

ARCH CAPITAL GROUP LTD.  
Form 10-Q  
August 07, 2009

**UNITED STATES  
SECURITIES AND EXCHANGE COMMISSION**

WASHINGTON, D.C. 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, 2009**

**Or**

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

**Commission file number: 001-26456**

**ARCH CAPITAL GROUP LTD.**

(Exact name of registrant as specified in its charter)

**Bermuda**

(State or other jurisdiction of incorporation or organization)

**Not Applicable**

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

Edgar Filing: ARCH CAPITAL GROUP LTD. - Form 10-Q

**Wessex House, 45 Reid Street**

**Hamilton HM 12, Bermuda**

(Address of principal executive offices)

**(441) 278-9250**

(Registrant's telephone number, including area code)

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

Indicate by check mark whether the registrant 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 (§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 definitions of "large accelerated filer," "accelerated filer" and "smaller reporting company" in Rule 12b-2 of the Exchange Act.

Large accelerated filer

Accelerated filer

Non-accelerated filer

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

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

**Class**  
Common Shares, \$0.01 par value

**Outstanding at July 31, 2009**  
60,999,191

**ARCH CAPITAL GROUP LTD.**

**INDEX**

	<b>Page No.</b>
<b><i>PART I. Financial Information</i></b>	
<i>Item 1 Consolidated Financial Statements</i>	
Report of Independent Registered Public Accounting Firm	2
Consolidated Balance Sheets June 30, 2009 (unaudited) and December 31, 2008	3
Consolidated Statements of Income For the three and six month periods ended June 30, 2009 and 2008 (unaudited)	4
Consolidated Statements of Changes in Shareholders' Equity For the six month periods ended June 30, 2009 and 2008 (unaudited)	5
Consolidated Statements of Comprehensive Income For the six month periods ended June 30, 2009 and 2008 (unaudited)	6
Consolidated Statements of Cash Flows For the six month periods ended June 30, 2009 and 2008 (unaudited)	7
Notes to Consolidated Financial Statements (unaudited)	8
<i>Item 2 Management's Discussion and Analysis of Financial Condition and Results of Operations</i>	41
<i>Item 3 Quantitative and Qualitative Disclosures About Market Risk</i>	72
<i>Item 4 Controls and Procedures</i>	72
<b><i>PART II. Other Information</i></b>	
<i>Item 1 Legal Proceedings</i>	73
<i>Item 2 Unregistered Sales of Equity Securities and Use of Proceeds</i>	73
<i>Item 4 Submission of Matters to a Vote of Security Holders</i>	74
<i>Item 5 Other Information</i>	76
<i>Item 6 Exhibits</i>	76

**Report of Independent Registered Public Accounting Firm**



## Edgar Filing: ARCH CAPITAL GROUP LTD. - Form 10-Q

To the Board of Directors and Shareholders of

Arch Capital Group Ltd.:

We have reviewed the accompanying consolidated balance sheets of Arch Capital Group Ltd. and its subsidiaries (the Company) as of June 30, 2009, and the related consolidated statements of income for the three-month and six-month periods ended June 30, 2009 and June 30, 2008, and the consolidated statements of changes in shareholders' equity, comprehensive income and cash flows for each of the six-month periods ended June 30, 2009 and June 30, 2008. These interim financial statements are the responsibility of the Company's management.

We conducted our review in accordance with the standards of the Public Company Accounting Oversight Board (United States). A review of interim financial information consists principally of applying analytical procedures and making inquiries of persons responsible for financial and accounting matters. It is substantially less in scope than an audit conducted in accordance with the standards of the Public Company Accounting Oversight Board (United States), the objective of which is the expression of an opinion regarding the financial statements taken as a whole. Accordingly, we do not express such an opinion.

Based on our review, we are not aware of any material modifications that should be made to the accompanying consolidated interim financial statements for them to be in conformity with accounting principles generally accepted in the United States of America.

As discussed in Note 8 to the consolidated financial statements, the Company changed the manner in which it accounts for other-than-temporary impairment losses in 2009.

We previously audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the consolidated balance sheet as of December 31, 2008, and the related consolidated statements of income, changes in shareholders' equity, comprehensive income and of cash flows for the year then ended (not presented herein), and in our report dated March 2, 2009, we expressed an unqualified opinion on those consolidated financial statements. In our opinion, the information set forth in the accompanying consolidated balance sheet information as of December 31, 2008, is fairly stated in all material respects in relation to the consolidated balance sheet from which it has been derived.

