase of Flagstone and are presented on the section above entitled "Gain on Bargain Purchase of Flagstone." Transaction expenses are primarily comprised of legal, financial advisory and audit related services.

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Year Ended December 31, 2011 compared to Year Ended December 31, 2010

Net income available to Validus for the year ended December 31, 2011 was \$21.3 million compared to \$402.6 million for the year ended December 31, 2010, a decrease of \$381.2 million or 94.7%. The primary factors driving the decrease in net income were:

Decrease in underwriting income of \$230.7 million due primarily to a \$256.8 million increase in loss and loss expenses from increased severity of catastrophe events. This was partially offset by a \$41.0 million increase in net premiums earned;

Decrease in net investment income of \$21.8 million;

Unfavorable movement in net unrealized gains on investments of \$65.9 million; and

Unfavorable movement in foreign exchange of \$23.5 million.

The change in net income available to Validus for the year ended December 31, 2011 of \$381.2 million as compared to the year ended December 31, 2010 is described in the following table:

(Dollars in thousands)	Year Ended December 31, 2011				
	Decrease (increase) over the year ended December 31, 2010				Total
	Validus Re	AlphaCat	Talbot	Corporate and other reconciling items	
Notable losses—(increase) decrease in net losses and loss expenses(a)	\$(46,951 )	\$—	\$(56,111 )	\$—	\$(103,062 )
Less: Notable losses—increase (decrease) net reinstatement premiums(a)	21,989	—	1,602	—	23,591
Other underwriting (loss) income	(193,159 )	32,895	(4,021 )	13,084	(151,201 )
Underwriting (loss) income(b)	(218,121 )	32,895	(58,530 )	13,084	(230,672 )
Net investment income	(14,922 )	(2,613 )	(3,907 )	(365 )	(21,807 )
Other income	3,452	7,617	(2,830 )	(7,740 )	499
Finance expenses	(2,306 )	(3,659 )	2,913	4,105	1,053
Operating (loss) income before taxes and income from operating affiliates	(231,897 )	34,240	(62,354 )	9,084	(250,927 )
Tax benefit	63	—	2,079	160	2,302
Net operating (loss) income	(231,834 )	34,240	(60,275 )	9,244	(248,625 )
Net realized gains (losses) on investments	(2,393 )	425	(1,998 )	—	(3,966 )
Net unrealized (losses) on investments	(59,314 )	(2,001 )	(4,628 )	—	(65,943 )
Foreign exchange (losses) gains	(18,902 )	99	(4,279 )	(393 )	(23,475 )
Transaction expenses	—	—	—	(17,433 )	(17,433 )
Net (loss) income	(312,443 )	32,763	(71,180 )	(8,582 )	(359,442 )
Net (income) attributable to noncontrolling interest	—	(21,793 )	—	—	(21,793 )
Net (loss) income available to Validus	\$(312,443 )	\$10,970	\$(71,180 )	\$(8,582 )	\$(381,235 )

Notable losses for the year ended December 31, 2011 include: the Tohoku earthquake, Gryphon Alpha mooring failure, Christchurch earthquake, Brisbane floods, CNRL Horizon, Cat 46, Cat 48, Jupiter 1, Danish floods, Hurricane Irene and the Thailand floods. Excludes reserve for potential development on 2011 notable loss events. Notable losses for the year ended December 31, 2010 include: the Chilean earthquake, Melbourne hailstorm, windstorm Xynthia, Deepwater Horizon, Aban Pearl, Bangkok riots, Perth hailstorm, New Zealand earthquake, Oklahoma windstorm, two Political risk losses, Hurricane Karl, Queensland floods, a Political violence loss, a Satellite failure and a Financial institutions loss.

(b) Non-GAAP Financial Measures. In presenting the Company's results, management has included and discussed underwriting income (loss) that is not calculated under standards or rules that comprise U.S. GAAP. Such measures are referred to as non-GAAP. Non-GAAP measures may be defined or calculated differently by other

companies. These measures should not be viewed as a substitute for those determined in accordance with U.S. GAAP. A reconciliation of this measure to net income, the most comparable U.S. GAAP financial measure, is presented in the section below entitled "Underwriting Income".

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## Other Non-GAAP Financial Measures

In presenting the Company's results, management has included and discussed certain schedules containing net operating income, underwriting income (loss), managed gross premiums written, annualized return on average equity and diluted book value per common share that are not calculated under standards or rules that comprise U.S. GAAP. Such measures are referred to as non-GAAP. Non-GAAP measures may be defined or calculated differently by other companies. These measures should not be viewed as a substitute for those determined in accordance with U.S. GAAP. The calculation of annualized return on average equity is discussed in the section above entitled "Financial Measures." A reconciliation of underwriting income to net income, the most comparable U.S. GAAP financial measure, is presented above in the section entitled "Underwriting Income (Loss)." A reconciliation of diluted book value per share to book value per share, the most comparable U.S. GAAP financial measure, is presented below. Operating income is calculated based on net income (loss) excluding net realized gains (losses), net unrealized gains (losses) on investments, income (loss) from investment affiliates, gains (losses) arising from translation of non-US\$ denominated balances and non-recurring items. A reconciliation of operating income to net income, the most comparable U.S. GAAP financial measure, is embedded in the table presenting results of operations for the years ended December 31, 2012 and 2011 in the section above entitled "Results of Operations." Realized gains (losses) from the sale of investments are driven by the timing of the disposition of investments, not by our operating performance. Gains (losses) arising from translation of non-U.S. dollar denominated balances are unrelated to our underlying business. Managed gross premiums written represents gross premiums written by the Company and its operating affiliates. Managed gross premiums written differs from total gross premiums written, which the Company believes is the most directly comparable GAAP measure, due to the inclusion of premiums written on behalf of the Company's operating affiliates, AlphaCat Re 2011 and AlphaCat Re 2012, which are accounted for under the equity method of accounting. A reconciliation of managed gross premiums written to gross premiums written, the most comparable U.S. GAAP financial measure, is presented in the section below.

The following tables present reconciliations of diluted book value per share to book value per share, the most comparable U.S. GAAP financial measure, at December 31, 2012 and December 31, 2011.

As at December 31, 2012

	Equity Amount	Shares	Exercise Price	Book Value Per Share
Book value per common share				
Total shareholders' equity	\$4,020,827	107,921,259		\$37.26
Diluted book value per common share				
Total shareholders' equity	4,020,827	107,921,259		
Assumed exercise of outstanding warrants	118,015	6,410,472	\$18.41	
Assumed exercise of outstanding stock options	37,745	1,823,947	\$20.69	
Unvested restricted shares	—	2,443,631		
Diluted book value per common share	\$4,176,587	118,599,309		\$35.22

As at December 31, 2011

	Equity Amount	Shares	Exercise Price	Book Value Per Share
Book value per common share				
Total shareholders' equity	\$3,448,425	99,471,080		\$34.67
Diluted book value per common share				
Total shareholders' equity	3,448,425	99,471,080		
Assumed exercise of outstanding warrants	121,445	6,916,678	\$17.56	
Assumed exercise of outstanding stock options	45,530	2,263,012	\$20.12	
Unvested restricted shares	—	3,340,729		
Diluted book value per common share	\$3,615,400	111,991,499		\$32.28



The following tables present reconciliations of total gross premiums written to total managed gross premiums written, the most comparable U.S. GAAP financial measure, at December 31, 2012 and December 31, 2011.

	Year Ended (unaudited)	
	December 31, 2012	December 31, 2011(a)
Total gross premiums written	\$2,166,440	\$2,124,691
Adjustments for:		
Gross premiums written on behalf of AlphaCat Re 2011	94,317	—
Gross premiums written on behalf of AlphaCat Re 2012	32,171	—
Total managed gross premiums written	\$2,292,928	\$2,124,691

(a) Total gross premiums written for the year ended December 31, 2011 included \$(1.4) million and \$60.0 million of gross premiums written from AlphaCat Re 2011, which was a consolidated subsidiary during the three months ended June 30, September 30 and December 31, 2011. The balance sheet of AlphaCat Re 2011 was deconsolidated as at December 31, 2011.

#### Financial Condition and Liquidity

Validus Holdings, Ltd. is a holding company and conducts no operations of its own. The Company relies primarily on cash dividends and other permitted payments from Validus Re and Talbot to pay finance expenses and other holding company expenses. There are restrictions on the payment of dividends from Validus Re and Talbot to the Company. Please refer to Part II, Item 5, “Market for Registrants Common Equity, Related Shareholder Matters and Issuer Purchases of Equity Securities” for further discussion of the Company’s dividend policy. We believe the dividend/distribution capacity of the Company’s subsidiaries will provide the Company with sufficient liquidity for the foreseeable future. We continue to generate substantial cash from operating activities and remain in a strong financial position, with resources available for reinvestment in existing businesses, strategic acquisitions and managing our capital structure to meet short- and long-term objectives.

#### Sources and Uses of Cash

Three main sources provide cash flows for the Company: operating activities, investing activities and financing activities. The movement in net cash provided by operating activities, net cash provided by (used in) investing activities, net cash (used in) provided by financing activities and the effect of foreign currency rate changes on cash and cash equivalents for the years ended December 31, 2012, 2011 and 2010 is described in the following table.

(Dollars in thousands)	Year Ended December 31,		
	2012 (a)	2011	2010
Net cash provided by operating activities	\$562,565	\$545,140	\$630,001
Net cash (used in) provided by investing activities	(268,915 )	(392,834 )	378,426
Net cash provided by (used in) financing activities	75,345	68,681	(774,842 )
Effect of foreign currency rate changes on cash and cash equivalents	17,540	(8,883 )	(430 )
Net increase in cash	\$386,535	\$212,104	\$233,155

(a) The results of operations for Flagstone are consolidated only from the November 30, 2012 date of acquisition.

#### Operating Activities

Cash flow from operating activities is derived primarily from the net receipt of premiums less claims and expenses related to underwriting activities.

During the year ended December 31, 2012, net cash provided by operating activities of \$562.6 million was driven primarily by an increase in the reserve for losses and loss expenses of \$116.9 million and a decrease of \$95.0 million in loss reserves recoverable and paid losses recoverable.

During the year ended December 31, 2011, net cash provided by operating activities of \$545.1 million was driven primarily by a significant portion of the 2011 incurred losses had yet to be paid as of December 31, 2011, which resulted in cash provided from operating activities for the period being higher than net income for the period.

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During the year ended December 31, 2010, net cash provided by operating activities of \$630.0 million was driven by increased levels of underwriting net premiums written arising from the impact of the IPC acquisition in late 2009. A significant portion of the 2010 incurred losses had yet to be paid as of December 31, 2010, which resulted in cash provided from operating activities for the period being higher than net income for the period.

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

#### Investing Activities

Cash flow from investing activities is derived primarily from the receipt of net proceeds on the Company's investment portfolio. As at December 31, 2012, the Company's portfolio was composed of fixed income investments, short-term and other investments amounting to \$6,764.0 million or 84.7% of total cash and investments. Please refer to Note 7 (c) to the Consolidated Financial Statements (Part II, Item 8) for further details of investments pledged as collateral.

During the year ended December 31, 2012, net cash used in investing activities of \$268.9 million was driven primarily by net purchases of investments of \$737.8 million and \$104.3 million of purchases of investments in operating and investment affiliates, partially offset by \$548.2 million in proceeds on maturities of investments.

During the year ended December 31, 2011, net cash provided by investing activities of \$392.8 million was driven primarily by the net sales of short term securities of \$208.3 million and a decrease in securities lending collateral of \$14.6 million. The decrease in securities lending collateral was due to the winding down of the securities lending program beginning in the third quarter of 2011.

During the year ended December 31, 2010, net cash provided by investing activities of \$378.4 million was driven primarily by the net sales of short term securities of \$208.3 million and a decrease in securities lending collateral of \$67.0 million.

#### Acquisitions and Investments in Affiliates

	Year Ended December 31,		
	2012	2011	2010
Net cash used in:			
Purchase of subsidiary, net of cash acquired	\$ 17,196	\$—	\$—
Investments in operating affiliates, net	(91,500	) (56,808	) —
Investments in investment affiliates, net	(12,835	) —	—

#### 2012 Acquisitions and Investments

Purchase of Subsidiary, net of cash acquired: On November 30, 2012, pursuant to a Merger Agreement, the Company acquired all of Flagstone's outstanding common shares in exchange for 0.1935 Company common shares and \$2.00 cash per Flagstone common share. The Flagstone Acquisition resulted in the payment of \$147.7 million in cash to Flagstone shareholders and the net cash acquired from Flagstone was \$164.9 million resulting in a net cash inflow to the Company of \$17.2 million.

The Company assumed a letter of credit facility and long term debt as described in Note 18 "Debt and financing arrangements" to Consolidated Financial Statements (Part II, Item 8). On August 30, 2012, Flagstone had a \$200.0 million secured committed letter of credit facility with Barclays Bank Plc (the "Barclays Facility"). The Barclays Facility was terminated prior to the acquisition date.

For additional information about our acquisitions, please refer to Note 5 "Business combination," to the Consolidated Financial Statements (Part II, Item 8) for further details.

Investments in operating affiliates, net: During the year ended December 31, 2012, the Company joined with other investors and contributed \$26.5 million to AlphaCat Re 2012, \$45.0 million to AlphaCat 2013 and \$20.0 million to the AlphaCat ILS funds. Please refer to Note 8 "Investment in affiliates" to the Consolidated Financial Statements (Part II, Item 8) for further details.

Investments in investment affiliates, net: During the year ended December 31, 2012, the Company made \$14.4 million in capital contributions to the Aquiline Financial Services Fund II L.P. and incurred \$1.4 million in net unrealized losses. Please refer to Note 8 "Investment in affiliates" to the Consolidated Financial Statements (Part II, Item 8) for further details.





## 2011 Investments

Investments in operating affiliates, net: In May 2011, the Company joined with other investors contributed \$50.0 million to AlphaCat Re 2011. During the fourth quarter of 2011, the Company sold a portion of its investment in AlphaCat Re 2011 for \$11.0 million and redeemed \$(67.8) million in cash in the deconsolidation of AlphaCat Re 2011.

## Financing Activities

Cash flow from financing activities is derived primarily from the issuance of common shares and debentures payable. During the year ended December 31, 2012, net cash provided by financing activities of \$75.3 million was driven primarily by the net cash received for the third party investment in PacRe of \$450.1 million, partially offset by \$260.0 million purchases of common shares under share repurchase program and \$110.0 million of quarterly dividends. During the year ended December 31, 2011, net cash provided by financing activities of \$68.7 million was driven primarily by the net cash received for the third party investment in non-controlling interest of \$192.1 million, partially offset by \$107.7 million of quarterly dividends.

During the year ended December 31, 2010, net cash used in financing activities of \$(774.8) million was driven primarily by the purchase of \$856.9 million of common shares under the Company's share repurchase program and the payment of \$105.7 million in quarterly dividends, partially offset by the issuance \$246.8 million of 8.875% Senior Notes due 2040.

	Year Ended December 31,		
	2012	2011	2010
Net cash used in:			
Net borrowings under long term revolving credit facilities	—	—	246,793
Payments on long term debt	(40,303	) (48,882	) (51,149

Details of the Company's debt and financing arrangements at December 31, 2012 are provided below.

(Dollars in thousands)	Maturity Date / Term	In Use/ Outstanding
2006 Junior Subordinated Deferrable Debentures	June 15, 2036	\$150,000
2007 Junior Subordinated Deferrable Debentures	June 15, 2037	139,800
2010 Senior Notes due 2040	January 26, 2040	250,000
\$400,000 syndicated unsecured letter of credit facility	March 9, 2016	—
\$525,000 syndicated secured letter of credit facility	March 9, 2016	376,570
\$500,000 secured letter of credit facility	Evergreen	92,402
Talbot FAL facility	December 31, 2015	25,000
PaCRe Senior secured letter of credit	May 10, 2013	219
IPC Bi-Lateral Facility	Evergreen	40,613
Flagstone Bi-Lateral Facility	Evergreen	381,019
Flagstone 2006 Junior Subordinated Deferrable Interest Notes	September 15, 2037	137,159
Flagstone 2007 Junior Subordinated Deferrable Interest Notes	September 15, 2036	113,750
Total		\$1,706,532

For additional information about our debt, including the terms of our financing arrangements, basis for variable interest rates and debt covenants, Please refer to Note 18 "Debt and financing arrangements" to the Consolidated Financial Statements (Part II, Item 8) for further details.

## Equity Transactions

	Year Ended December 31,		
	2012	2011	2010
Net cash used in:			
Share repurchases	\$(259,962	) \$(5,995	) \$(856,926
Dividends paid to shareholders	(110,037	) (107,691	) (105,662



Under share repurchase programs authorized by our Board of Directors, we purchased 8.1 million, 0.2 million, and 31.7 million common shares on the open market during the twelve months ended December 31, 2012, 2011 and 2010, respectively, for \$260.0 million, \$6.0 million and \$856.9 million, respectively. At December 31, 2012, the Company had \$122.3 million remaining for stock repurchases under the existing Board authorization.

During the twelve months ended December 31, 2012, 2011 and 2010, we paid cash dividends to shareholders of \$110.0 million, \$107.7 million and \$105.7 million, respectively, at \$1.00 per share for 2012, \$1.00 per share for 2011 and \$0.88 per share for 2010.

#### Capital Resources

Shareholders' equity at December 31, 2012 was \$4,455.1 million.

On February 6, 2013, the Company announced an increase in the quarterly cash dividend from \$0.25 to \$0.30 per common share and \$0.30 per common share equivalent for which each outstanding warrant is exercisable, payable on March 29, 2013 to holders of record on March 15, 2013. In addition, the Company announced a special dividend in the amount of \$2.00 per common share and \$2.00 per common share equivalent for which each outstanding warrant is exercisable, payable on February 26, 2013 to shareholders and warrant holders of record as of February 19, 2013.

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

On August 5, 2011, the Company filed a shelf registration statement on Form S-3 (No. 333-176116) with the U.S. Securities Exchange Committee under which we may offer from time to time common shares, preference shares, depository shares representing common shares or preference shares, senior or subordinated debt securities, warrants to purchase common shares, preference shares and debt securities, share purchase contracts, share purchase units and units which may consist of any combination of the securities listed above. In addition, the shelf registration statement will provide for secondary sales of common shares sold by the Company's shareholders. The registration statement is intended to provide the Company with additional flexibility to access capital markets for general corporate purposes, subject to market conditions and the Company's capital needs.

On May 25, 2011, the Company joined with other investors in capitalizing AlphaCat Re 2011, a special purpose reinsurer formed for the purpose of writing collateralized reinsurance and retrocessional reinsurance. At the time of formation, Validus Re had an equity interest in AlphaCat Re 2011 and as Validus Re held a majority of AlphaCat Re 2011's outstanding voting rights, the financial statements of AlphaCat Re 2011 were included in the consolidated financial statements of the Company.

On December 23, 2011, the Company completed a secondary offering of common shares of AlphaCat Re 2011 to third party investors, along with a partial sale of Validus Re's common shares to one of the third party investors. As a result of these transactions, Validus Re maintained an equity interest in AlphaCat Re 2011; however its share of AlphaCat Re 2011's outstanding voting rights decreased to 43.7%. As a result of the Company's voting interest falling below 50%, the individual assets and liabilities and corresponding noncontrolling interest of AlphaCat Re 2011 have been derecognized from the consolidated balance sheet of the Company as at December 31, 2011 and therefore the remaining investment in AlphaCat Re 2011 is treated as an equity method investment as at December 31, 2012 and 2011. The portion of AlphaCat Re 2011's earnings attributable to third party investors for the years ended December 31, 2012 and 2011 is recorded in the Consolidated Statements of Comprehensive Income (Loss) as net income attributable to noncontrolling interest.

On April 2, 2012, the Company capitalized PaCRE, a new Class 4 Bermuda reinsurer formed for the purpose of writing high excess property catastrophe reinsurance. PaCRE was funded with \$500.0 million of contributed capital. Validus invested \$50.0 million in PaCRE's common equity. The Company will underwrite business for PaCRE, for which it will be paid a profit commission based on PaCRE's underwriting results.

On May 29, 2012, the Company announced that it has joined with other investors in capitalizing AlphaCat Re 2012. AlphaCat Re 2012 is a new special purpose reinsurer formed for the purpose of writing collateralized reinsurance with

a particular focus on windstorm risks for Florida domiciled insurance companies. AlphaCat Re 2012 was funded with \$70.0 million of equity capital. The Company will underwrite business for AlphaCat Re 2012, for which it will be paid a commission for originating the business and a profit commission based on underwriting results.

On June 5, 2012, the Company announced the final results of its “modified Dutch auction” tender offer. Pursuant to this tender offer, the Company purchased 6,383,884 of its common shares at a price of \$32.00 per common share for a total cost of \$204.3 million, excluding fees and expenses relating to the tender offer. The Company funded the purchase of the shares in the tender offer using cash on hand.

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The Company may from time to time repurchase its securities, including common shares, Junior Subordinated Deferrable Debentures and Senior Notes. On February 6, 2013, the Board of Directors of the Company authorized an increase in the Company's common share repurchase authorization to \$500.0 million. This amount is in addition to, and in excess of, the \$1,206.8 million of common shares repurchased by the Company through February 6, 2013 under its previously authorized share repurchase program.

The Company repurchased 43,688,633 shares at a cost of \$1,227.1 million under the share repurchase programs for the period November 4, 2009 through February 13, 2013.

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

### Contractual Obligations and Commitments

The Company's contractual obligations and commitments as at December 31, 2012 are set out below:

(Dollars in thousands)	Payment Due by Period				
	Total	Less Than 1 Year	1 - 3 Years	3 - 5 Years	More Than 5 Years
Reserve for losses and loss expenses(a)	\$3,517,573	\$1,686,439	\$1,290,199	\$399,042	141,893
2010 Senior Notes due 2040—principal(b)	250,000	—	—	—	250,000
2010 Senior Notes due 2040—interest(b)	n/a	22,188	44,375	44,375	22,188 p.a.
2006 Junior Subordinated Deferrable Debentures—principal(c)	150,000	—	—	—	150,000
2006 Junior Subordinated Deferrable Debentures—interest(c)	n/a	8,747	17,494	17,494	8,747 p.a.
2007 Junior Subordinated Deferrable Debentures—principal(d)	200,000	—	—	—	200,000
2007 Junior Subordinated Deferrable Debentures—interest(d)	n/a	10,360	20,720	20,720	10,360 p.a.
Flagstone 2006 Junior Subordinated Deferrable Interest Notes—principal (e)	137,159	—	—	—	137,159
Flagstone 2006 Junior Subordinated Deferrable Interest Notes—interest (e)	n/a	5,278	20,720	7,576	5,278 p.a.
Flagstone 2007 Junior Subordinated Deferrable Interest Notes—principal (f)	113,750	—	—	—	113,750
Flagstone 2007 Junior Subordinated Deferrable Interest Notes—interest (f)	n/a	3,788	7,576	7,576	3,788 p.a.
Operating lease obligations	70,962	11,933	20,328	16,785	21,916
Aquiline Financial Services Fund II L.P. (g)	32,382	32,382	—	—	—

(a) The reserve for losses and loss expenses represents an estimate, including actuarial and statistical projections at a given point in time of an insurer's or reinsurer's expectations of the ultimate settlement and administration costs of claims incurred. As a result, it is likely that the ultimate liability will differ from such estimates, perhaps significantly. Such estimates are not precise in that, among other things, they are based on predictions of future developments and estimates of future trends in loss severity and frequency and other variable factors such as inflation, litigation and tort reform. This uncertainty is heightened by the short time in which the Company has operated, thereby providing limited claims loss emergence patterns specifically for the Company. The lack of historical information for the Company has necessitated the use of industry loss emergence patterns in deriving IBNR. Further, expected losses and loss ratios are typically developed using vendor and proprietary computer models and these expected loss ratios are a material component in the calculation deriving IBNR. Actual loss ratios will deviate from expected loss ratios and ultimate loss ratios will be greater or less than expected loss ratios.

During the loss settlement period, it often becomes necessary to refine and adjust the estimates of liability on a claim either upward or downward. Even after such adjustments, ultimate liability will exceed or be less than the revised estimates. The actual payment of the reserve for losses and loss expenses will differ from estimated payouts.

The 2010 Senior Notes mature on January 26, 2040, and are redeemable at the Company's option in whole or any time or in part from time to time at a make-whole redemption price. The Company may redeem the notes in whole, (b) but not in part, at any time upon the occurrence of certain tax events as described in the notes prospectus supplement. The 2010 Senior Notes bear interest at the rate of 8.875% per annum from January 26, 2010 to maturity or early redemption.

The 2006 Junior Subordinated Deferrable Debentures (the "2006 JSDs") mature on June 15, 2036, are redeemable at the Company's option at par beginning June 15, 2011, and require quarterly interest payments by the (c) Company to the holders of the 2006 Junior Subordinated Deferrable Debentures. Interest was payable at 9.069% per annum through June 15, 2011, and thereafter at a floating rate of three-month LIBOR plus 355 basis points, reset

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quarterly. We have estimated the interest due in 2013 and future years using the December 31, 2012 LIBOR rate. During the third quarter of 2012, the Company entered into an interest rate swap which fixed the rate of interest on the 2006 JSDs at 5.83125%. The term of the swap is matched to the maturity date of the 2006 JSDs.

The 2007 Junior Subordinated Deferrable Debentures (the "2007 JSDs") mature on June 15, 2037, are redeemable at the Company's option at par beginning June 15, 2012, and require quarterly interest payments by the Company to the holders of the 2007 Junior Subordinated Deferrable Debentures. Interest was payable at 8.480% (d)per annum through June 15, 2012, and thereafter at a floating rate of three-month LIBOR plus 295 basis points, reset quarterly. We have estimated the interest due in 2013 and future years using the December 31, 2012 LIBOR rate. During the third quarter of 2012, the Company entered into an interest rate swap which fixed the rate of interest on the 2007 JSDs at 5.18%. The term of the swap is matched to the maturity date of the 2007 JSDs.

The Flagstone 2006 Junior Subordinated Deferrable Interest Notes mature on September 15, 2036, are redeemable at the Company's option at par beginning September 15, 2011, and require quarterly interest payments by the (e)Company to the holders of the Flagstone 2006 Junior Subordinated Deferrable Interest Notes. Interest is payable at a floating rate of three-month LIBOR plus 354 basis points, reset quarterly. We have estimated the interest due in 2013 and future years using the December 31, 2012 LIBOR rate.

\$88,750 of the Flagstone 2007 Junior Subordinated Deferrable Interest Notes mature on July 30, 2037, are redeemable at the Company's option at par beginning July 30, 2012, and require quarterly interest payments by the Company to the holders of the Flagstone 2007 Junior Subordinated Deferrable Interest Notes. Interest is payable at a floating rate of three-month LIBOR plus 300 basis points, reset quarterly. \$25,000 of the Flagstone 2007 Junior (f)Subordinated Deferrable Interest Notes mature on September 15, 2037, are redeemable at the Company's option at par beginning September 15, 2012, and require quarterly interest payments by the Company to the holders of the Flagstone 2007 Junior Subordinated Deferrable Interest Notes. Interest is payable at a floating rate of three-month LIBOR plus 310 basis points, reset quarterly. We have estimated the interest due in 2013 and future years using the December 31, 2012 LIBOR rate.

Please refer to Note 20 (f) to the Consolidated Financial Statements (Part II, Item 8) for further details describing (g)the Aquiline commitment. While the commitment expires on July 2, 2015, it does not have a defined contractual commitment date and therefore it is included in the less than one year category.

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

(Dollars in thousands)	Capital at December 31, 2012
Validus Reinsurance, Ltd. (consolidated), excluding Validus Re Americas, Ltd. and Validus UPS, Ltd.	\$2,928,446
Validus Re Americas, Ltd. (formerly IPCRe, Ltd)	132,405
Validus UPS, Ltd. (formerly Flagstone)	1,028,281
Total Validus Reinsurance, Ltd. (consolidated)	4,089,132
Noncontrolling Interest in PaCRe, Ltd.	434,280
Talbot Holdings, Ltd. (consolidated)	774,184
Other subsidiaries, net	35,885
Other, net	(90,575 )
Total consolidated capitalization	5,242,906
Senior notes payable	(247,090 )
Debentures payable	(540,709 )
Total shareholders' equity	\$4,455,107

#### Ratings

The following table summarizes the financial strength ratings of the Company and its principal reinsurance and insurance subsidiaries from internationally recognized rating agencies as of February 15, 2013:





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

(a) The A.M. Best ratings were most recently affirmed on February 7, 2013

(b) The S&P ratings were most recently affirmed on August 30, 2012

(c) All Moody's ratings were most recently affirmed on August 31, 2012

(d) All Fitch ratings were most recently affirmed on May 8, 2012

Recent accounting pronouncements

Please refer to Note 4 to the Consolidated Financial Statements (Part II, Item 8) for further discussion of relevant recent accounting pronouncements.

## Debt and Financing Arrangements

The following table details the Company's borrowings and credit facilities as at December 31, 2012.

(Dollars in thousands)	Commitments(a)	In Use/Outstanding
2006 Junior Subordinated Deferrable Debentures	\$ 150,000	\$ 150,000
2007 Junior Subordinated Deferrable Debentures	200,000	139,800
2010 Senior Notes due 2040	250,000	250,000
\$400,000 syndicated unsecured letter of credit facility	400,000	—
\$525,000 syndicated secured letter of credit facility	525,000	376,570
\$500,000 bi-lateral secured letter of credit facility	500,000	92,402
Talbot FAL Facility(b)	25,000	25,000
PaCRE senior secured letter of credit facility	10,000	219
IPC Bi-Lateral Facility	80,000	40,613
Flagstone Bi-Lateral Facility	550,000	381,019
Flagstone 2006 Junior Subordinated Deferrable Interest Notes	137,159	137,159
Flagstone 2007 Junior Subordinated Deferrable Interest Notes	113,750	113,750
Total	\$ 2,940,909	\$ 1,706,532

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

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

Please refer to Note 18 to the Consolidated Financial Statements (Part II, Item 8) for further discussion of the Company's debt and financing arrangements.

## Regulation

Validus Re, Validus Re Americas, Ltd., Flagstone Reassurance Suisse SA (Bermuda Branch), PaCRE and Talbot Insurance (Bermuda) Ltd. ("TIBL") (together, the "Bermuda registered companies") are registered under the Insurance Act 1978 of Bermuda ("the Act"). Under the Act, the Bermuda registered companies are required annually to prepare and file Statutory Financial Statements and a Statutory Financial Return. The Act also requires the Bermuda registered companies to meet minimum solvency and liquidity requirements. For the year ended December 31, 2012, the Bermuda registered companies satisfied these requirements. Please refer to Note 24 to the Consolidated Financial Statements (Part II, Item 8) for further discussion of statutory and regulatory requirements.

Bermuda law limits the maximum amount of annual dividends or distributions payable by Bermuda registered companies to the Company and in certain cases requires the prior notification to, or the approval of, the Bermuda Monetary Authority. Subject to such laws, the directors of the Bermuda registered companies have the unilateral authority to declare or not declare dividends to the Company. There is no assurance that dividends will be declared or paid in the future.

Talbot's underwriting activities are regulated by the Financial Services Authority ("FSA"). The FSA has substantial powers of intervention in relation to the Lloyd's managing agents which it regulates including the power to remove their authorization to manage Lloyd's syndicates. In addition, Talbot's managing agent operates under the Lloyd's "franchise." Lloyd's approves annually Syndicate 1183's business plan and any subsequent material changes, and the amount of capital required to support that plan. Lloyd's may require changes to any business plan presented to it or additional capital to be provided to support the underwriting (known as Funds at Lloyd's).

The U.K. government has set out proposals to replace the current system of financial regulation, which it believes has weaknesses, with a new regulatory framework. The key weakness it identified was that no single institution has the responsibility, authority and tools to monitor the financial system as a whole, and respond accordingly. That power will be given to the Bank of England. The U.K. government intends to create a new Financial Policy Committee ("FPC") within the Bank, which will look at the wider economic and financial risks to the stability of the system.



In addition, the FSA will cease to exist in its current form, and the U.K. government will create two new focused financial regulators:

A new Prudential Regulation Authority (“PRA”) will be responsible for the day-to-day supervision of financial institutions that are subject to significant prudential regulation. It will adopt a more judgment-focused approach to regulation so that business models can be challenged, risks identified and action taken to preserve financial stability.

A new Financial Conduct Authority (“FCA”) will have a strong mandate for promoting confidence and transparency in financial services and to give greater protection for consumers of financial services.

The Financial Services Bill was introduced to Parliament on January 26, 2012 and received Royal Assent in December 2012. “Legal cutover,” when the new system will be operational, is expected to be April 2013.

In November 2007, Talbot established Talbot Risk Services Pte Ltd in Singapore to source business in the Far East under the Lloyd’s Asia Scheme. The Lloyd’s Asia Scheme was established by the Monetary Authority of Singapore to encourage members of Lloyd’s to expand insurance activities in Asia.

An EU directive covering the capital adequacy, risk management and regulatory reporting for insurers, known as Solvency II was adopted by the European Parliament in April 2009. A directive, known as Omnibus II, which will amend certain of the Solvency II proposals, including the implementation date, is due to be considered by the European Parliament in 2012. The proposed Solvency II insurance directive is currently expected to come into force with a soft launch on January 1, 2013 and a full implementation on January 1, 2014. Insurers and reinsurers are undertaking a significant amount of work to ensure that they meet the new requirements and this may divert resources from other operational roles. The Company’s implementation plans are well underway, although final Solvency II guidelines have not been published.

Flagstone Suisse is licensed to operate as a reinsurer in Switzerland and is also licensed in Bermuda through the Flagstone Suisse branch office and is not licensed in any other jurisdictions. Swiss law permits dividends to be declared only after profits have been allocated to the reserves required by law and to any reserves required by the articles of incorporation. The articles of incorporation of Flagstone Suisse do not require any specific reserves. Therefore, Flagstone Suisse must allocate any profits first to the reserve required by Swiss law generally, and may pay as dividends only the balance of the profits remaining after that allocation. In the case of Flagstone Suisse, Swiss law requires that 20% of the company’s profits be allocated to a “general reserve” until the reserve reaches 50% of its paid-in share capital. In addition, a Swiss reinsurance company may pay a dividend only if, after payment of the dividend, it will continue to comply with regulatory requirements regarding minimum capital, special reserves and solvency requirements.

#### Off-Balance Sheet Arrangements

The Company is not party to any off-balance sheet transaction, agreement or other contractual arrangement as defined by Item 303(a) (4) of Regulation S-K to which an entity unconsolidated with the Company is a party that management believes is reasonably likely to have a current or future effect on its financial condition, revenues or expenses, results of operations, liquidity, capital expenditures or capital resources that the Company believes is material to investors.

#### Investments

A significant portion of (re)insurance contracts written by the Company provide short-tail reinsurance coverage for losses resulting mainly from natural and man-made catastrophes, which could result in a significant amount of losses on short notice. Accordingly, the Company’s investment portfolio is structured to provide significant liquidity and preserve capital, which means the investment portfolio contains a significant amount of relatively short-term fixed maturity investments, such as U.S. government securities, U.S. government-sponsored enterprises securities, corporate debt securities and mortgage-backed and asset-backed securities.

Substantially all of the fixed maturity investments held at December 31, 2012 were publicly traded. At December 31, 2012, the average duration of the Company’s fixed maturity portfolio was 1.34 years (December 31, 2011: 1.63 years) and the average rating of the portfolio was AA- (December 31, 2011: AA-). At December 31, 2012, the total fixed maturity portfolio was \$5,085.3 million (December 31, 2011: \$4,894.1 million), of which \$1,062.8 million (December 31, 2011: \$882.9 million) were rated AAA.

On November 30, 2012, as part of the Flagstone Acquisition, the Company assumed Flagstone's investment portfolio containing \$910.3 million of cash and short term investments, \$231.4 million of asset-backed securities, \$90.0 million of non-agency residential mortgage-backed securities, \$19.0 million of catastrophe bonds, \$59.3 million fund of hedge funds and \$13.0 million of private equity funds.

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With the exception of the Company's bank loan portfolio, the Company's investment guidelines require that investments be rated BBB- or higher at the time of purchase. The Company reports the ratings of its investment portfolio securities at the lower of Moody's or Standard & Poor's rating for each investment security and, as a result, the Company's investment portfolio now has \$19.0 million of non-agency mortgage backed securities rated less than investment grade. The other components of less than investment grade securities held by the Company at December 31, 2012 were \$56.9 million of catastrophe bonds, \$658.9 million of bank loans and \$0.9 million of corporate bonds.

Cash and cash equivalents and investments held by Talbot of \$1,901.5 million at December 31, 2012 were held in trust for the benefit of cedants and policyholders and to facilitate the accreditation as an alien insurer/reinsurer by certain regulators (December 31, 2011: \$1,686.6 million). Total cash and cash equivalents and investments in Talbot were \$1,942.6 million at December 31, 2012 (December 31, 2011: \$1,743.0 million).

#### Goodwill and Intangible Assets

The Company has performed an impairment analysis of its carried goodwill and indefinite lived intangible assets as required by U.S. GAAP. The impairment analysis of goodwill and intangible assets was performed in line with Accounting Standards Update No. 2011-08, "Testing Goodwill for Impairment" ("ASU 2011-08") which was released in September 2011 and Accounting Standards Update No. 2012-02, "Testing Indefinite-Lived Intangible Assets for Impairment" ("ASU 2012-02") which was released in July 2012. The goodwill assessment included a qualitative analysis in determining whether it is more likely than not that the fair value of the reporting unit is less than its carrying amount. Reporting units are consistent with the segmental basis. The indefinite lived intangible asset assessment included a qualitative analysis in determining whether it is more likely than not that the fair value of the intangible asset is less than its carrying amount. Based on this analysis, management has concluded that an impairment valuation is not required against the carried goodwill and carried indefinite lived intangible assets.

#### Cash Flows

During the years ended December 31, 2012 and 2011, the Company generated net cash from operating activities of \$562.6 million and \$545.1 million, respectively. Cash flows from operations generally represent premiums collected, investment earnings realized and investment gains realized less losses and loss expenses paid and underwriting and other expenses paid. Cash flows from operations may differ substantially from net income.

On November 30, 2012, the Company completed its acquisition of Flagstone. Upon completion of the Merger each issued and outstanding share of Flagstone was converted into the right to receive 0.1935 Validus common shares, \$2.00 in cash, without interest, and cash in lieu of any fractional share to which the holder was entitled. The Flagstone acquisition resulted in the issuance by the Company of 14,290,389 common shares valued at \$34.87 per share and the payment of \$147.7 million to Flagstone shareholders.

As of December 31, 2012 and December 31, 2011, the Company had cash and cash equivalents of \$1,219.4 million and \$832.8 million, respectively.

The Company has written certain (re)insurance business that has loss experience generally characterized as having low frequency and high severity. This results in volatility in both results and operational cash flows. The potential for large claims or a series of claims under one or more reinsurance contracts means that substantial and unpredictable payments may be required within relatively short periods of time. As a result, cash flows from operating activities may fluctuate, perhaps significantly, between individual quarters and years. Management believes the Company's unused credit facility amounts and highly liquid investment portfolio are sufficient to support any potential operating cash flow deficiencies. Please refer to the table detailing the Company's borrowings and credit facilities as at December 31, 2012, presented above.

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

#### CAUTIONARY NOTE REGARDING FORWARD-LOOKING STATEMENTS

The Private Securities Litigation Reform Act of 1995 ("PSLRA") provides a "safe harbor" for forward-looking statements. Any prospectus, prospectus supplement, the Company's Annual Report to shareholders, any proxy statement, any other

Form 10-K, Form 10-Q or Form 8-K of the Company or any other written or oral statements made by or on behalf of the Company may include forward-looking statements that reflect the Company's current views with respect to future events and financial performance. Such statements include forward-looking statements both with respect to the Company in general, and to the insurance and reinsurance sectors in particular. Statements that include the words "expect", "intend", "plan", "believe", "project", "anticipate", "will", "may", and similar statements of a future or forward-looking nature identify forward-looking statements for

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purposes of the PSLRA or otherwise. All forward-looking statements address matters that involve risks and uncertainties. Accordingly, there are or will be important factors that could cause actual results to differ materially from those indicated in such statements and, therefore, you should not place undue reliance on any such statement. We believe that these factors include, but are not limited to, the following:

- unpredictability and severity of catastrophic events;
  - our ability to obtain and maintain ratings, which may affect by our ability to raise additional equity or debt financings, as well as other factors described herein;
  - adequacy of the Company's risk management and loss limitation methods;
  - cyclical nature of demand and pricing in the insurance and reinsurance markets;
  - the Company's ability to implement its business strategy during "soft" as well as "hard" markets;
  - adequacy of the Company's loss reserves;
  - continued availability of capital and financing;
  - the Company's ability to identify, hire and retain, on a timely and unimpeded basis and on anticipated economic and other terms, experienced and capable senior management, as well as underwriters, claims professionals and support staff;
  - acceptance of our business strategy, security and financial condition by rating agencies and regulators, as well as by brokers and (re)insureds;
  - competition, including increased competition, on the basis of pricing, capacity, coverage terms or other factors;
  - potential loss of business from one or more major insurance or reinsurance brokers;
  - the Company's ability to implement, successfully and on a timely basis, complex infrastructure, distribution capabilities, systems, procedures and internal controls, and to develop accurate actuarial data to support the business and regulatory and reporting requirements;
  - general economic and market conditions (including inflation, volatility in the credit and capital markets, interest rates and foreign currency exchange rates) and conditions specific to the insurance and reinsurance markets in which we operate;
  - the integration of businesses we may acquire or new business ventures, including overseas offices, we may start and the risk associated with implementing our business strategies and initiatives with respect to the new business ventures;
  - accuracy of those estimates and judgments used in the preparation of our financial statements, including those related to revenue recognition, insurance and other reserves, reinsurance recoverables, investment valuations, intangible assets, bad debts, taxes, contingencies, litigation and any determination to use the deposit method of accounting, which, for a relatively new insurance and reinsurance company like our company, are even more difficult to make than those made in a mature company because of limited historical information;
  - the effect on the Company's investment portfolio of changing financial market conditions including inflation, interest rates, liquidity and other factors;
  - acts of terrorism, political unrest, outbreak of war and other hostilities or other non-forecasted and unpredictable events;
  - availability and cost of reinsurance and retrocession coverage;
  - the failure of reinsurers, retrocessionaires, producers or others to meet their obligations to us;
  - the timing of loss payments being faster or the receipt of reinsurance recoverables being slower than anticipated by us;
  - changes in domestic or foreign laws or regulations, or their interpretations;
  - changes in accounting principles or the application of such principles by regulators;
  - statutory or regulatory or rating agency developments, including as to tax policy and reinsurance and other regulatory matters such as the adoption of proposed legislation that would affect Bermuda-headquartered companies and/or Bermuda-based insurers or reinsurers; and
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the other factors set forth herein under Part I Item 1A “Risk Factors” and under Part II Item 7 “Management’s Discussion and Analysis of Financial Condition and Results of Operations” and the other sections of this Annual Report on Form 10-K/A for the year ended December 31, 2012, as well as the risk and other factors set forth in the Company’s other filings with the SEC, as well as management’s response to any of the aforementioned factors.

In addition, other general factors could affect our results, including: (a) developments in the world’s financial and capital markets and our access to such markets; (b) changes in regulations or tax laws applicable to us, and (c) the effects of business disruption or economic contraction due to terrorism or other hostilities.

The foregoing review of important factors should not be construed as exhaustive and should be read in conjunction with the other cautionary statements that are included herein or elsewhere. Any forward-looking statements made in this report are qualified by these cautionary statements, and there can be no assurance that the actual results or developments anticipated by us will be realized or, even if substantially realized, that they will have the expected consequences to, or effects on, us or our business or operations. We undertake no obligation to update publicly or revise any forward-looking statement, whether as a result of new information, future developments or otherwise.

#### Item 7A. Quantitative And Qualitative Disclosures About Market Risk

We are principally exposed to five types of market risk:

• interest rate risk;

• foreign currency risk;

• credit risk;

• liquidity risk; and

• inflation risk.

**Interest Rate Risk:** The Company’s fixed maturity portfolio is exposed to interest rate risk. Fluctuations in interest rates have a direct impact on the market valuation of these investments. As interest rates rise, the market value of the Company’s fixed maturity portfolio falls and the Company has the risk that cash outflows will have to be funded by selling assets, which will be trading at depreciated values. As interest rates decline, the market value of the Company’s fixed income portfolio increases and the Company has reinvestment risk, as funds reinvested will earn less than is necessary to match anticipated liabilities. We manage interest rate risk by selecting investments with characteristics such as duration, yield, currency and liquidity tailored to the anticipated cash outflow characteristics of the insurance and reinsurance liabilities the Company assumes.

As at December 31, 2012, the impact on the Company’s fixed maturity and short-term investments from an immediate 100 basis point increase in market interest rates (based on U.S. treasury yield) would have resulted in an estimated decrease in market value of 1.3%, or approximately \$85.1 million. As at December 31, 2012, the impact on the Company’s fixed maturity portfolio from an immediate 100 basis point decrease in market interest rates would have resulted in an estimated increase in market value of 1.1% or approximately \$70.3 million.

As at December 31, 2011, the impact on the Company’s fixed maturity and short-term investments from an immediate 100 basis point increase in market interest rates (based on U.S. treasury yield) would have resulted in an estimated decrease in market value of 1.6%, or approximately \$84.0 million. As at December 31, 2011, the impact on the Company’s fixed maturity portfolio from an immediate 100 basis point decrease in market interest rates would have resulted in an estimated increase in market value of 0.7% or approximately \$34.8 million.