/s/ PricewaterhouseCoopers LLP

New York, New York

August 7, 2009

## ARCH CAPITAL GROUP LTD. AND SUBSIDIARIES

## CONSOLIDATED BALANCE SHEETS

(U.S. dollars in thousands, except share data)

	(Unaudited) June 30, 2009	December 31, 2008
<b>Assets</b>		
Investments:		
Fixed maturities available for sale, at market value (amortized cost: 2009, \$8,931,670; 2008, \$8,314,615)	\$ 8,944,110	\$ 8,122,221
Short-term investments available for sale, at market value (amortized cost: 2009, \$653,396; 2008, \$478,088)	660,859	479,586
Investment of funds received under securities lending agreements, at market value (amortized cost: 2009, \$570,816; 2008, \$750,330)	556,473	730,194
Other investments (cost: 2009, \$115,534; 2008, \$125,858)	115,260	109,601
Investment funds accounted for using the equity method	370,165	301,027
Total investments	10,646,867	9,742,629
Cash	336,693	251,739
Accrued investment income	70,854	78,052
Investment in joint venture (cost: \$100,000)	100,656	98,341
Fixed maturities and short-term investments pledged under securities lending agreements, at market value	559,385	728,065
Premiums receivable	735,969	628,951
Unpaid losses and loss adjustment expenses recoverable	1,740,248	1,729,135
Paid losses and loss adjustment expenses recoverable	53,432	63,294
Prepaid reinsurance premiums	283,488	303,707
Deferred income tax assets, net	63,838	60,192
Deferred acquisition costs, net	307,896	295,192
Receivable for securities sold	1,192,659	105,073
Other assets	549,950	532,175
<b>Total Assets</b>	<b>\$ 16,641,935</b>	<b>\$ 14,616,545</b>
<b>Liabilities</b>		
Reserve for losses and loss adjustment expenses	\$ 7,809,034	\$ 7,666,957
Unearned premiums	1,632,989	1,526,682
Reinsurance balances payable	158,974	138,509
Senior notes	300,000	300,000
Revolving credit agreement borrowings	100,000	100,000
Securities lending payable	574,014	753,528
Payable for securities purchased	1,432,395	123,309
Other liabilities	604,561	574,595
<b>Total Liabilities</b>	<b>12,611,967</b>	<b>11,183,580</b>
<b>Commitments and Contingencies</b>		
<b>Shareholders Equity</b>		
Non-cumulative preferred shares (\$0.01 par value, 50,000,000 shares authorized, issued: 13,000,000)	130	130
Common shares (\$0.01 par value, 200,000,000 shares authorized, issued: 2009, 60,980,806; 2008, 60,511,974)	610	605
Additional paid-in capital	1,006,315	994,585
Retained earnings	3,046,706	2,693,239

Edgar Filing: ARCH CAPITAL GROUP LTD. - Form 10-Q

Accumulated other comprehensive income (loss), net of deferred income tax		(23,793)		(255,594)
<b>Total Shareholders' Equity</b>		<b>4,029,968</b>		<b>3,432,965</b>
<b>Total Liabilities and Shareholders' Equity</b>	\$	<b>16,641,935</b>	\$	<b>14,616,545</b>

See Notes to Consolidated Financial Statements



## ARCH CAPITAL GROUP LTD. AND SUBSIDIARIES

## CONSOLIDATED STATEMENTS OF INCOME

(U.S. dollars in thousands, except share data)