As at December 31, 2012, the Company held \$1,108.0 million (December 31, 2011: \$829.5 million), or 21.8% (December 31, 2011: 16.9%), of the Company’s fixed maturity portfolio in asset-backed and mortgage-backed securities. These assets are exposed to prepayment risk, which occurs when holders of underlying loans increase the frequency with which they prepay the outstanding principal before the maturity date and/or refinance at a lower interest rate cost. The adverse impact of prepayment is more evident in a declining interest rate environment. As a result, the Company will be exposed to reinvestment risk, as cash flows received by the Company will be accelerated and will be reinvested at the prevailing interest rates.

**Foreign Currency Risk:** Certain of the Company’s reinsurance contracts provide that ultimate losses may be payable in foreign currencies depending on the country of original loss. Foreign currency exchange rate risk exists to the extent that there is an increase in the exchange rate of the foreign currency in which losses are ultimately owed. Therefore, we manage our foreign currency risk by seeking to match our liabilities under insurance and reinsurance

policies that are payable in foreign currencies with cash and investments that are denominated in such currencies. As of December 31, 2012, \$1,264.7 million, or 12.6% of our

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total assets and \$1,217.9 million, or 21.9% of our total liabilities were held in foreign currencies. As of December 31, 2012, \$152.3 million, or 2.7% of our total liabilities held in foreign currencies were non-monetary items which do not require revaluation at each reporting date. As of December 31, 2011, \$744.4 million, or 9.3% of our total assets and \$867.4 million, or 19.7% of our total liabilities were held in foreign currencies. As of December 31, 2011, \$104.5 million, or 2.4% of our total liabilities held in foreign currencies were non-monetary items which do not require revaluation at each reporting date. When necessary, we may also use derivatives to economically hedge un-matched foreign currency exposures, specifically forward contracts. Foreign currency forward contracts do not eliminate fluctuations in the value of our assets and liabilities denominated in foreign currencies but rather allow us to establish a rate of exchange for a future point in time. For further information on the accounting treatment of our foreign currency derivatives, refer to Item 8, Note 9 "Derivative Instruments Used in Hedging Activities," of the Consolidated Financial Statements. To the extent foreign currency exposure is not hedged or otherwise matched, the Company may experience exchange losses, which in turn would adversely affect the results of operations and financial condition.

**Credit Risk:** We are exposed to credit risk from the possibility that counterparties may default on their obligations to us. The Company's primary credit risks reside in investment in U.S. corporate bonds and recoverable from reinsurers. We limit our credit exposure by purchasing high quality fixed income investments to maintain an average portfolio credit quality of AA- or higher with mortgage and commercial mortgage-backed issues having an aggregate weighted average credit quality of AAA. In addition, we have limited our exposure to any single issuer to 3.0% or less of total investments, excluding treasury and agency securities. With the exception of the bank loan portfolio the Company's investment guidelines require that investments be rated BBB- or higher at the time of purchase. Where investments are downgraded below BBB-/Baa3, we permit our investment managers to hold up to 2.0% in aggregate market value, or up to 10.0% with written authorization of the Company. At December 31, 2012, 1.2% of the portfolio, excluding bank loans was below BBB-/Baa3 and we did not have an aggregate exposure to any single issuer of more than 0.7% of total investments, other than with respect to government securities.

The amount of the maximum exposure to credit risk is indicated by the carrying value of the Company's financial assets. The Company's primary credit risks reside in investment in U.S. corporate bonds and recoverables from reinsurers. The Company evaluates the financial condition of its reinsurers and monitors concentration of credit risk arising from its exposure to individual reinsurers. The reinsurance program is generally placed with reinsurers whose rating, at the time of placement, was A- or better rated by S & P or the equivalent with other rating agencies. Exposure to a single reinsurer is also controlled with restrictions dependent on rating. At December 31, 2012, 97.9% of reinsurance recoverables (which includes loss reserves recoverable and recoverables on paid losses) were from reinsurers rated A- or above, (December 31, 2011: 99.4% rated A- or above) or from reinsurers posting full collateral.

**Liquidity risk:** Certain of the Company's investments may become illiquid. Disruption in the credit markets may materially affect the liquidity of the Company's investments, including non-agency residential mortgage-backed securities and bank loans which represent 9.8% at December 31, 2012 (December 31, 2011: 8.3%) of total cash and investments. If the Company requires significant amounts of cash on short notice in excess of normal cash requirements (which could include claims on a major catastrophic event) in a period of market illiquidity, the investments may be difficult to sell in a timely manner and may have to be disposed of for less than what may otherwise have been possible under other conditions. At December 31, 2012, the Company had \$1,838.4 million of unrestricted, liquid assets, defined as unpledged cash and cash equivalents, short term investments, government and government agency securities. Details of the Company's debt and financing arrangements at December 31, 2012 are provided below.

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(Dollars in thousands)	Maturity Date / Term	In Use/ Outstanding
2006 Junior Subordinated Deferrable Debentures	June 15, 2036	\$ 150,000
2007 Junior Subordinated Deferrable Debentures	June 15, 2037	139,800
2010 Senior Notes due 2040	January 26, 2040	250,000
\$400,000 syndicated unsecured letter of credit facility	March 9, 2016	—
\$525,000 syndicated secured letter of credit facility	March 9, 2016	376,570
\$500,000 secured letter of credit facility	Evergreen	92,402
Talbot FAL facility	December 31, 2015	25,000
PaCRe Senior secured letter of credit	May 10, 2013	219
IPC Bi-Lateral Facility	Evergreen	40,613
Flagstone Bi-Lateral Facility	Evergreen	381,019
Flagstone 2006 Junior Subordinated Deferrable Interest Notes	September 15, 2037	137,159
Flagstone 2007 Junior Subordinated Deferrable Interest Notes	September 15, 2036	113,750
Total		\$ 1,706,532

**Inflation Risk:** We do not believe that inflation has had or will have a material effect on our combined results of operations, except insofar as (a) inflation may affect interest rates, and (b) losses and loss expenses may be affected by inflation.

#### Item 8. Financial Statements and Supplementary Data

Reference is made to Item 15 (a) of this Report for the Consolidated Financial Statements of Validus Holdings, Ltd. and the Notes thereto, as well as the Schedules to the Consolidated Financial Statements.

#### Item 9. Changes in and Disagreements with Accountants on Accounting and Financial Disclosure

None.

#### Item 9A. Controls and Procedures

##### Conclusion Regarding the Effectiveness of Disclosure Controls and Procedures

The Company carried out an evaluation, under the supervision and with the participation of the Company's management, including the Chief Executive Officer and Chief Financial Officer, of the effectiveness of disclosure controls and procedures pursuant to Rules 13a-15 and 15d-15 promulgated under the Securities Exchange Act of 1934, as amended, as of the end of the period covered by this report. Based on that evaluation, the Chief Executive Officer and Chief Financial Officer concluded that the disclosure controls and procedures are effective to provide reasonable assurance that all material information relating to the Company required to be filed in this report has been made known to them in a timely fashion.

##### Management's Report on Internal Control Over Financial Reporting

The Company's management is responsible for establishing and maintaining adequate internal control over financial reporting as defined in Rules 13a-15(f) and 15d-15(f) of the Securities Exchange Act of 1934, as amended.

The Company's internal control over financial reporting was designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles.

The Company's management assessed the effectiveness of the Company's internal control over financial reporting as of December 31, 2012. In making this assessment, it used the criteria set forth by the Committee of Sponsoring Organizations of the Treadway Commission (COSO) in Internal Control—Integrated Framework (the "Framework"). Based on its assessment, management concluded that, as of December 31, 2012, the Company's internal control over financial reporting was effective based on the Framework criteria.

The Company acquired all of the outstanding shares of Flagstone on November 30, 2012. Flagstone's total assets and total revenues represented approximately 19.4% and 2.4%, respectively of the Company's related consolidated financial statement amounts as of and for the year ended December 31, 2012. Consistent with the SEC's general guidance, Flagstone has been excluded



from the Company's assessment scope for the effectiveness of internal control over financial reporting as of December 31, 2012 because it was acquired by the Company in a purchase business combination during 2012.

The effectiveness of the Company's internal control over financial reporting as of December 31, 2012 has been audited by PricewaterhouseCoopers, an independent registered public accounting firm, as stated in their report included in this filing.

**Changes in Internal Control Over Financial Reporting**

There have been no changes in internal control over financial reporting identified in connection with the Company's evaluation required pursuant to Rules 13a-15 and 15d-15 promulgated under the Securities Exchange Act of 1934, as amended, that occurred during the most recent fiscal quarter that have materially affected, or are reasonably likely to materially affect, the Company's internal control over financial reporting.

**Item 9B. Other Information**

None.

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## PART III

## Item 10. Directors, Executive Officers and Corporate Governance

Certain of the information required by this item relating to the executive officers of the Company may be found starting at page 43. The balance of the information required by this item is omitted because a definitive proxy statement that involves the election of directors will be filed with the Securities and Exchange Commission not later than 120 days after the close of the fiscal year pursuant to Regulation 14A, which proxy statement is incorporated herein by reference.

## Item 11. Executive Compensation

This item is omitted because a definitive proxy statement that involves the election of directors will be filed with the Securities and Exchange Commission not later than 120 days after the close of the fiscal year pursuant to Regulation 14A, which proxy statement is incorporated herein by reference.

Item 12. Security Ownership of Certain Beneficial Owners and Management and Related Shareholder Matters  
Equity Compensation Plan Information

The following table displays certain information regarding our equity compensation plan at December 31, 2012:

(Dollars in thousands)	Number of Securities to be Issued Upon Exercise of Outstanding Options and Restricted Stock	Weighted-Average Exercise Price of Outstanding Options	Number of Securities Remaining Available for Future Issuance Under Equity compensation plans
2005 Amended and Restated Long-Term Incentive Plan	3,944,845	\$20.69	3,128,443
Director Stock Compensation Plan	5,001		52,142

The balance of the information required by this item is omitted because a definitive proxy statement that involves the election of directors will be filed with the Securities and Exchange Commission not later than 120 days after the close of the fiscal year pursuant to Regulation 14A, which proxy statement is incorporated herein by reference.

## Item 13. Certain Relationships and Related Transactions, and Director Independence

This item is omitted because a definitive proxy statement that involves the election of directors will be filed with the Securities and Exchange Commission not later than 120 days after the close of the fiscal year pursuant to Regulation 14A, which proxy statement is incorporated herein by reference.

## Item 14. Principal Accountant Fees and Services

This item is omitted because a definitive proxy statement that involves the election of directors will be filed with the Securities and Exchange Commission not later than 120 days after the close of the fiscal year pursuant to Regulation 14A, which proxy statement is incorporated herein by reference.



PART IV

Item 15. Exhibits and Financial Statement Schedules

Financial Statements, Financial Statement Schedules and Exhibits.

(a) Financial Statements and Financial Statement Schedules are included as pages F-1 to F-69.

(b) The exhibits numbers followed by an asterisk (\*) indicate exhibits physically filed with this Annual Report on Form 10-K/A. All other exhibit numbers indicate exhibits filed by incorporation by reference.

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EXHIBITS

Exhibit Number	Description of Document
2.1	Agreement and Plan of Merger, dated as of August 30, 2012, by and among Validus Holdings, Ltd., Validus UPS, Ltd., Flagstone Reinsurance Holdings, S.A. and Flagstone Reinsurance Holdings (Bermuda) Limited (incorporated by reference from the Company's Current Report on Form 8-K filed on September 4, 2012)
3.1	Memorandum of Association dated October 10, 2005 (Incorporated by reference from S-1 SEC File No. 333-139989)
3.2	Amended and Restated Bye-laws (Incorporated by reference from S-1 SEC File No. 333-139989)
4.1	Specimen Common Share Certificate (Incorporated by reference from S-1 SEC File No. 333-139989)
4.2	Certificate of Deposit of Memorandum of Increase of Share Capital dated October 28, 2005 (Incorporated by reference from S-1 SEC File No. 333-139989)
4.3	Form of Warrant (Incorporated by reference from S-1 SEC File No. 333-139989)
4.4	Form of Amendment to Warrants dated as of December 21, 2007 (Incorporated by reference from the Company's Current Report on Form 8-K filed with the SEC on December 1, 2007)
4.5	9.069% Junior Subordinated Deferrable Debentures Indenture dated as of June 15, 2006 (Incorporated by reference from S-1 SEC File No. 333-139989)
4.6	Form of 9.069% Junior Subordinated Deferrable Debentures (Included in Exhibit 4.5 hereto) (Incorporated by reference from S-1 SEC File No. 333-139989)
4.7	First Supplemental Indenture to the 9.069% Junior Subordinated Deferrable Debentures Indenture dated as of September 15, 2006 (Incorporated by reference from S-1 SEC File No. 333-139989)
4.8	8.480% Junior Subordinated Deferrable Debentures Indenture dated as of June 29, 2007 (Incorporated by reference from S-1 SEC File No. 333-139989)
4.9	Form of 8.480% Junior Subordinated Deferrable Debentures (Included in Exhibit 4.8 hereto) (Incorporated by reference from S-1 SEC File No. 333-139989)
4.10	Senior Note Indenture, by and between Validus Holdings, Ltd. and The Bank of New York Mellon, dated January 26, 2010 (Incorporated by reference from the Company's Current Report on Form 8-K filed with the SEC on January 26, 2010)
4.11	8.875% Senior Notes Supplemental Indenture, by and between Validus Holdings, Ltd. and The Bank of New York Mellon, dated January 26, 2010 (Incorporated by reference from the Company's Current Report on Form 8-K filed with the SEC on January 26, 2010)
4.12	Form of 8.875% Senior Note (Included in Exhibit 4.10 hereto) (Incorporated by reference from the Company's Current Report on Form 8-K filed with the SEC on January 26, 2010)
4.13	

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Shareholders' Agreement dated as of December 12, 2005 among Validus Holdings, Ltd. and the Shareholders Named Therein (Incorporated by reference from S-1 SEC File No. 333-139989)

4.14 Junior Subordinated Indenture dated as of August 23, 2006, between Flagstone Reinsurance Holdings Limited and JP Morgan Chase Bank, National Association, as trustee (Incorporated by reference from the Company's Current Report on Form 8-K filed with the SEC on November 30, 2012)

4.15 First Supplemental Indenture, dated as of May 17, 2010, among Flagstone Reinsurance Holdings, S.A., Flagstone Reinsurance Holdings Limited and The Bank of New York Mellon Trust Company, National Association, as trustee (Incorporated by reference from the Company's Current Report on Form 8-K filed with the SEC on November 30, 2012)

4.16 Second Supplemental Indenture, dated as of November 30, 2012, among Flagstone Reinsurance Holdings (Bermuda) Limited, Flagstone Reinsurance Holding, S.A. and The Bank of New York Mellon Trust Company, National Association, as trustee (Incorporated by reference from the Company's Current Report on Form 8-K filed with the SEC on November 30, 2012)

4.17 Third Supplemental Indenture, dated as of November 30, 2012, among Validus UPS, Ltd., Validus Holdings, Ltd. and The Bank of New York Mellon Trust Company, National Association, as trustee (Incorporated by reference from the Company's Current Report on Form 8-K filed with the SEC on November 30, 2012)

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- 4.18 Junior Subordinated Indenture, dated as of September 20, 2007, between Flagstone Reinsurance Holdings Limited and The Bank of New York Trust Company, National Association, as trustee (Incorporated by reference from the Company's Current Report on Form 8-K filed with the SEC on November 30, 2012)
- 4.19 First Supplemental Indenture, dated as of May 17, 2010, among Flagstone Reinsurance Holdings, S.A., Flagstone Reinsurance Holdings Limited and The Bank of New York Mellon Trust Company, National Association, as trustee (Incorporated by reference from the Company's Current Report on Form 8-K filed with the SEC on November 30, 2012)
- 4.20 Second Supplemental Indenture, dated as of November 30, 2012, among Flagstone Reinsurance Holdings (Bermuda) Limited, Flagstone Reinsurance Holdings, S.A. and The Bank of New York Mellon Trust Company, National Association, as trustee (Incorporated by reference from the Company's Current Report on Form 8-K filed with the SEC on November 30, 2012)
- 4.21 Third Supplemental Indenture, dated as of November 30, 2012, among Flagstone Finance S.A., Validus UPS, Ltd., Validus Holdings, Ltd. and Wilmington Trust Company, as trustee (Incorporated by reference from the Company's Current Report on Form 8-K filed with the SEC on November 30, 2012)
- 4.22 Junior Subordinated Indenture, dated as of June 8, 2007, among Flagstone Finance S.A., Flagstone Reinsurance Holdings Limited and Wilmington Trust Company, as trustee (Incorporated by reference from the Company's Current Report on Form 8-K filed with the SEC on November 30, 2012)
- 4.23 First Supplemental Indenture, dated as of May 17, 2010, among Flagstone Finance S.A., Flagstone Reinsurance Holdings, S.A. and Wilmington Trust Company, as trustee (Incorporated by reference from the Company's Current Report on Form 8-K filed with the SEC on November 30, 2012)
- 4.24 Second Supplemental Indenture, dated as of November 30, 2012, among Flagstone Finance S.A., Flagstone Reinsurance Holdings (Bermuda) Limited, Flagstone Reinsurance Holdings, S.A. and Wilmington Trust Company, as trustee (Incorporated by reference from the Company's Current Report on Form 8-K filed with the SEC on November 30, 2012)
- 4.25 Third Supplemental Indenture, dated as of November 30, 2012, among Flagstone Finance S.A., Validus UPS, Ltd., Validus Holdings, Ltd. and Wilmington Trust Company, as trustee (Incorporated by reference from the Company's Current Report on Form 8-K filed with the SEC on November 30, 2012)
- 4.26 Note Purchase Agreement, dated as of August 23, 2006, between Flagstone Reinsurance Holdings Limited and Merrill Lynch International (Incorporated by reference from the Company's Current Report on Form 8-K filed with the SEC on November 30, 2012)
- 4.27 Amendment No. 2, dated as of November 30, 2012, to the Note Purchase Agreement, among Validus UPS, Ltd., Validus Holdings, Ltd. and the noteholders named therein (Incorporated by reference from the Company's Current Report on Form 8-K filed with the SEC on November 30, 2012)
- 4.28 Amendment No. 2, dated as of November 30, 2012, to the Note Purchase Agreement, among Validus UPS, Ltd., Validus Holdings, Ltd. and the noteholders named therein (Incorporated by reference from the Company's Current Report on Form 8-K filed with the SEC on November 30, 2012)

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- 4.29 Share Purchase Warrant, dated November 30, 2012, between Validus Holdings, Ltd. and Leyton Limited (Incorporated by reference from the Company's Current Report on Form 8-K filed with the SEC on November 30, 2012)
- 10.1 Amendment and Restatement Agreement dated as of November 18, 2011 relating to the Talbot \$25 million Standby Letter of Credit Facility dated as of November 28, 2007, among Talbot Holdings Ltd., as Borrower, Validus Holdings, Ltd., as Guarantor, Lloyds TSB Bank Plc, as joint Mandated Lead Arranger, Agent, and Security Trustee, and ING Bank N.V., London Branch, as joint Mandated Lead Arranger (Incorporated by reference from the Company's Current Report on Form 8-K filed with the SEC on November 23, 2011)
- 10.2 Amended letter dated as of November 23, 2011 relating to a \$25 million Standby Letter of Credit Facility dated as of November 28, 2007, among Talbot Holdings Ltd, as Borrower, Validus Holdings, Ltd., as Guarantor, Lloyds TSB Bank Plc, as joint Mandated Lead Arranger, Agent and Security Trustee, and ING Bank N.V, London Branch, as joint Mandated Lead Arranger, as amended and restated on November 18, 2011 (Incorporated by reference from the Company's Current Report on Form 8-K filed with the SEC on November 29, 2011)
- 10.2.1 Amendment Letter, dated as of August 30, 2012, relating to a \$25 million Standby Letter of Credit Facility dated as of 28 November 2007, among Talbot Holdings Ltd., as Borrower, Validus Holdings, Ltd., as Guarantor, Lloyds TSB Bank Plc, as joint Mandated Lead Arranger, Agent, and Security Trustee, and ING Bank N.V., London Branch, as joint Mandated Lead Arranger, as amended (Incorporated by reference from the Company's Current Report on Form 8-K filed on September 4, 2012).
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- 10.3 Four-Year Unsecured Revolving Credit and Letter of Credit Facility, dated as of March 9, 2012, among Validus Holdings, Ltd., Validus Re Americas, Ltd., PaCRe, Ltd. and Validus Reinsurance, Ltd., the Lenders party thereto and JPMorgan Chase Bank, N.A., as administrative agent for the Lenders and Deutsche Bank Securities Inc, as syndication agent. (Incorporated by reference from the Company's Current Report on Form 8-K filed with the SEC on March 13, 2012)
- 10.4 Four-Year Secured Letter of Credit Facility, dated as of March 9, 2012, among Validus Holdings, Ltd., Validus Re Americas, Ltd. and Validus Reinsurance, Ltd., the Lenders party thereto and JPMorgan Chase Bank, N.A., as administrative agent for the Lenders and Deutsche Bank Securities Inc, as syndication agent. (Incorporated by reference from the Company's Current Report on Form 8-K filed with the SEC on March 13, 2012)
- 10.5 Amended and Restated Employment Agreement between Validus Holdings, Ltd. and Lixin Zeng dated as of November 1, 2012 (Incorporated by reference from the Company's Quarterly Report on Form 10-Q for the period ended September 30, 2012 filed with the SEC on November 6, 2012)
- 10.6 \* Amended and Restated Employment Agreement dated as of February 15, 2013 between Validus Holdings, Ltd. and Jeffrey D. Sangster
- 10.7 Third Amended and Restated Employment Agreement, dated as of May 21, 2012, by and between Validus Holdings, Ltd. and Conan M. Ward (Incorporated by reference from the Company's Current Report on Form 8-K filed on May 21, 2012)
- 10.8 Amended and Restated Employment Agreement between Validus Holdings, Ltd. and Edward J. Noonan (Incorporated by reference from S-1 SEC File No. 333-139989)
- 10.8.1 Amendment to Amended and Restated Employment Agreement between Validus Holdings, Ltd. and Edward J. Noonan (Incorporated by reference from the Company's Quarterly Report on Form 10-Q for the period ended September 30, 2008, filed with the SEC on November 13, 2008)
- 10.9 Amended and Restated Employment Agreement between Validus Holdings, Ltd. and Joseph E. (Jeff) Consolino dated as of February 17, 2011 (Incorporated by reference from the Company's Annual Report on Form 10-K for the year ended December 31, 2010, filed with the SEC on February 18, 2011)
- 10.10 Amended and Restated Employment Agreement between Validus Holdings, Ltd. and Stuart W. Mercer (Incorporated by reference from S-1 SEC File No. 333-139989)
- 10.11 Amendment to Amended and Restated Employment Agreement between Validus Holdings, Ltd. and Stuart W. Mercer (Incorporated by reference from the Company's Quarterly Report on Form 10-Q for the period ended September 30, 2008, filed with the SEC on November 13, 2008)
- 10.12 Employment Agreement dated as of September 1, 2010 between Validus Holdings, Ltd. and Jonathan P. Ritz. (Incorporated by reference from the Company's Current Report on Form 8-K filed with the SEC on September 8, 2010)
- 10.12.1 Amendment No. 1 to Employment Agreement between Validus Holdings, Ltd. and Jonathan P. Ritz dated as of October 1, 2010 (Incorporated by reference from the Company's Annual Report on Form 10-K for the year ended December 31, 2010, filed with the SEC on February 18, 2011)

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- 10.13 Service Agreement between Talbot Underwriting Services, Ltd. and Charles Neville Rupert Atkin (Incorporated by reference from the Company's Annual Report on Form 10-K for the year ended December 31, 2007, filed with the SEC on March 6, 2008)
- 10.14 Amended and Restated Employment Agreement between Validus Holdings, Ltd. and Robert F. Kuzloski dated as of April 1, 2011 (Incorporated by reference from the Company's Quarterly Report on Form 10-Q for the period ended September 30, 2011, filed with the SEC on November 4, 2011)
- 10.14.1 Amendment No. 1 to Amended and Restated Employment Agreement between Validus Holdings, Ltd. and Robert F. Kuzloski dated as of August 1, 2012 (Incorporated by reference from the Company's Quarterly Report on Form 10-Q for the period ended September 30, 2012 filed with the SEC on November 6, 2012)
- 10.15 Employment Agreement between Validus Holdings, Ltd. and Andrew Kudera dated as of February 2, 2010 (Incorporated by reference from the Company's Quarterly Report on Form 10-Q for the period ended September 30, 2011, filed with the SEC on November 4, 2011)
- 10.16 Investment Manager Agreement with BlackRock Financial Management, Inc. (Incorporated by reference from S-1 SEC File No. 333-139989)
- 10.17 Risk Reporting & Investment Accounting Services Agreement with BlackRock Financial Management, Inc. (Incorporated by reference from S-1 SEC File No. 333-139989)
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- 10.18 Validus Holdings, Ltd. 2005 Amended & Restated Long-Term Incentive Plan (Incorporated by reference from S-1 SEC File No. 333-139989)
- 10.19 Form of Amended Post-IPO Restricted Share Award Agreement for Validus Executive Officers (Incorporated by reference from the Company's Annual Report on Form 10-K for the year ended December 31, 2010, filed with the SEC on February 18, 2011)
- 10.20 Form of Pre-IPO Restricted Share Agreement for Executive Officers (Incorporated by reference from S-1 SEC File No. 333-139989)
- 10.21 Form of Amended Restricted Share Agreement for Talbot Executive Officers (Incorporated by reference from the Company's Annual Report on Form 10-K for the year ended December 31, 2010, filed with the SEC on February 18, 2011)
- 10.22 Amended and Restated Restricted Share Agreement between Validus Holdings, Ltd. and Edward J. Noonan (Incorporated by reference from S-1 SEC File No. 333-139989)
- 10.23 Stock Option Agreement between Validus Holdings, Ltd. and Edward J. Noonan (Incorporated by reference from S-1 SEC File No. 333-139989)
- 10.24 Form of Stock Option Agreement for Executive Officers prior to 2008 (Incorporated by reference from S-1 SEC File No. 333-139989)
- 10.25 Form of Stock Option Agreement for Executive Officers commencing in 2008 (Incorporated by reference from the Company's Annual Report on Form 10-K for the year ended December 31, 2007, filed with the SEC on March 6, 2008)
- 10.26 Form of Performance Share Award Agreement for Validus Executive Officers (Incorporated by reference from the Company's Annual Report on Form 10-K for the year ended December 31, 2010, filed with the SEC on February 18, 2011)
- 10.27 Form of Performance Share Award Agreement for Talbot Executive Officers (Incorporated by reference from the Company's Annual Report on Form 10-K for the year ended December 31, 2010, filed with the SEC on February 18, 2011)
- 10.28 Nonqualified Supplemental Deferred Compensation Plan (Incorporated by reference from S-1 SEC File No. 333-139989)
- 10.29 Validus Holdings, Ltd. Director Stock Compensation Plan (Incorporated by reference from S-1 SEC File No. 333-139989)
- 10.30 Amendment No. 1 to Validus Holdings, Ltd. Directors Stock Compensation Plan dated as of January 5, 2009 (Incorporated by reference from the Company's Annual Report on Form 10-K for the year ended December 31, 2008 filed with the SEC on February 27, 2009)
- 10.30.1 Assignment and Assumption Agreement dated as of December 20, 2011, by and among Aquiline Capital Partners LLC, Validus Reinsurance, Ltd. and Aquiline Capital Partners II GP (Offshore) Ltd.
- 10.31 \* Employment Agreement dated October 25 2012 between Validus America, Inc, and for purposes of Section 12.04, countersigned by Validus Holdings, Ltd. and John J. Hendrickson



- 21 \* Subsidiaries of the Registrant
- 23 \* Consent of PricewaterhouseCoopers
- 24 Power of attorney (Incorporated by Reference from signature page)
- 31 \* Rule 13a-14(a)/15d-14(a) Certifications
- 32 \* Section 1350 Certification
- 101.INS \* XBRL Instance Document
- 101.SCH \* XBRL Taxonomy Extension Schema Document
- 101.CAL \* XBRL Taxonomy Calculation Linkbase Document
- 101.LAB \* XBRL Taxonomy Extension Label Linkbase Document
- 101.PRE \* XBRL Taxonomy Extension Presentation Linkbase Document
- 101.DEF \* XBRL Taxonomy Extension Definition Linkbase Document

\*Filed herewith

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SIGNATURES

Pursuant to the requirements of Section 13 or 15(d) of the Securities Exchange Act of 1934, as amended, the Registrant has duly caused this Annual Report on Form 10-K/A to be signed on its behalf by the undersigned, thereunto duly authorized, in Pembroke, Bermuda, on March 25, 2013.

Validus Holdings, Ltd.

By: /s/ EDWARD J. NOONAN

Name: Edward J. Noonan

Title: Chief Executive Officer

By: /s/ JEFFREY D. SANGSTER

Name: Jeffrey D. Sangster

Title: Executive Vice President and Chief  
Financial Officer

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Pursuant to the requirements of the Securities Exchange Act of 1934, as amended, this Annual Report on Form 10-K/A has been signed below by the following persons on behalf of the Registrant and in the capacities and on the dates indicated.

Signature	Title	Date
/s/ EDWARD J. NOONAN Name: Edward J. Noonan	Chairman of the Board of Directors and Chief Executive Officer (Principal Executive Officer)	March 25, 2013
/s/ MAHMOUD ABDALLAH * Name: Mahmoud Abdallah	Director	March 25, 2013
/s/ MICHAEL CARPENTER * Name: Michael Carpenter	Director	March 25, 2013
/s/ JOSEPH E. (JEFF) CONSOLINO * Name: Joseph E. (Jeff) Consolino	Director	March 25, 2013
/s/ MATTHEW J. GRAYSON * Name: Matthew J. Grayson	Director	March 25, 2013
/s/ JEFFREY W. GREENBERG * Name: Jeffrey W. Greenberg	Director	March 25, 2013
/s/ JOHN J. HENDRICKSON * Name: John J. Hendrickson	Director	March 25, 2013
/s/ JEAN-MARIE NESSI * Name: Jean-Marie Nessi	Director	March 25, 2013
/s/ MANDAKINI PURI * Name: Mandakini Puri	Director	March 25, 2013
/s/ ALOK SINGH * Name: Alok Singh	Director	March 25, 2013
/s/ CHRISTOPHER E. WATSON * Name: Christopher E. Watson	Director	March 25, 2013

\*/s/ EDWARD J. NOONAN  
Name: Edward J. Noonan  
Attorney-in-fact

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AND FINANCIAL STATEMENT SCHEDULES

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Schedules other than those listed are omitted for the reason that they are not required, are not applicable or that equivalent information has been included in the financial statements, notes thereto, or elsewhere herein.

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Report of Independent Registered Public Accounting Firm

To the Board of Directors and Shareholders of  
Validus Holdings, Ltd.

In our opinion, the consolidated financial statements listed in the accompanying index present fairly, in all material respects, the financial position of Validus Holdings, Ltd. and its subsidiaries at December 31, 2012 and December 31, 2011, and the results of their operations and their cash flows for each of the three years in the period ended December 31, 2012 in conformity with accounting principles generally accepted in the United States of America. In addition, in our opinion, the financial statement schedules listed in the accompanying index present fairly, in all material respects, the information set forth therein when read in conjunction with the related consolidated financial statements. Also in our opinion, the Company maintained, in all material respects, effective internal control over financial reporting as of December 31, 2012, based on criteria established in Internal Control—Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO). The Company's management is responsible for these financial statements and financial statement schedules, for maintaining effective internal control over financial reporting and for its assessment of the effectiveness of internal control over financial reporting, included in Management's Report on Internal Control over Financial Reporting appearing under Item 9A. Our responsibility is to express opinions on these financial statements, on the financial statement schedules, and on the Company's internal control over financial reporting based on our integrated audits. We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audits to obtain reasonable assurance about whether the financial statements are free of material misstatement and whether effective internal control over financial reporting was maintained in all material respects. Our audits of the financial statements included examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, and evaluating the overall financial statement presentation. Our audit of internal control over financial reporting included obtaining an understanding of internal control over financial reporting, assessing the risk that a material weakness exists, and testing and evaluating the design and operating effectiveness of internal control based on the assessed risk. Our audits also included performing such other procedures as we considered necessary in the circumstances. We believe that our audits provide a reasonable basis for our opinions.

A company's internal control over financial reporting is a process designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles. A company's internal control over financial reporting includes those policies and procedures that (i) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the company; (ii) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the company are being made only in accordance with authorizations of management and directors of the company; and (iii) provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use, or disposition of the company's assets that could have a material effect on the financial statements.

Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements. Also, projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

As described in Management's Report on Internal Control over Financial Reporting appearing under Item 9A in the 2012 Form 10-K, management has excluded Flagstone Reinsurance Holdings, S.A. (Flagstone) from its assessment of internal control over financial reporting as of December 31, 2012 because it was acquired by the Company in a purchase business combination during 2012. We have also excluded Flagstone from our audit of internal control over financial reporting. Flagstone is a wholly-owned subsidiary whose total assets and total revenues represent 19.4% and 2.4%, respectively, of the related consolidated financial statement amounts as of and for the year ended December 31, 2012.

/s/ PricewaterhouseCoopers

PricewaterhouseCoopers  
Hamilton, Bermuda  
February 15, 2013

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## PART I. FINANCIAL INFORMATION

## ITEM I. FINANCIAL STATEMENTS

Validus Holdings, Ltd.

Consolidated Balance Sheets

As at December 31, 2012 and 2011

(Expressed in thousands of U.S. dollars, except share and per share information)

	December 31, 2012	December 31, 2011
<b>Assets</b>		
Fixed maturities, at fair value (amortized cost: 2012—\$5,008,514; 2011—\$4,859,705)	\$5,085,334	\$4,894,145
Short-term investments, at fair value (amortized cost: 2012—\$1,112,929; 2011—\$280,299)	1,114,250	280,191
Other investments, at fair value (amortized cost: 2012—\$583,068; 2011—\$15,002)	564,448	16,787
Cash and cash equivalents	1,219,379	832,844
Total investments and cash	7,983,411	6,023,967
Investments in affiliates	172,329	53,031
Premiums receivable	802,159	646,354
Deferred acquisition costs	146,588	121,505
Prepaid reinsurance premiums	99,593	91,381
Securities lending collateral	225	7,736
Loss reserves recoverable	439,967	372,485
Paid losses recoverable	46,435	90,495
Intangible assets	110,569	114,731
Goodwill	20,393	20,393
Accrued investment income	21,321	25,906
Other assets	177,274	50,487
Total assets	\$10,020,264	\$7,618,471
<b>Liabilities</b>		
Reserve for losses and loss expenses	\$3,517,573	\$2,631,143
Unearned premiums	894,362	772,382
Reinsurance balances payable	138,550	119,899
Securities lending payable	691	8,462
Deferred income taxes	20,259	16,720
Net payable for investments purchased	38,346	1,256
Accounts payable and accrued expenses	167,577	83,402
Senior notes payable	247,090	246,982
Debentures payable	540,709	289,800
Total liabilities	\$5,565,157	\$4,170,046
Commitments and contingent liabilities	—	—
<b>Shareholders' equity</b>		
Common shares, 571,428,571 authorized, par value \$0.175 (Issued: 2012—152,698,191; 2011—134,503,065; Outstanding: 2012—107,921,259; 2011—99,471,080)	\$26,722	\$23,538
Treasury shares (2012—44,776,932; 2011—35,031,985)	(7,836	) (6,131
Additional paid-in-capital	2,160,478	1,893,890
Accumulated other comprehensive (loss)	(2,953	) (6,601

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Retained earnings	1,844,416	1,543,729
Total shareholders' equity available to Validus	4,020,827	3,448,425
Noncontrolling interest	434,280	—
Total shareholders' equity	\$4,455,107	\$3,448,425

Total liabilities and shareholders' equity \$10,020,264 \$7,618,471

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

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Validus Holdings, Ltd.

Consolidated Statements of Comprehensive Income

For the Years Ended December 31, 2012, 2011 and 2010

(Expressed in thousands of U.S. dollars, except share and per share information)

	December 31, 2012	December 31, 2011	December 31, 2010
<b>Revenues</b>			
Gross premiums written	\$2,166,440	\$2,124,691	\$1,990,566
Reinsurance premiums ceded	(307,506)	) (289,241)	) (229,482)
Net premiums written	1,858,934	1,835,450	1,761,084
Change in unearned premiums	14,282	(33,307)	) 39
Net premiums earned	1,873,216	1,802,143	1,761,123
Gain on bargain purchase, net of expenses	17,701	—	—
Net investment income	107,936	112,296	134,103
Net realized gains on investments	18,233	28,532	32,498
Net unrealized gains (losses) on investments	17,585	(19,991)	) 45,952
(Loss) from investment affiliate	(964)	) —	—
Other income	22,396	5,718	5,219
Foreign exchange gains (losses)	4,798	(22,124)	) 1,351
<b>Total revenues</b>	<b>2,060,901</b>	<b>1,906,574</b>	<b>1,980,246</b>
<b>Expenses</b>			
Losses and loss expenses	999,446	1,244,401	987,586
Policy acquisition costs	334,698	314,184	292,899
General and administrative expenses	263,652	197,497	209,290
Share compensation expenses	26,709	34,296	28,911
Finance expenses	53,857	54,817	55,870
Transaction expenses	—	17,433	—
<b>Total expenses</b>	<b>1,678,362</b>	<b>1,862,628</b>	<b>1,574,556</b>
Net income before taxes and income from operating affiliates	382,539	43,946	405,690
Tax (expense)	(2,501)	) (824)	) (3,126)
Income from operating affiliates	12,580	—	—
<b>Net income</b>	<b>\$392,618</b>	<b>\$43,122</b>	<b>\$402,564</b>
Net loss (income) attributable to noncontrolling interest	15,820	(21,793)	) —
<b>Net income available to Validus</b>	<b>\$408,438</b>	<b>\$21,329</b>	<b>\$402,564</b>
<b>Other comprehensive income (loss)</b>			
Foreign currency translation adjustments	3,648	(1,146)	) (604)
<b>Other comprehensive income (loss)</b>	<b>\$3,648</b>	<b>\$(1,146)</b>	<b>\$(604)</b>
<b>Comprehensive income available to Validus</b>	<b>\$412,086</b>	<b>\$20,183</b>	<b>\$401,960</b>
<b>Earnings per share</b>			
Weighted average number of common shares and common share equivalents outstanding			
Basic	97,184,110	98,607,439	116,018,364
Diluted	102,384,923	100,928,284	120,630,945
Basic earnings per share available to common shareholders	\$4.13	\$0.14	\$3.41
Diluted earnings per share available to common shareholders	\$3.99	\$0.14	\$3.34

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Cash dividends declared per share	\$ 1.00	\$ 1.00	\$ 0.88
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The accompanying notes are an integral part of these consolidated financial statements.

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Validus Holdings, Ltd.

Consolidated Statements of Shareholders' Equity

For the Years Ended December 31, 2012, 2011 and 2010

(Expressed in thousands of U.S. dollars, except share and per share information)

	December 31, 2012	December 31, 2011	December 31, 2010
Common shares			
Balance—Beginning of period	\$23,538	\$23,247	\$23,033
Common shares issued, net	3,184	291	214
Balance—End of period	\$26,722	\$23,538	\$23,247
Treasury shares			
Balance—Beginning of period	\$(6,131)	\$(6,096)	\$(553)
Repurchase of common shares	(1,705)	(35)	(5,543)
Balance—End of period	\$(7,836)	\$(6,131)	\$(6,096)
Additional paid-in capital			
Balance—Beginning of period	\$1,893,890	\$1,860,960	\$2,675,680
Common shares issued, net	498,136	4,594	7,752
Repurchase of common shares	(258,257)	(5,960)	(851,383)
Share compensation expenses	26,709	34,296	28,911
Balance—End of period	\$2,160,478	\$1,893,890	\$1,860,960
Accumulated other comprehensive (loss)			
Balance—Beginning of period	\$(6,601)	\$(5,455)	\$(4,851)
Other comprehensive income (loss)	3,648	(1,146)	(604)
Balance—End of period	\$(2,953)	\$(6,601)	\$(5,455)
Retained earnings			
Balance—Beginning of period	\$1,543,729	\$1,632,175	\$1,337,811
Dividends	(107,751)	(109,775)	(108,200)
Net income	392,618	43,122	402,564
Net loss (income) attributable to noncontrolling interest	15,820	(21,793)	—
Balance—End of period	\$1,844,416	\$1,543,729	\$1,632,175
Total shareholders' equity available to Validus	\$4,020,827	\$3,448,425	\$3,504,831
Noncontrolling interest	\$434,280	\$—	\$—
Total shareholders' equity	\$4,455,107	\$3,448,425	\$3,504,831

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

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Validus Holdings, Ltd.

Consolidated Statements of Cash Flows

For the Years Ended December 31, 2012, 2011 and 2010

(Expressed in thousands of U.S. dollars, except share and per share information)

	December 31, 2012	December 31, 2011	December 31, 2010
Cash flows provided by (used in) operating activities			
Net income	\$392,618	\$43,122	\$402,564
Adjustments to reconcile net income to cash provided by (used in) operating activities:			
Share compensation expenses	26,709	34,296	28,911
Bargain purchase gain	(49,702)	—	—
Amortization of discount on senior notes	108	108	81
Loss from investment affiliate	964	—	—
Net realized (gains) on investments	(18,233)	(28,532)	(32,498)
Net unrealized (gains) losses on investments	(17,585)	19,991	(45,952)
Amortization of intangible assets	10,159	4,162	4,162
Income from operating affiliates	(12,580)	—	—
Foreign exchange (gains) losses included in net income	(16,123)	9,659	(1,451)
Amortization of premium on fixed maturities	24,289	31,150	32,175
Change in:			
Premiums receivable	19,860	(77,634)	(19,011)
Deferred acquisition costs	(1,875)	2,392	(11,568)
Prepaid reinsurance premiums	3,116	(19,964)	1,747
Loss reserves recoverable	40,708	(89,232)	(102,268)
Paid losses recoverable	54,248	(62,566)	(13,244)
Income taxes recoverable	522	1,216	994
Accrued investment income	7,404	7,750	4,351
Other assets	(9,618)	(574)	(13,198)
Reserve for losses and loss expenses	116,902	596,325	419,350
Unearned premiums	(17,148)	43,866	4,412
Reinsurance balances payable	(12,365)	56,041	(659)
Deferred income taxes	1,040	(8,146)	277
Accounts payable and accrued expenses	19,147	(18,290)	(29,174)
Net cash provided by operating activities	562,565	545,140	630,001
Cash flows provided by (used in) investing activities			
Proceeds on sales of investments	3,393,740	4,058,495	5,349,053
Proceeds on maturities of investments	548,226	353,006	349,851
Purchases of fixed maturities	(3,726,611)	(4,551,070)	(5,612,979)
Sales (purchases) of short-term investments, net	74,954	(215,055)	208,278
(Purchases) sales of other investments	(479,856)	3,967	17,210
Decrease in securities lending collateral	7,771	14,631	67,013
Purchase of investment in operating affiliates	(91,500)	—	—
Purchase of investment in affiliate	(12,835)	—	—
Proceeds on sale of AlphaCat Re 2011	—	11,000	—
Cash (redeemed) in deconsolidation of AlphaCat Re 2011	—	(67,808)	—
Purchase of subsidiary, net of cash acquired	17,196	—	—
Net cash (used in) provided by investing activities	(268,915)	(392,834)	378,426
Cash flows provided by (used in) financing activities			
Net proceeds on issuance of senior notes	—	—	246,793

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Issuance of common shares, net	3,015	4,885	7,966
Purchases of common shares under share repurchase program	(259,962	) (5,995	) (856,926 )
Dividends paid	(110,037	) (107,691	) (105,662 )
Decrease in securities lending payable	(7,771	) (14,631	) (67,013 )
Third party investment in noncontrolling interest	450,100	192,113	—
Net cash provided by (used in) financing activities	75,345	68,681	(774,842 )
Effect of foreign currency rate changes on cash and cash equivalents	17,540	(8,883	) (430 )
Net increase in cash	386,535	212,104	233,155
Cash and cash equivalents—beginning of period	832,844	620,740	387,585
Cash and cash equivalents—end of period	\$1,219,379	\$832,844	\$620,740
Taxes paid (recovered) during the period	\$3,832	\$(4,632	) \$2,379
Interest paid during the period	\$43,249	\$43,777	\$36,552

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

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Validus Holdings, Ltd.

Notes to Consolidated Financial Statements (Continued)

(Expressed in thousands of U.S. dollars, except share and per share information)

1. Nature of the business

Validus Holdings, Ltd. (the "Company") was incorporated under the laws of Bermuda on October 19, 2005. The Company provides reinsurance, insurance coverage and insurance linked securities management through three distinct global operating segments, Validus Re, Talbot and AlphaCat. Validus Re, the Company's principal reinsurance operating segment, operates as a Bermuda-based provider of short-tail reinsurance products on a global basis. Talbot, the Company's principal insurance operating segment manages Syndicate 1183 at Lloyd's of London ("Lloyd's") and writes short-tail insurance products on a worldwide basis. AlphaCat is a Bermuda based investment adviser, managing third-party capital in insurance linked securities and other investments in the property catastrophe reinsurance space. On November 30, 2012, the Company acquired all of the outstanding common shares of Flagstone Reinsurance Holdings, S.A. ("Flagstone") in exchange for 0.1935 Company common shares and \$2.00 cash per Flagstone common share (the "Flagstone Acquisition"). For segmental reporting purposes, the results of Flagstone's operations since the acquisition date have been included within the Validus Re segment in the consolidated financial statements. Refer to Note 5 "Business combination" for further information.