	(Unaudited) Three Months Ended June 30,		(Unaudited) Six Months Ended June 30,	
	2009	2008	2009	2008
<b>Revenues</b>				
Net premiums written	\$ 693,854	\$ 686,118	\$ 1,516,717	\$ 1,497,460
Decrease (increase) in unearned premiums	5,404	19,557	(116,895)	(83,551)
Net premiums earned	699,258	705,675	1,399,822	1,413,909
Net investment income	100,485	117,120	196,367	239,313
Net realized gains (losses)	(11,793)	(1,920)	(16,957)	46,766
Total other-than-temporary impairment losses	(20,657)	(10,749)	(113,646)	(23,460)
Portion of loss recognized in other comprehensive income (loss), before taxes	(206)		56,649	
Net impairment losses recognized in earnings	(20,863)	(10,749)	(56,997)	(23,460)
Fee income	817	1,238	1,742	2,306
Equity in net income (loss) of investment funds accounted for using the equity method	75,890	19,583	66,309	(2,730)
Other income	4,950	4,968	8,901	9,004
<b>Total revenues</b>	<b>848,744</b>	<b>835,915</b>	<b>1,599,187</b>	<b>1,685,108</b>
<b>Expenses</b>				
Losses and loss adjustment expenses	398,858	404,625	799,400	809,042
Acquisition expenses	123,814	119,226	250,272	233,865
Other operating expenses	99,294	102,578	186,410	199,765
Interest expense	5,712	5,788	11,424	11,312
Net foreign exchange (gains) losses	53,658	(298)	28,453	23,289
<b>Total expenses</b>	<b>681,336</b>	<b>631,919</b>	<b>1,275,959</b>	<b>1,277,273</b>
<b>Income before income taxes</b>	<b>167,408</b>	<b>203,996</b>	<b>323,228</b>	<b>407,835</b>
Income tax expense	8,818	5,253	18,308	13,209
<b>Net income</b>	<b>158,590</b>	<b>198,743</b>	<b>304,920</b>	<b>394,626</b>
Preferred dividends	6,461	6,461	12,922	12,922
<b>Net income available to common shareholders</b>	<b>\$ 152,129</b>	<b>\$ 192,282</b>	<b>\$ 291,998</b>	<b>\$ 381,704</b>
<b>Net income per common share</b>				
Basic	\$ 2.52	\$ 3.05	\$ 4.84	\$ 5.95
Diluted	\$ 2.43	\$ 2.92	\$ 4.67	\$ 5.71
<b>Weighted average common shares and common share equivalents outstanding</b>				
Basic	60,417,391	62,995,550	60,365,758	64,145,533
Diluted	62,626,317	65,748,119	62,589,856	66,886,972



## ARCH CAPITAL GROUP LTD. AND SUBSIDIARIES

## CONSOLIDATED STATEMENTS OF CHANGES IN SHAREHOLDERS EQUITY

(U.S. dollars in thousands)

	2009	(Unaudited) Six Months Ended June 30,	2008
<b>Non-Cumulative Preferred Shares</b>			
Balance at beginning and end of period	\$	130	\$ 130
<b>Common Shares</b>			
Balance at beginning of year		605	673
Common shares issued, net		5	2
Purchases of common shares under share repurchase program			(56)
Balance at end of period		610	619
<b>Additional Paid-in Capital</b>			
Balance at beginning of year		994,585	1,451,667
Common shares issued		2,557	3,511
Exercise of stock options		1,233	9,073
Common shares retired		(6,243)	(391,776)
Amortization of share-based compensation		14,267	17,511
Other		(84)	(350)
Balance at end of period		1,006,315	1,089,636
<b>Retained Earnings</b>			
Balance at beginning of year		2,693,239	2,428,117
Cumulative effect of change in accounting principle, adoption of FSP FAS 115-2/124-2 (1)		61,469	
Balance at beginning of year, as adjusted		2,754,708	2,428,117
Dividends declared on preferred shares		(12,922)	(12,922)
Net income		304,920	394,626
Balance at end of period		3,046,706	2,809,821
<b>Accumulated Other Comprehensive Income (Loss)</b>			
Balance at beginning of year		(255,594)	155,224
Cumulative effect of change in accounting principle, adoption of FSP FAS 115-2/124-2 (1)		(61,469)	
Balance at beginning of year, as adjusted		(317,063)	155,224
Change in unrealized appreciation (decline) in value of investments, net of deferred income tax		339,708	(169,023)
Portion of other-than-temporary impairment losses recognized in other comprehensive income, net of deferred income tax		(56,649)	
Foreign currency translation adjustments, net of deferred income tax		10,211	(174)
Balance at end of period		(23,793)	(13,973)
<b>Total Shareholders Equity</b>	\$	4,029,968	\$ 3,886,233

(1) FASB Staff Position No. FAS 115-2 and FAS 124-2, Recognition and Presentation of Other-Than-Temporary Impairments ( FSP FAS 115-2/124-2 )



**ARCH CAPITAL GROUP LTD. AND SUBSIDIARIES**  
**CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME**

(U.S. dollars in thousands)

	(Unaudited) Six Months Ended June 30,	
	2009	2008
<b>Comprehensive Income</b>		
Net income	\$ 304,920	\$ 394,626
Other comprehensive income (loss), net of deferred income tax		
Unrealized appreciation (decline) in value of investments:		
Unrealized holding gains (losses) arising during period	261,248	(127,124)
Portion of other-than-temporary impairment losses recognized in other comprehensive income, net of deferred income tax	(56,649)	
Reclassification of net realized (gains) losses, net of income taxes, included in net income	78,460	(41,899)
Foreign currency translation adjustments	10,211	(174)
<b>Other comprehensive income (loss)</b>	<b>293,270</b>	<b>(169,197)</b>
<b>Comprehensive Income</b>	<b>\$ 598,190</b>	<b>\$ 225,429</b>