2. Basis of preparation and consolidation

These consolidated financial statements include Validus Holdings, Ltd. and its wholly and majority owned subsidiaries (together, the "Company") and have been prepared in accordance with accounting principles generally accepted in the United States of America ("U.S. GAAP").

In the opinion of management, these consolidated financial statements reflect all adjustments (consisting of normal recurring accruals) considered necessary for a fair presentation of the Company's financial position and results of operations as at the end of and for the periods presented. Certain amounts in prior periods have been reclassified to conform to current period presentation. All significant intercompany accounts and transactions have been eliminated. The preparation of financial statements in conformity with U.S. GAAP requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from these estimates. The significant estimates reflected in the Company's consolidated financial statements include the reserve for losses and loss expenses, premium estimates for business written on a line slip or proportional basis, the valuation of goodwill and intangible assets, reinsurance recoverable balances including the provision for unrecoverable reinsurance recoverable balances and investment valuation. Actual results could differ from those estimates. The term "ASC" used in these notes refers to Accounting Standard Codifications issued by the United States Financial Accounting Standards Board ("FASB").

3. Significant accounting policies

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

(a) Premiums

Insurance premiums written are recorded in accordance with the terms of underlying policies. Reinsurance premiums written are recorded at the inception of the policy and are estimated based on information received from brokers, ceding companies and reinsureds, and any subsequent differences arising on such estimates will be recorded in the periods in which they are determined. Premiums written are earned on a pro-rata basis over the term of the policy. For contracts and policies written on a losses occurring basis, the risk period is generally the same as the contract or policy terms. For contracts written on a policies attaching basis, the risk period is based on the terms of the underlying contracts and policies and is generally assumed to be 24 months. The portion of the premiums written applicable to the unexpired terms of the underlying contracts and policies in force are recorded as unearned premiums. Mandatory reinstatement premiums are recorded at the time a loss event occurs.

(b) Policy acquisition costs

Policy acquisition costs are costs that vary with, and are directly related to, the successful production of new and renewal business, and consist principally of commissions and brokerage expenses. Acquisition costs are shown net of commissions earned on reinsurance ceded. These costs are deferred and amortized over the periods in which the related premiums are earned. Deferred

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Validus Holdings, Ltd.

Notes to Consolidated Financial Statements (Continued)

(Expressed in thousands of U.S. dollars, except share and per share information)

acquisition costs are limited to their estimated realizable value based on the related unearned premiums and anticipated claims expenses. The realizable value of the Company's deferred acquisition costs is determined without consideration of investment income. Policy acquisition costs also include profit commission. Profit commissions are recognized when earned.

(c) Reserve for losses and loss expenses

The reserve for losses and loss expenses includes reserves for unpaid reported losses and for losses incurred but not reported ("IBNR"). The reserve for unpaid reported losses and loss expenses is established by management based on reports from brokers, ceding companies and insureds and represents the estimated ultimate cost of events or conditions that have been reported to, or specifically identified by the Company. The reserve for incurred but not reported losses and loss expenses is established by management based on actuarially determined estimates of ultimate losses and loss expenses. Inherent in the estimate of ultimate losses and loss expenses are expected trends in claim severity and frequency and other factors which may vary significantly as claims are settled. Accordingly, ultimate losses and loss expenses may differ materially from the amounts recorded in the consolidated financial statements. These estimates are reviewed regularly and, as experience develops and new information becomes known, the reserves are adjusted as necessary. Such adjustments, if any, will be recorded in earnings in the period in which they become known. Prior period development arises from changes to loss estimates recognized in the current year that relate to loss reserves established in previous calendar years.

(d) Reinsurance

In the normal course of business, the Company seeks to reduce the potential amount of loss arising from claims events by reinsuring certain levels of risk assumed in various areas of exposure with other insurers or reinsurers. The accounting for reinsurance ceded depends on the method of reinsurance. If the policy is on a "losses occurring" basis, reinsurance premiums ceded are expensed (and any commissions thereon are earned) on a pro-rata basis over the period the reinsurance coverage is provided. If the policy is a "risks attaching" policy, reinsurance premiums ceded are expensed (and any commissions thereon are earned) in line with the gross premiums earned to which the risk attaching policy relates. Prepaid reinsurance premiums represent the portion of premiums ceded applicable to the unexpired term of policies in force. Mandatory reinstatement premiums ceded are recorded and expensed at the time a loss event occurs. Reinsurance recoverables are based on contracts in force. The method for determining the reinsurance recoverable on unpaid loss and loss expenses involves actuarial estimates of unpaid losses and loss expenses as well as a determination of the Company's ability to cede unpaid losses and loss expenses under its reinsurance treaties. The use of different assumptions could have a material effect on the provision for uncollectible reinsurance. To the extent the creditworthiness of the Company's reinsurers was to deteriorate due to adverse events affecting the reinsurance industry, such as a large number of major catastrophes, actual uncollectible amounts could be significantly greater than the Company's provision. Amounts recoverable from reinsurers are estimated in a manner consistent with the underlying liabilities.

(e) Investments

Fair value is defined as the price received to transfer an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date reflecting the highest and best use valuation concepts. The guidance for "Fair Value Measurement and Disclosure" provides a framework for measuring fair value by creating a hierarchy of fair value measurements that distinguishes market data between observable independent market inputs and unobservable market assumptions by the reporting entity. The guidance further expands disclosures about such fair value measurements. The guidance applies broadly to most existing accounting pronouncements that require or permit fair value measurements (including both financial and non-financial assets and liabilities) but does not require any new fair value measurements. The Company has adopted all authoritative guidance in effect as of the balance sheet date regarding certain market conditions that allow for fair value measurements that incorporate unobservable inputs where active market transaction based measurements are unavailable.



In May 2011, the FASB issued Accounting Standards Update No. 2011-04, "Amendments to Achieve Common Fair Value

Measurement and Disclosure Requirements in U.S. GAAP and IFRSs" ("ASU 2011-04"). The objective of ASU 2011-04 is to provide common fair value measurement and disclosure requirements in U.S. GAAP and IFRSs. Consequently, the amendments change the wording used to describe many of the requirements in U.S. GAAP for measuring fair value and for disclosing information about fair value measurements. For many of the requirements, the amendments do not result in a change in the application of the requirements in ASC Topic 820 "Fair Value Measurements". ASU 2011-04 is effective for interim and annual periods beginning after December 15, 2011. Effective January 1, 2012, the Company prospectively adopted this amended guidance.

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Validus Holdings, Ltd.

Notes to Consolidated Financial Statements (Continued)

(Expressed in thousands of U.S. dollars, except share and per share information)

Short-term investments comprise investments with a remaining maturity of less than one year at time of purchase and money market funds held at the Company's investment managers.

All investment transactions are recorded on a first-in-first-out basis and realized gains and losses on the sale of investments are determined on the basis of amortized cost. Interest on fixed maturity securities is recorded in net investment income when earned and is adjusted for any amortization of premium or accretion of discount.

For mortgage-backed securities, and any other holdings for which there is a prepayment risk, prepayment assumptions are evaluated and revised as necessary. Any adjustments required due to the resultant change in effective yields and maturities are recognized retrospectively. Prepayment fees or call premiums that are only payable to the Company when a security is called prior to its maturity, are earned when received and reflected in net investment income.

(f) Other investments

Other investments consist of an investment in four Paulson & Co. Inc. managed hedge funds (the "Paulson hedge funds"), three investment funds and three private equity investments assumed from the Flagstone Acquisition, a fund of hedge funds and a deferred compensation trust held in mutual funds. All investment transactions are recorded on a first-in-first-out basis and realized gains and losses on the sale of investments are determined on the basis of amortized cost. Other investments are carried at fair value with interest and dividend income, income distributions and realized and unrealized gains and losses included in net income for the year. The fair value of other investments is generally established on the basis of the net valuation criteria established by the managers of the investments. These net valuations are determined based upon the valuation criteria established by the governing documents of such investments. In addition, due to a lag in reporting, some of the fund managers, fund administrators, or both, are unable to provide final fund valuations as of the Company's reporting date. In these circumstances, the Company estimates the fair value of these funds by starting with the prior month's or prior quarter's fund valuation, adjusting these valuations for capital calls, redemptions or distributions and the impact of changes in foreign currency exchange rates, and then estimating the return for the current period. In circumstances in which the Company estimates the return for the current period, it uses all credible information available. For the Paulson hedge funds, this principally includes preliminary estimates reported by its fund managers, obtaining the valuation of underlying portfolio investments where such underlying investments are publicly traded and therefore have a readily observable price, using information that is available to the Company with respect to the underlying investments, reviewing various indices for similar investments or asset classes, as well as estimating returns based on the results of similar types of investments for which the Company has reported results, or other valuation methods, as necessary. Actual final fund valuations may differ, perhaps materially so, from the Company's estimates and these differences are recorded in the period they become known as a change in estimate.

(g) Derivative instruments

Fair Value Hedges

The Company uses derivative instruments in the form of foreign currency forward exchange contracts to manage foreign currency risk. A foreign currency forward exchange contract involves an obligation to purchase or sell a specified amount of a specified currency at a future date at a price set at the time of the contract. Foreign currency forward exchange contracts will not eliminate fluctuations in the value of our assets and liabilities denominated in foreign currencies but rather allow the Company to establish a rate of exchange for a future point in time. The foreign currency forward exchange contracts are recorded as derivatives at fair value as either assets or liabilities, depending on their rights or obligations, with changes in fair value recorded as a net foreign exchange gain or loss in the Company's Statements of Comprehensive Income.

To qualify for hedge accounting treatment, a derivative must be highly effective in mitigating the designated changes in value or cash flow of the hedged item. The Company formally documents all relationships between designated hedging instruments and hedged items, as well as its risk management objective and strategy for undertaking various hedge transactions. The documentation process includes linking derivatives to specific assets or liabilities on the

balance sheet. The Company also formally assesses, both at the hedge's inception and on an ongoing basis, whether the derivatives that are used in hedging transactions are highly effective in offsetting changes in fair values or cash flows of hedged items. The Company assesses the effectiveness of its designated hedges on an individual currency basis. If the ratio obtained with this method is within the range of 80% to 125%, the Company considers the hedge effective. The Company discontinues hedge accounting prospectively when it is determined that the derivative is no longer highly effective in offsetting changes in the fair value or cash flows of a hedged item; the derivative is de-designated as a hedging

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Validus Holdings, Ltd.

Notes to Consolidated Financial Statements (Continued)

(Expressed in thousands of U.S. dollars, except share and per share information)

instrument; or the derivative expires or is sold, terminated or exercised. To the extent that the Company discontinues hedge accounting, because, based on management's assessment, the derivative no longer qualifies as an effective hedge, the derivative will continue to be carried in the Consolidated Balance Sheets at its fair value, with changes in its fair value recognized in current period net income through foreign exchange gains (losses).

**Cash Flow Hedges**

The Company uses derivative instruments in the form of interest rate swaps to manage the interest rate exposure associated with certain assets and liabilities. These derivatives are recorded at fair value. Changes in the fair value of a derivative that is designated and qualifies as a cash flow hedge are recorded in other comprehensive income ("OCI") and are reclassified into earnings when the variability of the cash flow of the hedged item impacts earnings. Gains and losses on derivative contracts that are reclassified from OCI to current period earnings are included in the line item in the Consolidated Statements of Comprehensive Income in which the cash flows of the hedged item are recorded. Any hedge ineffectiveness is recorded immediately in current period earnings.

To qualify for hedge accounting treatment, a derivative must be highly effective in mitigating the designated changes in value or cash flow of the hedged item. The Company formally documents all relationships between designated hedging instruments and hedged items, as well as its risk management objective and strategy for undertaking various hedge transactions. The documentation process includes linking derivatives to specific assets or liabilities on the balance sheet. The Company also formally assesses, both at the hedge's inception and on an ongoing basis (when required), whether the derivatives that are used in hedging transactions are highly effective in offsetting changes in fair values or cash flows of hedged items. The Company assesses the effectiveness of its designated hedges on an individual contract basis. The Company currently applies the long haul method when assessing the hedge's effectiveness.

The Company discontinues hedge accounting prospectively when it is determined that the derivative is no longer highly effective in offsetting changes in the fair value or cash flows of a hedged item; the derivative is de-designated as a hedging instrument; or the derivative expires or is sold, terminated or exercised. When hedge accounting is discontinued because the Company becomes aware that it is not probable that the forecasted transaction will occur, the derivative continues to be carried on the balance sheet at its fair value, and gains and losses that were accumulated in OCI are recognized immediately in earnings.

**(h) Cash and cash equivalents**

The Company considers time deposits and money market funds with an original maturity of 30 days or less as equivalent to cash.

**(i) Foreign exchange**

The U.S. dollar is the functional currency of the Company and the majority of the subsidiaries. For these companies, monetary assets and liabilities denominated in foreign currencies are revalued at the exchange rates in effect at the balance sheet date and revenues and expenses denominated in foreign currencies are translated at the prevailing exchange rate on the transaction date with the resulting foreign exchange gains and losses included in earnings. Assets and liabilities of subsidiaries whose functional currency is not the U.S. dollar are translated at prevailing year end exchange rates. Revenue and expenses of such foreign operations are translated at average exchange rates during the year. The net effect of translation differences between functional and reporting currencies in foreign operations, net of applicable deferred income taxes, are included in "accumulated other comprehensive (loss)."

**(j) Stock plans**

The Company accounts for its stock plans in accordance with the U.S. GAAP fair value recognition provisions for "Stock Compensation." Accordingly, the Company recognizes the compensation expense for stock option grants, restricted share grants and performance share awards based on the fair value of the award on the date of grant over the requisite service period.

**(k) Warrants**

The Company has accounted for certain warrant contracts issued to our sponsoring investors in conjunction with the capitalization of the Company, and which may be settled by the Company using either the physical settlement or net-share settlement

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Validus Holdings, Ltd.

Notes to Consolidated Financial Statements (Continued)

(Expressed in thousands of U.S. dollars, except share and per share information)

methods, in accordance with U.S. GAAP guidance for “Derivatives and Hedging, Contracts in Entity’s Own Equity.” Accordingly, the fair value of these warrants has been recorded in equity as an addition to additional paid-in capital.

(l) Earnings per share

Basic earnings per common share is calculated by dividing net income available to common shareholders by the weighted average number of common shares outstanding. Diluted earnings per common share are based on the weighted average number of common shares and share equivalents excluding any anti-dilutive effects of warrants, options and other awards under stock plans.

(m) Income taxes and uncertain tax provisions

Deferred tax assets and liabilities are recorded in accordance with U.S. GAAP “Income Taxes” guidance. Consistent with this guidance, the Company records deferred income taxes which reflect the tax effect of the temporary differences between the carrying amounts of assets and liabilities for financial reporting purposes and their respective tax bases.

The Company is not subject to any income, withholding or capital gains taxes under current Bermuda law. The Company has operations in subsidiary form in various other jurisdictions around the world, including but not limited to the U.K., U.S., Switzerland and Canada that are subject to relevant taxes in those jurisdictions.

The Company recognizes the tax benefits of uncertain tax positions only where the position is “more likely than not” to be sustained assuming examination by tax authorities. The Company did not recognize any resulting liabilities for unrecognized tax benefits.

(n) Business combinations

The Company accounts for business combinations in accordance with ASC Topic 805 “Business Combinations.” On November 30, 2012, the Company acquired all of the outstanding shares of Flagstone. The transaction was accounted for as an acquisition method business combination. Accordingly, the purchase price was allocated to assets and liabilities based on their estimated fair value at the acquisition date. The excess of the value of the net assets acquired over the purchase price was recorded as gain on bargain purchase and is shown as a separate component of revenues in the Company’s Consolidated Statements of Comprehensive Income for the year ended December 31, 2012. Flagstone’s accounting policies have been conformed to those of the Company.

(o) Goodwill and other intangible assets

The Company accounts for goodwill and other intangible assets recognized in business combinations in accordance with U.S. GAAP guidance. A purchase price paid that is in excess of net assets (“goodwill”) arising from a business combination is recorded as an asset, and is not amortized. Goodwill is deemed to have an indefinite life and is not amortized, but tested at least annually for impairment. Where the total fair value of net assets acquired exceeds consideration paid (“negative goodwill”), the acquirer will record a gain as a result of the bargain purchase, to be recognized through the consolidated statements of comprehensive income at the close of the transaction.

Intangible assets with a finite life are amortized over the estimated useful life of the asset. Intangible assets with an indefinite useful life are not amortized. Syndicate capacity is deemed to have an indefinite life. Intangible assets with definite lives are amortized on a straight line basis over the estimated useful lives. Trademark and Distribution Network are deemed to have definite lives and are therefore amortized. Refer also to Note 6 “Goodwill and other intangible assets.”

Goodwill and indefinite-lived intangible assets are tested for impairment on an annual basis or more frequently if events or changes in circumstances indicate that the carrying amount may not be recoverable. Such events or circumstances may include an economic downturn in a geographic market or change in the assessment of future operations.

In September 2011, the FASB issued Accounting Standards Update No. 2011-08, “Testing Goodwill for Impairment” (“ASU 2011-08”). The objective of ASU 2011-08 is to simplify how entities test goodwill for impairment. The amendments permit an entity to first assess qualitative factors to determine whether it is more likely than not that the

fair value of a reporting unit is less than its carrying amount as a basis for determining whether it is necessary to perform the two-step goodwill impairment test described in ASC Topic 350 “Intangibles—Goodwill and Other.” If it is determined that it is more likely than not that the fair

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Validus Holdings, Ltd.

Notes to Consolidated Financial Statements (Continued)

(Expressed in thousands of U.S. dollars, except share and per share information)

value of a reporting unit is less than its carrying amount, the two step goodwill impairment test should be performed as described below. The amendments were effective for annual and interim goodwill impairment tests performed for fiscal years beginning after December 15, 2011. Early adoption was permitted and the Company chose to early adopt. The first step identifies potential impairments by comparing the fair value of a reporting unit with its book value, including goodwill. Reporting units are consistent with the segmental basis. If the carrying value exceeds the fair value, the second step calculates the possible impairment loss by comparing the implied fair value of goodwill with the carrying amount. If the implied goodwill is less than the carrying amount, a write-down would be recorded. The measurement of fair values in reporting units is determined on a number of factors and assumptions including ranges of future discounted earnings, forecast revenue and operating expenses and effective tax rates.

In July 2012, the FASB issued Accounting Standards Update No. 2012-02, "Testing Indefinite-Lived Intangible Assets for Impairment" ("ASU 2012-02"). The objective of ASU 2012-02 is to simplify how entities test intangibles for impairment. The amendments permit an entity to first assess qualitative factors to determine whether it is more likely than not that an indefinite-lived intangible asset is impaired as a basis for determining whether it is necessary to perform the quantitative impairment described in ASC Topic 350 "Intangibles - Goodwill and Other - General Intangibles Other than Goodwill." The amendments are effective for annual and interim impairment tests performed for fiscal years beginning after September 15, 2012. Early adoption is permitted and the Company has chosen to early adopt.

If the goodwill or intangible asset is impaired, it is written down to its realizable value with a corresponding expense reflected in the Consolidated Statements of Comprehensive Income.

(p) Investments in affiliates

Investments in which the Company has significant influence over the operating and financial policies of the investee are accounted for under the equity method of accounting. Under this method, the Company records its proportionate share of income or loss from such investments in its results for the period.

(q) Variable interest entities ("VIE")

The Company accounts for its investment in the AlphaCat ILS funds as variable interest entities ("VIE") in accordance with FASB ASC Topic 810 "Consolidation." Entities that do not have sufficient equity at risk to allow the entity to finance its activities without additional financial support or in which the equity investors, as a group, do not have the characteristic of a controlling financial interest are referred to as variable interest entities. A VIE is consolidated by the variable interest holder that is determined to have the controlling financial interest (primary beneficiary). Refer to Note 8 "Investments in affiliates" for further details.

(r) Noncontrolling interest

The Company accounts for its noncontrolling interest in accordance with ASC Topic 810 "Consolidation." Accordingly, the noncontrolling shareholders' interest is presented separately in the Company's Consolidated Balance Sheets and Consolidated Statement of Shareholders' Equity. The net loss (income) attributable to noncontrolling interest is presented separately in the Company's Consolidated Statements of Comprehensive Income. Refer also to Note 9 "Noncontrolling interest."

4. Recent accounting pronouncements

(a) Recently Issued Accounting Standards Not Yet Adopted

In December 2011, the FASB issued Accounting Standards Update No. 2011-11, "Disclosures about Offsetting Assets and

Liabilities" ("ASU 2011-11"). The objective of ASU 2011-11 is to enhance disclosures by requiring improved information about financial instruments and derivative instruments in relation to netting arrangements. ASU 2011-11



is effective for interim and annual periods beginning on or after January 1, 2013. The adoption of this guidance is not expected to have a material impact on the Company's consolidated financial statements.

In October 2012, the FASB issued Accounting Standards Update No. 2012-04, "Technical Corrections and Improvements" ("ASU - 2012-04"). The objective of ASU 2012-04 is to clarify the Codification, correct unintended application of guidance, or make minor improvements to the Codification that are not expected to have a significant effect on current accounting

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Validus Holdings, Ltd.

Notes to Consolidated Financial Statements (Continued)

(Expressed in thousands of U.S. dollars, except share and per share information)

practice or create a significant administrative cost to most entities. Additionally, the amendments will make the Codification easier to understand and the fair value measurement guidance easier to apply by eliminating inconsistencies and providing needed clarifications. The amendments that will not have transition guidance will be effective upon issuance. For public entities, the amendments that are subject to the transition guidance will be effective for fiscal periods beginning after December 15, 2012. The adoption of this guidance is not expected to have a material impact on the Company's consolidated financial statements.

In January 2013, the FASB issued Accounting Standards Update No. 2013-01, "Clarifying the Scope of Disclosures about Offsetting Assets and Liabilities" ("ASU 2013-01"). The objective of ASU 2013-01 is to address implementation issues about the scope of ASU 2011-11, Disclosures about Offsetting Assets and Liabilities. The amendments clarify that the scope of ASU 2011-11 applies to derivatives, including bifurcated embedded derivatives, repurchase agreements and reverse repurchase agreements, and securities borrowing and securities lending transactions that are either or subject to an enforceable master netting arrangement or similar agreement. Entities with other types of financial assets and financial liabilities subject to a master netting arrangement or similar agreement also are affected because these amendments make them no longer subject to the disclosure requirements in ASU 2011-11. ASU 2013-01 is effective for interim and annual periods beginning on or after January 1, 2013. The Company is currently evaluating the impact of this guidance; however, since this update affects disclosures only, it is not expected to have a material impact on the Company's consolidated financial statements.

In February 2013, the FASB issued Accounting Standard Update No. 2013-02, "Reporting of Amounts Reclassified Out of Accumulated Other Comprehensive Income" ("ASU 2013-02"). The objective of this update is to improve the reporting of reclassifications out of accumulated other comprehensive income. The amendments do not change the current requirements for reporting net income or other comprehensive income in financial statements. However, the amendments require an entity to provide information about the amounts reclassified out of accumulated other comprehensive income by component. The amendments are effective prospectively for reporting periods beginning after December 15, 2012. Early adoption is permitted. The Company is currently evaluating the impact of this guidance; however, since this update affects disclosures only, it is not expected to have a material impact on the Company's consolidated financial statements.

5. Business combination

On November 30, 2012, pursuant to a merger agreement, the Company acquired all of the outstanding common shares of Flagstone in exchange for 0.1935 Company common shares and \$2.00 cash per Flagstone common share (the "Flagstone Acquisition"). The Flagstone Acquisition was undertaken to enhance the Company's leadership position in the property catastrophe reinsurance industry and to create a company with greater size and economies of scale. The aggregate purchase price paid by the Company was \$646,037 for adjusted tangible net assets acquired of \$689,742. Reduced investment yields and lower returns on equity have led to the majority of publicly traded reinsurance companies trading at discounts. This was the primary factor responsible for a purchase price less than the fair value of Flagstone's net assets, and the recognition of a bargain purchase gain on acquisition.

The estimates of fair values for tangible assets acquired and liabilities assumed were determined by management based on various market and income analyses and asset appraisals. Significant judgment was required to arrive at these estimates of fair value and changes to assumptions used could have led to materially different results.

In addition, at closing, the Company recorded a \$2,595 intangible asset for the acquired Flagstone customer relationships. This intangible asset was related to the acquired broker distribution network and was fair valued using a variation of the income approach. Under this approach, the Company estimated the present value of expected future cash flows to an assumed hypothetical market participant resulting from the existing Flagstone customer relationships, considering attrition, and discounting at a weighted average cost of capital. In addition, the Company also recorded a

\$3,402 intangible asset for the acquired Flagstone brand name.

The composition of the purchase price and the fair value of net assets acquired is summarized as follows:

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Validus Holdings, Ltd.

Notes to Consolidated Financial Statements (Continued)

(Expressed in thousands of U.S. dollars, except share and per share information)

Total allocable purchase price		
Flagstone shares outstanding at November 30, 2012	73,852,137	
Exchange ratio	0.1935	
Validus common shares issued, gross of taxes withheld	14,290,389	
Validus share price at acquisition	34.87	
Total value of Validus shares issued		498,306
Total cash consideration paid at \$2.00 per Flagstone share		147,731
Total allocable purchase price		646,037
Tangible assets acquired		
Cash and cash equivalents	159,339	
Investments	1,323,002	
Receivables (a)	171,620	
Other assets	129,245	
Tangible assets acquired		1,783,206
Liabilities acquired		
Net loss reserves and paid losses recoverable	639,641	
Unearned premiums, net of expenses	104,592	
Debentures payable	250,657	
Other liabilities	98,574	
Liabilities acquired		1,093,464
Net tangible assets acquired, at fair value		689,742
Bargain purchase gain before establishment of intangible assets		43,705
Intangible asset—customer relationships and brand name		5,997
Bargain purchase gain on acquisition of Flagstone		49,702

(a) Premiums receivable of \$171,620 are net of an allowance for doubtful accounts of \$2,216 and are expected to be fully recoverable.

The Company also incurred transaction and termination expenses related to the Flagstone Acquisition. Transaction expenses included legal and financial advisory services. Termination expenses are primarily comprised of severance costs in connection with certain Flagstone employment contracts that have been terminated. Finally, the customer relationships and brand name intangible assets have been fully amortized at the acquisition date as it was not expected to significantly contribute to the Company's future cash flows beyond December 31, 2012. The gain on bargain purchase, net of expenses has been presented as a separate line item in the Company's Consolidated Statements of Comprehensive Income, and is composed of the following:

	Year Ended	
	December 31, 2012	
Bargain purchase gain on acquisition of Flagstone	49,702	
Transaction expenses	(5,760	)
Termination expenses	(20,244	)
Amortization of intangible asset—customer relationships and brand name	(5,997	)
Gain on bargain purchase, net of expenses	17,701	

The following selected audited information has been provided to present a summary of the results of Flagstone since the acquisition date, that have been included within the Validus Re segment in the consolidated financial statements

for the year ended December 31, 2012.

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Validus Holdings, Ltd.

Notes to Consolidated Financial Statements (Continued)

(Expressed in thousands of U.S. dollars, except share and per share information)

	From Acquisition Date to December 31, 2012
Net premiums written	\$11,305
Total revenue	26,778
Total expenses	(17,061 )
Net income	\$9,717

Supplemental Pro Forma Information

Operating results of Flagstone have been included in the consolidated financial statements from the November 30, 2012 acquisition date. The following selected unaudited pro forma financial information has been provided to present a summary of the combined results of the Company and Flagstone, assuming the transaction had been effected on January 1, 2011. The unaudited pro forma data is for informational purposes only and does not necessarily represent results that would have occurred if the transaction had taken place on the basis assumed above.

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Validus Holdings, Ltd.

Notes to Consolidated Financial Statements (Continued)

(Expressed in thousands of U.S. dollars, except share and per share information)

	Year ended December 31, 2012 (unaudited)	Year ended December 31, 2011 (unaudited)	
Revenues			
Gross premiums written	\$2,536,535	\$2,914,388	
Reinsurance premiums ceded	(397,008	(520,506	)
Net premiums written	2,139,527	2,393,882	
Change in unearned premiums	86,935	(20,261	)
Net premiums earned	2,226,462	2,373,621	
Net investment income	126,140	143,472	
Net realized gains on investments	63,601	37,366	
Net unrealized gains (losses) on investments	5,654	(47,101	)
(Loss) from investment affiliate	(964	—	)
Other income	29,984	11,152	
Foreign exchange gains (losses)	1,363	(26,605	)
Total revenues	2,452,240	2,491,905	
Expenses			
Losses and loss expenses	1,242,449	1,920,936	
Policy acquisition costs	413,579	429,509	
General and administrative expenses	323,061	282,183	
Share compensation expenses	30,750	35,427	
Transaction expenses	—	17,433	
Finance expenses	64,306	66,485	
Total expenses	2,074,145	2,751,973	
Net income before taxes and income from operating affiliates	378,095	(260,068	)
Tax (expense)	(3,385	(773	)
Income (loss) from operating affiliates	12,868	(922	)
Net income (loss) from continuing operations	387,578	(261,763	)
Net income (loss) from discontinued operations, net of taxes	19,366	(21,662	)
Net income (loss)	406,944	(283,425	)
Net loss (income) attributable to noncontrolling interest	14,685	(24,515	)
Net income (loss) available (attributable) to Validus	421,629	(307,940	)
Basic earnings per share	\$3.73	\$(3.20	)
Diluted earnings per share	\$3.62	\$(3.20	)

## 6. Goodwill and other intangible assets

Following the Flagstone Acquisition on November 30, 2012, the Company recorded intangible assets (including certain amortization thereon) and a gain on bargain purchase, net of expenses. Intangible assets of \$5,997 were recognized as a result of the Flagstone Acquisition (relating to customer relationships and brand name). As of December 31, 2012, the customer relationships and brand name intangible asset have been fully amortized as it was

not expected to significantly contribute to the Company's future cash flows beyond December 31, 2012.

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Validus Holdings, Ltd.

Notes to Consolidated Financial Statements (Continued)

(Expressed in thousands of U.S. dollars, except share and per share information)

Following the acquisition of Talbot Holdings Ltd. on July 2, 2007, the Company recorded intangible assets in the name of Syndicate Capacity, Trademark and Distribution Network (including certain amortization thereon) and goodwill. Syndicate Capacity represents Talbot's authorized premium income limit to write insurance business in the Lloyd's market. Talbot has owned 100% of Syndicate 1183's capacity since 2002 and there are no third party tenure rights. The capacity is renewed annually at no cost to Talbot, but may be freely purchased or sold, subject to Lloyd's approval. The ability to write insurance business under the syndicate capacity is indefinite with the premium income limit being set yearly by Talbot, subject to Lloyd's approval. Trademark and Distribution Network are estimated to have finite useful economic lives of 10 years and are amortized on a straight line basis over such periods. Syndicate Capacity and goodwill are estimated to have indefinite useful lives. Goodwill includes amounts related to the value of the workforce. The goodwill and intangibles are recorded entirely in the Company's Talbot segment.

The following table shows an analysis of goodwill and other intangible assets included in the Talbot segment:

	Goodwill	Intangible assets with an indefinite life	Intangible assets with a finite life	Total
Gross balance at December 31, 2012	\$20,393	\$91,843	\$41,616	\$153,852
Accumulated amortization	—	—	(22,890)	(22,890)
Net balance at December 31, 2012	\$20,393	\$91,843	\$18,726	\$130,962
Gross balance at December 31, 2011	\$20,393	\$91,843	\$41,616	\$153,852
Accumulated amortization	—	—	(18,728)	(18,728)
Net balance at December 31, 2011	\$20,393	\$91,843	\$22,888	\$135,124
Gross balance at December 31, 2010	\$20,393	\$91,843	\$41,616	\$153,852
Accumulated amortization	—	—	(14,566)	(14,566)
Net balance at December 31, 2010	\$20,393	\$91,843	\$27,050	\$139,286

The estimated remaining amortization expense for the Trademark and Distribution Network is as follows:

2013	\$4,162
2014	4,162
2015	4,162
2016	4,162
2017 and thereafter	2,078
	\$18,726

As described in "Significant accounting policies", the annual impairment test was performed. Neither goodwill nor the indefinite-lived intangible assets were deemed to be impaired.

## 7. Investments

The Company's investments in fixed maturities, short-term investments and other investments are classified as trading and carried at fair value, with related net unrealized gains or losses included in earnings. The Company has adopted all authoritative guidance in effect as of the balance sheet date regarding certain market conditions that allow for fair value measurements that incorporate unobservable inputs where active market transaction based measurements are unavailable.

## (a) Classification within the fair value hierarchy

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

input that is significant to the fair value measurement in its entirety.

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Validus Holdings, Ltd.

Notes to Consolidated Financial Statements (Continued)

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Level 1 inputs are quoted prices (unadjusted) in active markets for identical assets or liabilities that the reporting entity has the ability to access at the measurement date. Level 2 inputs are inputs other than quoted prices within Level 1 that are observable for the asset or liability, either directly or indirectly. A significant adjustment to a Level 2 input could result in the Level 2 measurement becoming a Level 3 measurement. Level 3 inputs are unobservable inputs for the asset or liability.

Level 1 primarily consists of financial instruments whose value is based on quoted market prices or alternative indices including overnight repos and commercial paper.

Level 2 includes financial instruments that are valued through independent external sources using models or other valuation methodologies. These models are primarily industry-standard models that consider various assumptions, including time value, yield curve, prepayment speeds, default rates, loss severity, current market and contractual prices for the underlying financial instruments, as well as other relevant economic measures. Substantially all of these assumptions are observable in the marketplace, can be derived from observable data or are supported by observable levels at which transactions are executed in the marketplace. The Company performs internal procedures on the valuations received from independent external sources. Investments in U.S. and Non-U.S. government/agency securities, corporate bonds, mortgage backed securities, bank loans, municipal bonds and asset-backed securities are classified as Level 2 in the fair value hierarchy. The fair value of these securities is derived from index providers, pricing vendors and broker quotations based on inputs that are observable for the asset such as reported trades, bids, offers, benchmark yields and broker-dealer quotes. Catastrophe bonds are classified as Level 2 in the fair value hierarchy as determined by reference to direct dealer quotations. Those indications are based on current market conditions, including liquidity and transactional history, recent issue price of similar catastrophe bonds and seasonality of the underlying risks.

Level 3 includes financial instruments that are valued using market approach and income approach valuation techniques. These models incorporate both observable and unobservable inputs. The Company's hedge funds, a fund of hedge funds and private equity investments are the only financial instruments in this category as at December 31, 2012. For each respective hedge fund investment, the Company obtains and reviews the valuation methodology used by the fund administrators and investment managers to ensure that the hedge fund investments are following fair value principles consistent with U.S. GAAP in determining the net asset value ("NAV").

Other investments consist of hedge funds, a fund of hedge funds, private equity investments and a deferred compensation trust held in mutual funds. The hedge funds were valued at \$538,526 at December 31, 2012. The hedge funds consist of an investment in four Paulson & Co. managed funds and three investment funds assumed from the Flagstone Acquisition. The Paulson & Co. Inc. funds' administrator provides monthly reported NAVs with a one-month delay in its valuation. As a result, the funds' administrator's November 30, 2012 NAV was used as a partial basis for fair value measurement in the Company's December 31, 2012 balance sheet. The fund manager provides an estimate of the NAV at December 31, 2012 based on estimated performance. The Company adjusts fair value to the fund manager's estimated NAV that incorporates relevant valuation sources on a timely basis. As this valuation technique incorporates both observable and significant unobservable inputs, the fund is classified as a Level 3 asset. To determine the reasonableness of the estimated NAV, the Company assesses the variance between the fund manager's estimated NAV and the fund administrator's NAV. Material variances are recorded in the current reporting period while immaterial variances are recorded in the following reporting period. These managed hedge funds are subject to quarterly liquidity.

The Flagstone investment funds and private equity investments' monthly reported NAV is provided with a one-month or one-quarter delay in its valuation. As a result, the November 30, 2012 NAV or the September 30, 2012 NAV was used as a basis for fair value measurement in the Company's December 31, 2012 balance sheet. As this valuation technique incorporates both observable and significant unobservable inputs, the investments funds and private equity

investments are classified as Level 3 assets.

The fund of hedge funds is a side pocket valued at \$4,056 at December 31, 2012. While a redemption request has been submitted, the timing of receipt of proceeds on the side pocket is unknown. The fund's administrator provides a monthly reported NAV with a one-month delay in its valuation. As a result, the fund administrator's November 30, 2012 NAV was used as a basis for fair value measurement in the Company's December 31, 2012 balance sheet. The fund manager provides an estimate of the fund NAV at December 31, 2012 based on the estimated performance provided from the underlying third-party funds. To determine the reasonableness of the NAV, the Company compares the one-month delayed fund administrator's NAV to the fund manager's estimated NAV that incorporates relevant valuation sources on a timely basis. Material variances are recorded in the current reporting period while immaterial variances are recorded in the following reporting period. As this valuation technique incorporates both observable and significant unobservable inputs, the fund of hedge funds is classified as a Level 3 asset.

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At December 31, 2012, the Company's investments were allocated between Levels 1, 2 and 3 as follows:

	Level 1	Level 2	Level 3	Total
U.S. Government and Government Agency	\$—	\$1,099,230	\$—	\$1,099,230
Non-U.S. Government and Government Agency	—	302,279	—	302,279
States, municipalities, political subdivision	—	42,063	—	42,063
Agency residential mortgage-backed securities	—	388,874	—	388,874
Non-Agency residential mortgage-backed securities	—	106,456	—	106,456
U.S. corporate	—	1,210,173	—	1,210,173
Non-U.S. corporate	—	593,265	—	593,265
Bank loans	—	673,383	—	673,383
Catastrophe bonds	—	56,947	—	56,947
Asset-backed securities	—	612,664	—	612,664
Total fixed maturities	—	5,085,334	—	5,085,334
Short-term investments	1,063,175	51,075	—	1,114,250
Fund of hedge funds	—	—	4,757	4,757
Private equity investments	—	—	12,951	12,951
Hedge funds (a)	—	—	538,526	538,526
Mutual funds	—	8,214	—	8,214
Total	\$1,063,175	\$5,144,623	\$556,234	\$6,764,032
Noncontrolling interest (a)	—	—	(432,737)	(432,737)
Total investments excluding noncontrolling interest	\$1,063,175	\$5,144,623	\$123,497	\$6,331,295

(a) The Company has an equity interest of 10% in PaCRE, the remaining 90% interest is held by third party investors.

At December 31, 2011, the Company's investments were allocated between Levels 1, 2 and 3 as follows:

	Level 1	Level 2	Level 3	Total
U.S. Government and Government Agency	\$—	\$1,182,393	\$—	\$1,182,393
Non-U.S. Government and Government Agency	—	449,358	—	449,358
States, municipalities, political subdivision	—	26,291	—	26,291
Agency residential mortgage-backed securities	—	468,054	—	468,054
Non-Agency residential mortgage-backed securities	—	32,706	—	32,706
U.S. corporate	—	1,329,758	—	1,329,758
Non-U.S. corporate	—	579,675	—	579,675
Bank loans	—	467,256	—	467,256
Catastrophe bonds	—	29,952	—	29,952
Asset-backed securities	—	328,299	—	328,299
Commercial mortgage-backed securities	—	403	—	403
Total fixed maturities	—	4,894,145	—	4,894,145
Short-term investments	257,854	22,337	—	280,191
Fund of hedge funds	—	—	5,627	5,627
Private equity investment	—	—	3,253	3,253
Mutual funds	—	7,907	—	7,907
Total	\$257,854	\$4,924,389	\$8,880	\$5,191,123

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Validus Holdings, Ltd.

Notes to Consolidated Financial Statements (Continued)

(Expressed in thousands of U.S. dollars, except share and per share information)

At December 31, 2012, Level 3 investments excluding the noncontrolling interest totaled \$123,497, representing 2.0% of total investments, excluding noncontrolling interest, measured at fair value on a recurring basis. At December 31, 2011, Level 3 investments totaled \$8,880 representing 0.2% of total investments measured at fair value on a recurring basis.

The following tables present a reconciliation of the beginning and ending balances for all investments measured at fair value on a recurring basis using Level 3 inputs during the years ending December 31, 2012 and 2011:

	Year Ended December 31, 2012		
	Fixed Maturity Investments	Other Investments	Total Fair Market Value
Level 3 investments—Beginning of period	\$—	\$ 8,880	\$ 8,880
Purchases (a)	—	572,287	572,287
Sales	—	(1,682	) (1,682
Issuances	—	—	—
Settlements	—	—	—
Realized gains	—	100	100
Unrealized (losses)	—	(21,018	) (21,018
Amortization	—	—	—
Transfers	—	(2,333	) (2,333
Level 3 investments—End of period	\$—	\$ 556,234	\$ 556,234
Noncontrolling interest (b)	—	(432,737	) (432,737
Level 3 investments excluding noncontrolling interest	\$—	\$ 123,497	\$ 123,497

(a) Includes \$70,657 assumed from the Flagstone Acquisition.

	Year Ended December 31, 2011		
	Fixed Maturity Investments	Other Investments	Total Fair Market Value
Level 3 investments—Beginning of period	\$—	\$ 12,892	\$ 12,892
Purchases	—	3,253	3,253
Sales	—	(7,220	) (7,220
Issuances	—	—	—
Settlements	—	—	—
Realized gains	—	697	697
Unrealized (losses)	—	(742	) (742
Amortization	—	—	—
Transfers	—	—	—
Level 3 investments—End of period	\$—	\$ 8,880	\$ 8,880

(b) The Company has an equity interest of 10% in PaCRe, the remaining 90% interest is held by third party investors.

There have not been any transfers between Levels 1 and 2 during the year ended December 31, 2012. During the year ended December 31, 2012, there was a transfer of an investment into Level 3 of the fair value hierarchy. This transfer was due to the conversion of a bank loan to another investment. There was also a transfer of the private equity investment out of Level 3 “Other investments” to “Investments in affiliates” during the year ended December 31, 2012. Refer to Note 8 “Investments in affiliates.”

(c) Net investment income

Net investment income was derived from the following sources:



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Validus Holdings, Ltd.

Notes to Consolidated Financial Statements (Continued)

(Expressed in thousands of U.S. dollars, except share and per share information)

	Year Ended		
	December 31, 2012	December 31, 2011	December 31, 2010
Fixed maturities and short-term investments	\$105,937	\$111,983	\$132,669
Other investments	2,790	—	—
Cash and cash equivalents	7,259	7,285	8,180
Securities lending income	14	58	200
Total gross investment income	116,000	119,326	141,049
Investment expenses	(8,064 )	(7,030 )	(6,946 )
Net investment income	\$107,936	\$112,296	\$134,103

(c) Fixed maturity, short-term and other investments

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

	Year Ended		
	December 31, 2012	December 31, 2011	December 31, 2010
Fixed maturities, short-term and other investments and cash equivalents			
Gross realized gains	\$38,905	\$45,026	\$76,920
Gross realized (losses)	(20,672 )	(16,494 )	(44,422 )
Net realized gains on investments	18,233	28,532	32,498
Net unrealized gains (losses) on securities lending	260	39	(1,009 )
Change in net unrealized gains (losses) on investments	17,325	(20,030 )	46,961
Total net realized gains and change in net unrealized gains (losses) on investments	\$35,818	\$8,541	\$78,450
Noncontrolling interest (a)	(17,263 )	—	—
Total net realized gains and change in net unrealized gains (losses) on investments excluding noncontrolling interest	\$18,555	\$8,541	\$78,450

(a) The Company has an equity interest of 10% in PaCRe, the remaining 90% interest is held by third party investors. The amortized cost, gross unrealized gains and (losses) and estimated fair value of investments at December 31, 2012 were as follows:



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Validus Holdings, Ltd.

Notes to Consolidated Financial Statements (Continued)

(Expressed in thousands of U.S. dollars, except share and per share information)

	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Estimated Fair Value
U.S. Government and Government Agency	\$ 1,091,357	\$ 7,957	\$(84	) \$ 1,099,230
Non-U.S. Government and Government Agency	295,602	6,904	(227	) 302,279
States, municipalities, political subdivision	41,286	800	(23	) 42,063
Agency residential mortgage-backed securities	375,368	13,708	(202	) 388,874
Non-Agency residential mortgage-backed securities	106,536	1,266	(1,346	) 106,456
U.S. corporate	1,189,173	21,681	(681	) 1,210,173
Non-U.S. corporate	582,115	11,373	(223	) 593,265
Bank loans	663,217	10,593	(427	) 673,383
Catastrophe bonds	56,757	481	(291	) 56,947
Asset-backed securities	607,103	5,767	(206	) 612,664
Commercial mortgage-backed securities	—	—	—	—
Total fixed maturities	5,008,514	80,530	(3,710	) 5,085,334
Total short-term investments	1,112,929	1,349	(28	) 1,114,250
Other investments				
Fund of hedge funds	4,677	299	(219	) 4,757
Hedge funds (a)	559,335	21,814	(42,623	) 538,526
Private equity investments	12,857	94	—	12,951
Mutual funds	6,199	2,015	—	8,214
Total other investments	583,068	24,222	(42,842	) 564,448
Total	\$ 6,704,511	\$ 106,101	\$(46,580	) \$ 6,764,032
Noncontrolling interest (a)	\$(450,000	) \$(19,427	) \$36,690	\$(432,737
Total investments excluding noncontrolling interest	\$ 6,254,511	\$ 86,674	\$(9,890	) \$ 6,331,295

(a) The Company has an equity interest of 10% in PaCRe, the remaining 90% interest is held by third party investors. The amortized cost, gross unrealized gains and (losses) and estimated fair value of investments at December 31, 2011 were as follows:

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Validus Holdings, Ltd.

Notes to Consolidated Financial Statements (Continued)

(Expressed in thousands of U.S. dollars, except share and per share information)

	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Estimated Fair Value
U.S. Government and Government Agency	\$ 1,170,810	\$ 11,630	\$(47)	) \$ 1,182,393
Non-U.S. Government and Government Agency	446,258	9,173	(6,073)	) 449,358
States, municipalities, political subdivision	25,715	586	(10)	) 26,291
Agency residential mortgage-backed securities	451,751	16,622	(319)	) 468,054
Non-Agency residential mortgage-backed securities	39,134	143	(6,571)	) 32,706
U.S. corporate	1,314,375	24,932	(9,549)	) 1,329,758
Non-U.S. corporate	577,743	6,320	(4,388)	) 579,675
Bank loans	475,770	2,435	(10,949)	) 467,256
Catastrophe bonds	29,250	702	—	29,952
Asset-backed securities	328,497	900	(1,098)	) 328,299
Commercial mortgage-backed securities	402	1	—	403
Total fixed maturities	4,859,705	73,444	(39,004)	) 4,894,145
Total short-term investments	280,299	1	(109)	) 280,191
Other investments				
Fund of hedge funds	5,244	383	—	5,627
Private equity investment	3,253	—	—	3,253
Mutual funds	6,505	1,402	—	7,907
Total other investments	15,002	1,785	—	16,787
Total	\$ 5,155,006	\$ 75,230	\$(39,113)	) \$ 5,191,123

The following table sets forth certain information regarding the investment ratings of the Company's fixed maturities portfolio as at December 31, 2012 and 2011. Investment ratings are the lower of Moody's or Standard & Poor's rating for each investment security, presented in Standard & Poor's equivalent rating. For investments where Moody's and Standard & Poor's ratings are not available, Fitch ratings are used and presented in Standard & Poor's equivalent rating.

	December 31, 2012		December 31, 2011		
	Estimated Fair Value	% of Total	Estimated Fair Value	% of Total	
AAA	\$ 1,062,794	20.9	% \$ 882,912	18.0	%
AA	1,862,322	36.6	% 2,077,981	42.5	%
A	1,049,969	20.6	% 1,078,793	22.0	%
BBB	374,447	7.4	% 345,091	7.1	%
Investment grade	4,349,532	85.5	% 4,384,777	89.6	%
BB	373,907	7.4	% 254,409	5.2	%
B	330,416	6.5	% 231,420	4.7	%
CCC	4,483	0.1	% 12,578	0.3	%
CC	3,259	0.1	% 4,605	0.1	%
D/NR	23,737	0.4	% 6,356	0.1	%
Non-Investment grade	735,802	14.5	% 509,368	10.4	%
Total Fixed Maturities	\$ 5,085,334	100.0	% \$ 4,894,145	100.0	%



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Validus Holdings, Ltd.

Notes to Consolidated Financial Statements (Continued)

(Expressed in thousands of U.S. dollars, except share and per share information)

The amortized cost and estimated fair value amounts for fixed maturity securities held at December 31, 2012 and 2011 are shown below by contractual maturity. Actual maturity may differ from contractual maturity because certain borrowers may have the right to call or prepay certain obligations with or without call or prepayment penalties.

	December 31, 2012		December 31, 2011	
	Amortized Cost	Estimated Fair Value	Amortized Cost	Estimated Fair Value
Due in one year or less	\$526,529	\$530,499	\$520,631	\$523,107
Due after one year through five years	2,971,118	3,018,544	3,160,647	3,186,711
Due after five years through ten years	418,377	424,304	350,459	346,654
Due after ten years	3,483	3,993	8,184	8,211
	3,919,507	3,977,340	4,039,921	4,064,683
Asset-backed and mortgage-backed securities	1,089,007	1,107,994	819,784	829,462
Total	\$5,008,514	\$5,085,334	\$4,859,705	\$4,894,145

The Company has a four-year, \$525,000 secured letter of credit facility provided by a syndicate of commercial banks (the "Four Year Facility"). At December 31, 2012, approximately \$376,570 (December 31, 2011: \$nil) of letters of credit were issued and outstanding under this facility for which \$517,210 of investments were pledged as collateral (December 31, 2011: \$nil). In 2007, the Company entered into a \$100,000 standby letter of credit facility which provides Funds at Lloyd's (the "Talbot FAL Facility"). On November 19, 2009, the Company entered into a Second Amendment to the Talbot FAL Facility to reduce the commitment from \$100,000 to \$25,000. At December 31, 2012, \$25,000 (December 31, 2011: \$25,000) of letters of credit were issued and outstanding under the Talbot FAL Facility for which \$41,372 of investments were pledged as collateral (December 31, 2011: \$44,623). In addition, \$2,139,068 of investments were held in trust at December 31, 2012 (December 31, 2011: \$2,129,570). Of those, \$1,901,468 were held in trust for the benefit of Talbot's cedants and policyholders, and to facilitate the accreditation of Talbot as an alien insurer/reinsurer by certain regulators (December 31, 2011: \$1,686,586). In 2009, the Company entered into a \$500,000 secured letter of credit facility provided by Citibank Europe plc (the "Secured Bi-Lateral Letter of Credit Facility"). At December 31, 2012 approximately \$92,402 (December 31, 2011: \$nil) letters of credit were issued and outstanding under this facility for which \$125,991 of investments were pledged as collateral (December 31, 2011: \$nil).

The Company assumed two letters of credit facilities as part of the acquisition of IPC Holdings, Ltd. (the "IPC Acquisition"). A Credit Facility between IPC, IPCRe Limited, the Lenders party thereto and Wachovia Bank, National Association (the "IPC Syndicated Facility") and a Letters of Credit Master Agreement between Citibank N.A. and IPCRe Limited (the "IPC Bi-Lateral Facility"). At March 31, 2010, the IPC Syndicated Facility was closed. At December 31, 2012, the IPC Bi-Lateral Facility had \$40,613 (December 31, 2011: \$57,146) letters of credit issued and outstanding for which \$98,593 (December 31, 2011: \$105,428) of investments were held in an associated collateral account.

As part of the acquisition of Flagstone, the Company assumed a Letters of Credit Master Agreement between Citibank Europe Plc and Flagstone Reassurance Suisse, S.A. (the "Flagstone Bi-Lateral Facility"). At December 31, 2012, the Flagstone Bi-Lateral Facility had \$381,019 (December 31, 2011: \$nil) letters of credit issued and outstanding for which \$416,414 (December 31, 2011: \$nil) of investments were held in an associated collateral account.

(d) Securities lending

The Company participates in a securities lending program whereby certain securities from its portfolio are loaned to third parties for short periods of time through a lending agent. The Company retains all economic interest in the securities it lends and receives a fee from the borrower for the temporary use of the securities. Collateral in the form of cash, government securities and letters of credit is required at a rate of 102% of the market value of the loaned securities and is held by a third party. As at December 31, 2012, the Company had \$678 (December 31, 2011: \$8,286)

in securities on loan. During the year ended December 31, 2012, the Company recorded a \$260 unrealized gain on this collateral on its Statements of Comprehensive Income (December 31, 2011: unrealized gain \$39; December 31, 2010: unrealized loss \$(1,009)).

Securities lending collateral reinvested includes corporate floating rate securities and overnight repos with an average reset period of 2.0 days (December 31, 2011: 3.9 days). As at December 31, 2012, the securities lending collateral reinvested by the Company in connection with its securities lending program was allocated between Levels 1, 2 and 3 as follows:

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Validus Holdings, Ltd.

Notes to Consolidated Financial Statements (Continued)

(Expressed in thousands of U.S. dollars, except share and per share information)

	Level 1	Level 2	Level 3	Total
Cash and cash equivalents	\$225	—	—	\$225
Total	\$225	\$—	\$—	\$225

As at December 31, 2011, the securities lending collateral reinvested by the Company in connection with its securities lending program was allocated between Levels 1, 2 and 3 as follows:

	Level 1	Level 2	Level 3	Total
Corporate	\$—	\$255	\$—	\$255
Cash and cash equivalents	7,481	—	—	7,481
Total	\$7,481	\$255	\$—	\$7,736

The following table sets forth certain information regarding the investment ratings of the Company's securities lending collateral reinvested as at December 31, 2012 and 2011. Investment ratings are the lower of Moody's or Standard & Poor's rating for each investment security, presented in Standard & Poor's equivalent rating. For investments where Moody's and Standard & Poor's ratings are not available, Fitch ratings are used and presented in Standard & Poor's equivalent rating.

	December 31, 2012		December 31, 2011		
	Estimated Fair Value	% of Total	Estimated Fair Value	% of Total	
NR	\$—	0.0	% \$255	3.3	%
NR – Short-term investments(a)	225	100.0	% 7,481	96.7	%
Total	\$225	100.0	% \$7,736	100.0	%

(a) This amount relates to certain short-term investments with short original maturities which are generally not rated. The amortized cost and estimated fair value amounts for securities lending collateral reinvested by the Company at December 31, 2012 and 2011 are shown by contractual maturity below. Actual maturity may differ from contractual maturity because certain borrowers may have the right to call or prepay certain obligations with or without call or prepayment penalties.

	December 31, 2012		December 31, 2011	
	Amortized Cost	Estimated Fair Value	Amortized Cost	Estimated Fair Value
Due in one year or less	\$691	\$225	\$7,462	\$7,481
Due after one year through five years	—	—	1,000	255
Total	\$691	\$225	\$8,462	\$7,736

## 8. Investments in affiliates

## (a) Operating affiliates

## AlphaCat Re 2011, Ltd.

On May 25, 2011, the Company joined with other investors in capitalizing AlphaCat Re 2011, Ltd. ("AlphaCat Re 2011"), a special purpose reinsurer formed for the purpose of writing collateralized reinsurance and retrocessional reinsurance. At the time of formation, Validus Re had a majority voting equity interest in AlphaCat Re 2011 and as a result the financial statements of AlphaCat Re 2011 were included in the consolidated financial statements of the Company.

On December 23, 2011, AlphaCat Re 2011 completed a secondary offering of its common shares to third party investors, along with a partial sale of Validus Re's common shares to one of the third party investors.

As a result of these transactions, Validus Re Consolidated maintained an equity interest in AlphaCat Re 2011, however its share of AlphaCat Re 2011's outstanding voting rights decreased to 43.7%. As a result of the Company's

voting interest falling below 50%, the individual assets and liabilities and corresponding noncontrolling interest of AlphaCat Re 2011 were derecognized

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Validus Holdings, Ltd.

Notes to Consolidated Financial Statements (Continued)

(Expressed in thousands of U.S. dollars, except share and per share information)

from the consolidated balance sheet of the Company as at December 31, 2011 and the remaining investment in AlphaCat Re 2011 has been treated as an equity method investment effective December 31, 2011. The portion of AlphaCat Re 2011's earnings attributable to third party investors for the year ended December 31, 2011 were recorded in the Consolidated Statements of Comprehensive Income as net income attributable to noncontrolling interest.

AlphaCat Re 2012, Ltd.

On May 29, 2012, the Company joined with other investors in capitalizing AlphaCat Re 2012, Ltd. ("AlphaCat Re 2012"), a special purpose reinsurer formed for the purpose of writing collateralized reinsurance with a particular focus on windstorm risks for Florida domiciled insurance companies. The Company holds an equity interest of 37.9% and a voting interest of 49.0% in AlphaCat Re 2012, therefore the investment has been treated as an equity method investment as at December 31, 2012.

AlphaCat 2013, Ltd.

On December 17, 2012, the Company joined with other investors in capitalizing AlphaCat 2013, Ltd. ("AlphaCat 2013"), a new special purpose vehicle formed for the purpose of investing in collateralized reinsurance. The Company holds an equity interest of 18.9% and a voting interest of 40.9% in AlphaCat 2013, therefore the investment has been treated as an equity method investment as at December 31, 2012.

The following table presents a reconciliation of the beginning and ending investment in operating affiliate balances for the year ended December 31, 2012:

	Year Ended December 31, 2012			
	Investment in operating affiliate (AlphaCat Re 2011)	Investment in operating affiliate (AlphaCat Re 2012)	Investment in operating affiliate (AlphaCat 2013)	Total
As at December 31, 2011	\$53,031	\$—	\$—	\$53,031
Purchase of shares	—	26,500	45,000	71,500
Income from operating affiliates	9,761	2,819	—	12,580
As at December 31, 2012	\$62,792	\$29,319	\$45,000	\$137,111

The following table presents the Company's investments in AlphaCat Re 2011, AlphaCat Re 2012 and AlphaCat 2013, as at December 31, 2012:

	Investment in operating affiliates				
	Investment at cost	Voting ownership %	Equity ownership %	Carrying value	
AlphaCat Re 2011	\$41,389	43.7	% 22.3	% \$62,792	
AlphaCat Re 2012	\$26,500	49.0	% 37.9	% \$29,319	
AlphaCat 2013	\$45,000	40.9	% 18.9	% \$45,000	
Total	\$112,889			\$137,111	

The following table presents certain summarized financial information of the investees as a whole at December 31, 2012 and for the year ended:

	Combined investees summarized financial data			
	Total assets	Total liabilities	Total revenue	Net income
AlphaCat Re 2011	\$366,697	\$47,345	\$104,031	\$43,852
AlphaCat Re 2012	\$98,596	\$21,586	\$19,496	\$7,445
AlphaCat 2013	\$228,144	\$—	\$—	\$—





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Validus Holdings, Ltd.

Notes to Consolidated Financial Statements (Continued)

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## (b) Investment in Insurance Linked Securities ("ILS")

The Company received \$219,400 of third party subscriptions in the AlphaCat ILS funds as of December 31, 2012. The AlphaCat ILS funds invest in instruments with returns linked to property catastrophe reinsurance, retrocession and ILS contracts. Two of the funds are variable interest entities and are consolidated by the Company as Validus Re is deemed to be the primary beneficiary. The other fund is also a variable interest entity, however, it is not consolidated by the Company as Validus Re is not deemed to be the primary beneficiary. As a result, the investment in this fund is included in "Investments in affiliates" as at December 31, 2012. The Company's investment in this fund amounted to \$20,000 as at December 31, 2012. The Company's maximum exposure to loss with respect to this investment is limited to the investment carrying amount reported in the Company's Consolidated Balance Sheet.

## (c) Investment affiliate

Aquiline Financial Services Fund II L.P.

On December 20, 2011, Validus Re Consolidated entered into an Assignment and Assumption Agreement (the "Agreement") with Aquiline Capital Partners LLC, a Delaware limited liability company (the "Assignor") and Aquiline Capital Partners II GP (Offshore) Ltd., a Cayman Islands company limited by shares (the "General Partner") pursuant to which Validus Re Consolidated has assumed 100% of the Assignor's interest in Aquiline Financial Services Fund II L.P. (the "Partnership") representing a total capital commitment of \$50,000 (the "Commitment"), as a limited partner in the Partnership (the "Transferred Interest"). The Transferred Interest is governed by the terms of an Amended and Restated Exempted Limited Partnership Agreement dated as of July 2, 2010 (the "Limited Partnership Agreement"). Pursuant to the terms of the Limited Partnership Agreement, the Commitment will expire on July 2, 2015.

The private equity limited partnership provides quarterly capital account statements with a three-month delay in its valuation. As a result, the limited partnership's September 30, 2012 capital account statement was used as a basis for calculation of the Company's share of partnership income for the year.

The following table presents a reconciliation of the beginning and ending investment in the Company's investment affiliate balance for the year ended December 31, 2012:

	Year Ended December 31, 2012
	Investment in limited partnership (Aquiline Financial Services Fund II L.P.)(a)
As at December 31, 2011	\$ 3,253
Capital contributions	14,365
Net unrealized loss on investments (a)	(1,436 )
Loss from investment affiliate	(964 )
As at December 31, 2012	\$ 15,218

(a) As at December 31, 2011, this investment was included in "Other investments" as a Level 3 investment in the fair value hierarchy, hence the change in fair value was included in net unrealized (losses) gains on investments.

The following table presents the Company's investment in investment affiliate as at December 31, 2012:

	Investment in investment affiliate			
	Investment at cost	Voting ownership %	Equity ownership %	Carrying value
Aquiline Financial Services Fund II L.P.	\$ 17,618	—	% 6.7	% \$ 15,218

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Validus Holdings, Ltd.

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## 9. Noncontrolling interest

On April 2, 2012, the Company joined with other investors in capitalizing PaCRE, Ltd. (“PaCRE”), a new Class 4 Bermuda reinsurer formed for the purpose of writing high excess property catastrophe reinsurance. Validus Re has a majority voting equity interest in PaCRE and as a result, the financial statements of PaCRE are included in the consolidated financial statements of the Company. The portion of PaCRE’s earnings attributable to third party investors for the year ended December 31, 2012 is recorded in the Consolidated Statements of Comprehensive Income as net loss (income) attributable to noncontrolling interest.

The following table presents a reconciliation of the beginning and ending balances of noncontrolling interest for the year ended December 31, 2012:

	Noncontrolling interest - PaCRE
Balance—December 31, 2011	\$—
Purchase of shares by noncontrolling interest	450,100
Net (loss) attributable to noncontrolling interest	(15,820 )
Balance—December 31, 2012	\$434,280

## 10. Derivative instruments used in hedging activities

The Company enters into derivative instruments for risk management purposes, specifically to hedge unmatched foreign currency exposures and interest rate exposures. As at December 31, 2012, the Company held a foreign currency forward contract to mitigate the risk of foreign currency exposure of unpaid losses denominated in Chilean Pesos (CLP) as well as foreign currency forward contracts to mitigate the risk of fluctuations in the Euro to U.S. dollar exchange rates. As at December 31, 2012, the Company held two interest rate swap contracts to mitigate the risk of interest rate exposure on the payment of interest on the Company's 2006 and 2007 Junior Subordinated Deferrable Debentures.

As part of the Flagstone Acquisition, the Company assumed currency swaps and foreign currency forward contracts which are not designated as hedging instruments.

The following table summarizes information on the location and amount of the derivative fair value on the consolidated balance sheet at December 31, 2012:

Derivatives designated as hedging instruments:	Net notional exposure	Asset derivatives		Liability derivatives	
		Balance Sheet location	Fair value	Balance Sheet location	Fair value
Foreign currency forward contracts	\$35,976	Other assets	\$—	Accounts payable and accrued expenses	\$223
Interest rate swap contracts	\$289,800	Other assets	\$—	Accounts payable and accrued expenses	\$220
Derivatives not designated as hedging instruments:	Net notional exposure	Asset derivatives		Liability derivatives	
		Balance Sheet location	Fair value	Balance Sheet location	Fair value
Currency swaps	\$17,153	Other assets	\$—	Accounts payable and accrued expenses	\$772
	\$310,541	Other assets	\$—		\$394

Foreign currency  
forward contracts

Accounts payable and  
accrued expenses

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Validus Holdings, Ltd.

Notes to Consolidated Financial Statements (Continued)

(Expressed in thousands of U.S. dollars, except share and per share information)

The following table summarizes information on the location and amount of the derivative fair value on the consolidated balance sheet at December 31, 2011:

Derivatives designated as hedging instruments:	Net notional exposure	Asset derivatives		Liability derivatives	
		Balance Sheet location	Fair value	Balance Sheet location	Fair value
Foreign currency forward contracts	\$75,323	Other assets	\$476	Accounts payable and accrued expenses	\$—

## (a) Classification within the fair value hierarchy

As described in Note 7 "Investments," under U.S. GAAP, a company must determine the appropriate level in the fair value

hierarchy for each fair value measurement. The assumptions used within the valuation are observable in the marketplace, can be derived from observable data or are supported by observable levels at which transactions are executed in the marketplace. Accordingly, these derivatives were classified within Level 2 of the fair value hierarchy.

## (b) Derivative instruments designated as a fair value hedge

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

The following table provides the total impact on earnings relating to the derivative instruments formally designated as fair value hedges along with the impact of the related hedged items for the year ended December 31, 2012:

Derivatives designated as fair value hedges and related hedged item:	Location of gain (loss) recognized in income	Year Ended December 31, 2012		
		Amount of gain (loss) recognized in income on derivative	Amount of gain (loss) on hedged item recognized in income attributable to risk being hedged	Amount of gain (loss) recognized in income on derivative (ineffective portion)
Foreign currency forward contracts (a)	Foreign exchange (loss) gain	\$ 1,017	\$ (912 )	\$ (105 )

Derivatives designated as fair value hedges and related hedged item:	Location of gain (loss) recognized in income	Year Ended December 31, 2011		
		Amount of gain (loss) recognized in income on derivative	Amount of gain (loss) on hedged item recognized in income attributable to risk being hedged	Amount of gain (loss) recognized in income on derivative (ineffective portion)
Foreign currency forward contracts	Foreign exchange (loss) gain	\$ (3,994 )	\$ 3,994	\$ —

(a) There were no designated hedge derivatives as part of the Flagstone Acquisition as at December 31, 2012, however some were held during the one-month period from November 30, 2012 to December 31, 2012.

## (c) Derivative instruments designated as a cash flow hedge

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

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Validus Holdings, Ltd.

Notes to Consolidated Financial Statements (Continued)

(Expressed in thousands of U.S. dollars, except share and per share information)

The following table provides the total impact on other comprehensive income and earnings relating to the derivative instruments formally designated as cash flow hedges along with the impact of the related hedged items for the year ended December 31, 2012:

Derivatives designated as cash flow hedges and related hedged item:	Location of the effective portion recognized in other comprehensive (loss) recognized in income	Year Ended December 31, 2012			
		Location of the effective portion subsequently reclassified to earnings and the ineffective portion excluded from effectiveness testing	Amount of effective portion recognized in other comprehensive income	Amount of effective portion subsequently reclassified to earnings	Amount of ineffective portion excluded from effectiveness testing
Interest rate swap contracts	Other comprehensive income	Finance expenses	\$ 1,588	\$(1,588)	\$—

There was no interest rate swap contract activity for the year ended December 31, 2011.

## 11. Premiums receivable

Premiums receivable are composed of premiums in the course of collection, net of commissions and brokerage, and premiums accrued but unbilled, net of commissions and brokerage. The following is a breakdown of the components of premiums receivable at December 31, 2012 and 2011:

	Premiums in course of collection	Premiums accrued but unbilled	Total
Balance as at December 31, 2011	\$175,111	\$471,243	\$646,354
Change during 2012	39,780	116,025	155,805
Balance as at December 31, 2012	\$214,891	\$587,268	\$802,159
Balance as at December 31, 2010	\$118,342	\$450,419	\$568,761
Change during 2011	56,769	20,824	77,593
Balance as at December 31, 2011	\$175,111	\$471,243	\$646,354

## 12. Reserve for losses and loss expenses

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

expenses will not exceed the total reserves.

The following table represents an analysis of paid and unpaid losses and loss expenses incurred and a reconciliation of the beginning and ending unpaid losses and loss expenses for the years ended December 31, 2012, 2011 and 2010:

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(Expressed in thousands of U.S. dollars, except share and per share information)

	Years Ended		
	December 31, 2012	December 31, 2011	December 31, 2010
Reserve for losses and loss expenses, beginning of year	\$2,631,143	\$2,035,973	\$1,622,134
Losses and loss expenses recoverable	(372,485 )	(283,134 )	(181,765 )
Net reserves for losses and loss expenses, beginning of year	2,258,658	1,752,839	1,440,369
Net loss reserves acquired in Flagstone acquisition	639,641	—	—
Increase (decrease) in net losses and loss expenses incurred in respect of losses occurring in:			
Current year	1,174,415	1,400,520	1,144,196
Prior years	(174,969 )	(156,119 )	(156,610 )
Total incurred losses and loss expenses	999,446	1,244,401	987,586
Less net losses and loss expenses paid in respect of losses occurring in:			
Current year	(182,146 )	(266,247 )	(288,594 )
Prior years	(653,874 )	(476,779 )	(384,828 )
Total net paid losses	(836,020 )	(743,026 )	(673,422 )
Foreign exchange	15,881	4,444	(1,694 )
Net reserve for losses and loss expenses, end of year	3,077,606	2,258,658	1,752,839
Losses and loss expenses recoverable	439,967	372,485	283,134
Reserve for losses and loss expenses, end of year	\$3,517,573	\$2,631,143	\$2,035,973
Incurred losses and loss expenses comprise:			

	Years Ended		
	December 31, 2012	December 31, 2011	December 31, 2010
Gross losses and loss expenses	\$1,192,494	\$1,555,275	\$1,411,192
Reinsurance recoverable	(193,048 )	(310,874 )	(423,606 )
Net incurred losses and loss expenses	\$999,446	\$1,244,401	\$987,586
The December 31, 2012 and 2011 gross reserves balance comprises reserves for reported claims of \$1,719,098 and \$1,414,442, respectively, and reserves for claims incurred but not reported of \$1,798,475 and \$1,216,701, respectively. The net favorable development on prior years by segment and line of business is as follows:			

## Year Ended December 31, 2012

	Property	Marine	Specialty	Total
Validus Re	\$(45,733 )	\$(11,298 )	\$(15,530 )	\$(72,561 )
Talbot	(26,263 )	(40,060 )	(36,085 )	(102,408 )
Net favorable development	\$(71,996 )	\$(51,358 )	\$(51,615 )	\$(174,969 )

(a) AlphaCat does not have any development on prior accident years.

The amount recorded represents management's best estimate of expected losses and loss expenses on premiums earned. Favorable loss development on prior years totaled \$174,969. For Validus Re, the property lines experienced favorable development of \$45,733 primarily due to a reduction in the loss estimates on large loss events and favorable development on attritional losses and various smaller loss events. The marine lines experienced favorable development of \$11,298 primarily due to favorable development on large loss events and attritional losses and various smaller loss events. The specialty lines experienced favorable development of \$15,530 primarily due to favorable development on attritional losses partially offset by adverse development on large loss events. For Talbot, the property lines experienced \$26,263 of favorable development primarily due to lower than expected claims development on

large losses and catastrophe events as well as favorable development on attritional losses. The marine lines

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Validus Holdings, Ltd.

Notes to Consolidated Financial Statements (Continued)

(Expressed in thousands of U.S. dollars, except share and per share information)

experienced \$40,060 of favorable development primarily due to favorable development on attritional losses. The specialty lines experienced \$36,085 of favorable development primarily due to lower than expected development on large losses and catastrophe events as well as favorable development on attritional losses.

	Year Ended December 31, 2011			
	Property	Marine	Specialty	Total
Validus Re	\$(49,020 )	\$(10,234 )	\$(9,356 )	\$(68,610 )
Talbot	(22,169 )	(31,382 )	(33,958 )	(87,509 )
Net favorable development	\$(71,189 )	\$(41,616 )	\$(43,314 )	\$(156,119 )

(a) AlphaCat does not have any development on prior accident years.

The amount recorded represents management's best estimate of expected losses and loss expenses on premiums earned. Favorable loss development on prior years totaled \$156,119. For Validus Re, the property lines experienced favorable development of \$49,020 primarily due to a reduction in the loss estimates on large loss events and favorable development on attritional losses and various smaller loss events. The marine lines experienced favorable development of \$10,234 primarily due to favorable development on large loss events and attritional losses and various smaller loss events. The specialty lines experienced favorable development of \$9,356 primarily due to favorable development on attritional losses partially offset by adverse development on large loss events. For Talbot, the property lines experienced \$22,169 of favorable development primarily due to lower than expected claims development on large losses and catastrophe events as well as favorable development on attritional losses. The marine lines experienced \$31,382 of favorable development primarily due to favorable development on attritional losses. The specialty lines experienced \$33,958 of favorable development primarily due to lower than expected development on large losses and catastrophe events as well as favorable development on attritional losses.

	Year Ended December 31, 2010			
	Property	Marine	Specialty	Total
Validus Re	\$(49,831 )	\$(17,616 )	\$(3,170 )	\$(70,617 )
Talbot	(22,450 )	(52,415 )	(11,128 )	(85,993 )
Net favorable development (a)	\$(72,281 )	\$(70,031 )	\$(14,298 )	\$(156,610 )

(a) AlphaCat has not incurred any losses in 2010 and therefore does not have any development on prior accident years. The amount recorded represents management's best estimate of expected losses and loss expenses on premiums earned. Favorable loss development on prior years totaled \$156,610. For Validus Re, the property and specialty lines experienced favorable development of \$49,831 and \$3,170, respectively, primarily due to lower than expected claims development. The marine lines experienced \$17,616 of favorable development primarily due to higher than expected recoveries associated with the 2007 California wildfires, as well as lower than expected claims development. For Talbot, the property lines experienced \$22,450 of favorable development primarily due to lower than expected claims development on the property facultative and binder lines, together with favorable development on hurricanes Katrina and Ike. The marine lines experienced \$52,415 of favorable development primarily due to lower than expected attritional loss development across a number of lines, in particular on the hull and energy lines. The specialty lines experienced \$11,128 of favorable development primarily due to lower than expected claims across most of the specialty sub-classes, partially offset by one notable loss on the financial institutions lines.

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Notes to Consolidated Financial Statements (Continued)

(Expressed in thousands of U.S. dollars, except share and per share information)

## 13. Accounts payable and accrued expenses

The following are the components of accounts payable and accrued expenses:

	Years Ended	
	December 31, 2012	December 31, 2011
Accrued interest on debt	\$10,662	\$10,454
Amounts due to brokers	3,628	18,996
Trade and compensation payables	153,287	53,952
Total	\$167,577	\$83,402

## 14. Reinsurance

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

## (a) Effects of reinsurance on premiums written and earned

The effects of reinsurance on premiums written and earned for the years ended December 31, 2012, 2011 and 2010 are as follows:

Year Ended December 31, 2012									
	Validus Re		AlphaCat		Talbot		Total		
	Written	Earned	Written	Earned	Written	Earned	Elimination	Written	Earned
Direct	\$1,551	\$364	\$—	\$—	\$548,940	\$535,508	\$—	\$550,491	\$535,872
Assumed	1,130,408	1,174,681	21,603	17,666	529,696	529,544	(65,758)	1,615,949	1,721,891
Ceded	(144,578 )	(151,774 )	—	—	(228,686 )	(232,773 )	65,758	(307,506 )	(384,547 )
Total	\$987,381	\$1,023,271	\$21,603	\$17,666	\$849,950	\$832,279	\$—	\$1,858,934	\$1,873,216
Year Ended December 31, 2011									
	Validus Re		AlphaCat		Talbot		Total		
	Written	Earned	Written	Earned	Written	Earned	Elimination	Written	Earned
Direct	\$—	\$—	\$—	\$—	\$510,200	\$480,432	\$—	\$510,200	\$480,432
Assumed	1,114,493	1,092,951	75,727	65,966	503,922	507,383	(79,651 )	1,614,491	1,666,300
Ceded	(150,718 )	(127,026 )	—	—	(218,174 )	(217,563 )	79,651	(289,241 )	(344,589 )
Total	\$963,775	\$965,925	\$75,727	\$65,966	\$795,948	\$770,252	\$—	\$1,835,450	\$1,802,143
Year Ended December 31, 2010									
	Validus Re		AlphaCat		Talbot		Total		
	Written	Earned	Written	Earned	Written	Earned	Elimination	Written	Earned
Direct	\$—	\$—	\$—	\$—	\$460,337	\$450,348	\$—	\$460,337	\$450,348
Assumed	1,089,443	1,116,167	11,796	11,082	520,736	503,021	(91,746)	1,530,229	1,630,270
Ceded	(63,147 )	(76,049 )	—	—	(258,081 )	(243,446 )	91,746	(229,482 )	(319,495 )
Total	\$1,026,296	\$1,040,118	\$11,796	\$11,082	\$722,992	\$709,923	\$—	\$1,761,084	\$1,761,123

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Validus Holdings, Ltd.

Notes to Consolidated Financial Statements (Continued)

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## (b) Credit risk

The Company evaluates the financial condition of its reinsurers and monitors concentration of credit risk arising from its exposure to individual reinsurers. The reinsurance program is generally placed with reinsurers whose rating, at the time of placement, was A- or better rated by Standard & Poor's or the equivalent with other rating agencies. Exposure to a single reinsurer is also controlled with restrictions dependent on rating. At December 31, 2012, 97.9% of reinsurance recoverables (which includes loss reserves recoverable and recoverables on paid losses) were from reinsurers rated A- or better and included \$185,255 of IBNR recoverable (December 31, 2011: \$125,298).

Reinsurance recoverables by reinsurer are as follows:

	December 31, 2012		December 31, 2011		
	Reinsurance Recoverable	% of Total	Reinsurance Recoverable	% of Total	
Top 10 reinsurers	\$360,234	74.1	% \$323,315	69.8	%
Other reinsurers' balances > \$1 million	115,262	23.7	% 132,417	28.6	%
Other reinsurers' balances < \$1 million	10,906	2.2	% 7,248	1.6	%
Total	\$486,402	100.0	% \$462,980	100.0	%

	December 31, 2012			
	Rating	Reinsurance Recoverable	% of Total	
Top 10 Reinsurers				
Lloyd's Syndicates	A+	\$71,469	19.9	%
National Indemnity	AA+	59,941	16.6	%
Everest Re	A+	51,340	14.3	%
Fully Collateralized	NR	47,445	13.2	%
Hannover Re	AA-	40,552	11.3	%
Munich Re	AA-	20,954	5.8	%
Transatlantic Re	A+	20,320	5.6	%
Swiss Re	AA-	16,992	4.7	%
Allianz	AA-	16,367	4.5	%
XL Re	A	14,854	4.1	%
Total		\$360,234	100.0	%

	December 31, 2011			
	Rating	Reinsurance Recoverable	% of Total	
Top 10 Reinsurers				
Lloyd's Syndicates	A+	\$77,419	24.0	%
Allianz	AA-	59,764	18.5	%
Hannover Re	AA-	39,762	12.3	%
Everest Re	A+	38,618	11.9	%
Transatlantic Re	A+	21,344	6.6	%
Tokio Millenium Re Ltd.	AA-	20,432	6.3	%
Fully Collateralized	NR	18,140	5.6	%
Odyssey Reinsurance Company	A-	16,737	5.2	%
Platinum Underwriters	A	15,833	4.9	%
Munich Re	AA-	15,266	4.7	%
Total		\$323,315	100.0	%



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Validus Holdings, Ltd.

Notes to Consolidated Financial Statements (Continued)

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At December 31, 2012 and December 31, 2011, the provision for uncollectible reinsurance relating to losses recoverable was \$6,602 and \$6,821, respectively. To estimate the provision for uncollectible reinsurance recoverable, the reinsurance recoverable is first allocated to applicable reinsurers. This determination is based on a process rather than an estimate, although an element of judgment is applied. As part of this process, ceded IBNR is allocated by reinsurer. Of the \$486,402 reinsurance recoverable at December 31, 2012 (December 31, 2011: \$462,980), \$47,445 was fully collateralized (December 31, 2011: \$18,140).

The Company uses a default analysis to estimate uncollectible reinsurance. The primary components of the default analysis are reinsurance recoverable balances by reinsurer and default factors used to determine the portion of a reinsurer's balance deemed to be uncollectible. Default factors require considerable judgment and are determined using the current rating, or rating equivalent, of each reinsurer as well as other key considerations and assumptions.

15. Share capital

(a) Authorized and issued

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

On September 4, 2009, the Company acquired all of the outstanding shares of IPC from a group of institutional and other investors. Pursuant to the Amalgamation Agreement, the Company acquired all of IPC's outstanding common shares in exchange for the Company's common shares and cash. The Company issued 54,556,762 common shares (and 21,506 restricted share awards) valued at \$24.10 per share as partial consideration for the acquisition.

The Company may from time to time repurchase its securities, including common shares, Junior Subordinated Deferrable Debentures Junior Subordinated Deferrable Interest Notes and Senior Notes. In November 2009, the Board of Directors of the Company authorized an initial \$400,000 share repurchase program. On February 17, 2010, the Board of Directors of the Company authorized the Company to return up to \$750,000 to shareholders. This amount was in addition to, and in excess of, the \$135,494 of common shares purchased by the Company through February 17, 2010 under its previously authorized \$400,000 share repurchase program. On May 6, 2010, the Board of Directors authorized a self tender offer pursuant to which the Company repurchased \$300,000 in common shares. On November 4, 2010, the Board of Directors authorized a self tender offer pursuant to which the Company repurchased \$238,362 in common shares. In addition, the Board of Directors authorized separate repurchase agreements with funds affiliated with or managed by each of Aquiline Capital Partners LLC, New Mountain Capital LLC, and Vestar Capital Partners pursuant to which the Company repurchased \$61,638 in common shares. On December 20, 2010, the Board of Directors authorized the Company to return up to an additional \$400,000 to shareholders. This amount is in addition to the \$929,173 of common shares purchased by the Company through December 23, 2010 under its previously authorized share repurchase program.

On June 5, 2012, the Company announced the final results of its "modified Dutch auction" tender offer. Pursuant to this tender offer the Company purchased 6,383,884 of its common shares at a price of \$32.00 per common share for a total cost of \$204,284, excluding fees and expenses relating to the tender offer. The Company funded the purchase of the shares in the tender offer using cash on hand.

On November 30, 2012, the Company acquired all of the outstanding shares of Flagstone from a group of institutional and other investors. Pursuant to the Merger Agreement, the Company acquired all of Flagstone's outstanding common shares in exchange for the Company's common shares and cash. The Company issued 14,202,664 common shares, net of 87,725 shares withheld for income taxes, valued at \$34.87 per share as partial consideration for the acquisition. In addition, 1,638,875 common shares recorded in treasury are owned by Validus UPS, Ltd., a wholly-owned subsidiary

of Validus Holdings, Ltd. As part of the Flagstone Acquisition, warrants to acquire Flagstone shares were converted into 121,942 warrants to acquire the Company's common shares. In accordance with the merger agreement, these warrants have a \$62.02 strike price and expire on December 31, 2013.

The Company has repurchased approximately 43,138,057 common shares for an aggregate purchase price of \$1,206,845 from the inception of its share repurchase program to December 31, 2012. The Company had \$122,328 remaining under its authorized share repurchase program as of December 31, 2012.

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Validus Holdings, Ltd.

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

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

	Common Shares
Common shares issued, December 31, 2011	134,503,065
Restricted share awards vested, net of shares withheld	1,572,634
Restricted share units vested, net of shares withheld	15,173
Options exercised	439,065
Warrants exercised	326,715
Direct issuance of common stock	15,841,539
Common shares issued, December 31, 2012	152,698,191
Treasury shares, December 31, 2012	(44,776,932 )
Common shares outstanding, December 31, 2012	107,921,259
	Common Shares
Common shares issued, December 31, 2010	132,838,111
Restricted share awards vested, net of shares withheld	569,104
Restricted share units vested, net of shares withheld	9,497
Employee seller shares vested	197,174
Options exercised	459,932
Warrants exercised	428,884
Direct issuance of common stock	363
Common shares issued, December 31, 2011	134,503,065
Treasury shares, December 31, 2011	(35,031,985 )
Common shares outstanding, December 31, 2011	99,471,080
	Common Shares
Common shares issued, December 31, 2009	131,616,349
Restricted share awards vested, net of shares withheld	405,055
Restricted share units vested, net of shares withheld	57,192
Employee seller shares vested	203,544
Options exercised	550,014
Warrants exercised	5,957
Common shares issued, December 31, 2010	132,838,111
Treasury shares, December 31, 2010	(34,836,885 )
Common shares outstanding, December 31, 2010	98,001,226

## (b) Warrants

The Company had outstanding as at December 31, 2012 warrants to purchase, in the aggregate, up to 6,410,472 (December 31, 2011: 6,916,678) common shares. As at December 31, 2011, 1,726,011 of the warrants are to purchase non-voting common shares. There were no non-voting warrants outstanding as of December 31, 2012.

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The warrants may be settled using either the physical settlement or net-share settlement methods. The warrants have been classified as equity instruments, in accordance with U.S. GAAP guidance for “Derivatives and Hedging, Contracts in Entity’s own Equity.” The warrants were measured at fair value and recorded in additional paid-in capital. The fair value of each warrant issued was estimated on the date of grant using the Black-Scholes option-pricing model. The volatility assumption used, of approximately 30.0%, was derived from the historical volatility of the share price of a range of publicly-traded Bermuda reinsurance companies of a similar business nature to the Company. No allowance was made for any potential illiquidity associated with the private trading of the Company’s shares. The other assumptions in the warrant-pricing model were as follows:

	July 24, 2007	February 3, 2006	December 15, 2005		
	Issuance	Issuance	Issuance		
Warrants issued	256,409	8,593	8,446,727		
Average strike price	\$20.00	\$17.50	\$17.50		
Volatility	30.0	% 30.0	% 30.0	%	%
Risk-free rate	4.5	% 4.5	% 4.5	%	%
Expected dividend yield	0.0	% 0.0	% 0.0	%	%
Expected term (years)	8	10	10		
Calculated fair value per warrant	\$11.28	\$8.89	\$8.89		

No further warrants are anticipated to be issued. The holder of the warrant is entitled to exercise the warrant in whole or in part at any time until the expiration date.

During the year ended December 31, 2012, 628,147 warrants were exercised which resulted in the issuance of 326,715 common shares. During the year ended December 31, 2011, 1,018,184 warrants were exercised which resulted in the issuance of 428,884 common shares.

## (c) Deferred share units

Under the terms of the Company’s Director Stock Compensation Plan, non-management directors may elect to receive their director fees in deferred share units rather than cash. The number of share units distributed in case of election under the plan is equal to the amount of the annual retainer fee otherwise payable to the director on such payment date divided by 100% of the fair market value of a share on such payment date. Additional deferred share units are issued in lieu of dividends that accrue on these deferred share units. The total outstanding deferred share units at December 31, 2012 were 5,001 (December 31, 2011: 4,850).

## (d) Dividends

On February 9, 2012, the Company announced a quarterly cash dividend of \$0.25 (2011: \$0.25) per common share and \$0.25 per common share equivalent for which each outstanding warrant is exercisable. This dividend was paid on March 30, 2012 to holders of record on March 15, 2012.

On May 2, 2012, the Company announced a quarterly cash dividend of \$0.25 (2011: \$0.25) per common share and \$0.25 per common share equivalent for which each outstanding warrant is exercisable. This dividend was paid on June 29, 2012 to holders of record on June 15, 2012.

On July 25, 2012, the Company announced a quarterly cash dividend of \$0.25 (2011: \$0.25) per common share and \$0.25 per common share equivalent for which each outstanding warrant is exercisable. This dividend was paid on September 28, 2012 to holders of record on September 14, 2012.

On November 1, 2012, the Company announced a quarterly cash dividend of \$0.25 (2011: \$0.25) per common share and \$0.25 per common share equivalent for which each outstanding warrant is exercisable. This dividend was paid on December 28, 2012 to holders of record on December 14, 2012.



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Validus Holdings, Ltd.

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## 16. Retirement plans

The Company provides pension benefits to eligible employees through various plans which are managed externally and sponsored by the Company. The Company's contributions are expensed as incurred. The Company's expenses for its defined contribution retirement plans for the years ended December 31, 2012, 2011 and 2010 were \$9,233, \$7,591 and \$7,564, respectively.

## Defined Benefit Plan

The Company assumed the defined benefit plan as the result of the Flagstone Acquisition. Under Swiss pension law, the Company is required to maintain a pension plan for its employees in Switzerland, which is classified and accounted for as a defined benefit plan. As at December 31, 2012, the net unfunded status at the end of the year was \$1,033 and was included in other liabilities in the Consolidated Balance Sheets. The fair value of plan assets as at December 31, 2012 was \$5,252.

## 17. Stock plans

## Stock plans

## (a) Long Term Incentive Plan and Short Term Incentive Plan

The Company's Amended and Restated 2005 Long Term Incentive Plan ("LTIP") provides for grants to employees of options, stock appreciation rights ("SARs"), restricted shares, restricted share units, performance shares, dividend equivalents or other share-based awards. In addition, the Company may issue restricted share awards or restricted share units in connection with awards issued under its annual Short Term Incentive Plan ("STIP"). The total number of shares reserved for issuance under the LTIP and STIP are 13,126,896 shares of which 3,128,443 shares are remaining. The LTIP and STIP are administered by the Compensation Committee of the Board of Directors. No SARs have been granted to date. Grant prices are established at the fair market value of the Company's common shares at the date of grant.

## i. Options

Options may be exercised for voting common shares upon vesting. Options have a life of 10 years and vest either ratably or at the end of the required service period from the date of grant. Fair value of the option awards at the date of grant is determined using the Black-Scholes option-pricing model.

Expected volatility is based on stock price volatility of comparable publicly-traded companies. The Company used the simplified method consistent with U.S. GAAP authoritative guidance on stock compensation expenses to estimate expected lives for options granted during the period as historical exercise data was not available and the options met the requirement as set out in the guidance.

The Company has not granted any stock options awards since September 4, 2009.

Share compensation expenses in respect of options of \$142 were recorded for the year ended December 31, 2012 (2011:\$1,770, 2010: \$3,845). The expenses represent the proportionate accrual of the fair value of each grant based on the remaining vesting period.

Activity with respect to options for the year ended December 31, 2012 was as follows:

	Options	Weighted Average Grant Date Fair Value	Weighted Average Grant Date Exercise Price
Options outstanding, December 31, 2011	2,263,012	\$6.69	\$20.12
Options granted	—	—	—
Options exercised	(439,065	) 7.44	17.73
Options forfeited	—	—	—
Options outstanding, December 31, 2012	1,823,947	\$6.52	\$20.69

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Options exercisable at December 31, 2012	1,823,947	\$6.52	\$20.69
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Validus Holdings, Ltd.