See Notes to Consolidated Financial Statements

## ARCH CAPITAL GROUP LTD. AND SUBSIDIARIES

## CONSOLIDATED STATEMENTS OF CASH FLOWS

(U.S. dollars in thousands)

	(Unaudited) Six Months Ended June 30,	
	2009	2008
<b>Operating Activities</b>		
Net income	\$ 304,920	\$ 394,626
Adjustments to reconcile net income to net cash provided by operating activities:		
Net realized (gains) losses	17,451	(43,547)
Net impairment losses recognized in earnings	56,997	23,460
Equity in net (income) loss of investment funds accounted for using the equity method and other income	(70,234)	(6,009)
Share-based compensation	14,267	17,511
Changes in:		
Reserve for losses and loss adjustment expenses, net of unpaid losses and loss adjustment expenses recoverable	88,914	278,357
Unearned premiums, net of prepaid reinsurance premiums	116,092	85,364
Premiums receivable	(95,693)	(126,518)
Deferred acquisition costs, net	(10,420)	(29,810)
Reinsurance balances payable	17,465	(47,774)
Other liabilities	7,991	48,281
Other items, net	70,795	(3,133)
<b>Net Cash Provided By Operating Activities</b>	<b>518,545</b>	<b>590,808</b>
<b>Investing Activities</b>		
Purchases of fixed maturity investments	(10,197,956)	(7,510,262)
Proceeds from sales of fixed maturity investments	9,482,469	7,044,479
Proceeds from redemptions and maturities of fixed maturity investments	377,034	317,369
Purchases of other investments	(32,351)	(187,652)
Proceeds from sales of other investments	19,794	89,324
Investment in joint venture		(100,000)
Net (purchases) sales of short-term investments	(61,105)	60,739
Change in investment of securities lending collateral	179,514	585,516
Purchases of furniture, equipment and other assets	(11,519)	(4,984)
<b>Net Cash Provided By (Used For) Investing Activities</b>	<b>(244,120)</b>	<b>294,529</b>
<b>Financing Activities</b>		
Purchases of common shares under share repurchase program	(1,552)	(389,753)
Proceeds from common shares issued, net	(1,380)	8,050
Revolving credit agreement borrowings		100,000
Change in securities lending collateral	(179,514)	(585,516)
Other	(549)	1,276
Preferred dividends paid	(12,922)	(12,922)
<b>Net Cash Used For Financing Activities</b>	<b>(195,917)</b>	<b>(878,865)</b>
Effects of exchange rate changes on foreign currency cash	6,446	157
Increase in cash	84,954	6,629
Cash beginning of year	251,739	239,915
<b>Cash end of period</b>	<b>\$ 336,693</b>	<b>\$ 246,544</b>

Edgar Filing: ARCH CAPITAL GROUP LTD. - Form 10-Q

Income taxes paid, net	\$	22,118	\$	5,233
Interest paid	\$	11,496	\$	11,259

See Notes to Consolidated Financial Statements

**ARCH CAPITAL GROUP LTD. AND SUBSIDIARIES**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)**

**1. General**

Arch Capital Group Ltd. ( ACGL ) is a Bermuda public limited liability company which provides insurance and reinsurance on a worldwide basis through its wholly owned subsidiaries.

The interim consolidated financial statements have been prepared in conformity with accounting principles generally accepted in the United States of America ( GAAP ) and include the accounts of ACGL and its wholly owned subsidiaries (together with ACGL, the Company ). All significant intercompany transactions and balances have been eliminated in consolidation. The preparation of financial statements in conformity with GAAP requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates and assumptions. In the opinion of management, the accompanying unaudited interim consolidated financial statements reflect all adjustments (consisting of normally recurring accruals) necessary for a fair statement of results on an interim basis. The results of any interim period are not necessarily indicative of the results for a full year or any future periods.

Certain information and footnote disclosures normally included in financial statements prepared in accordance with GAAP have been condensed or omitted; however, management believes that the disclosures are adequate to make the information presented not misleading. This report should be read in conjunction with the Company s Annual Report on Form 10-K for the year ended December 31, 2008, including the Company s audited consolidated financial statements and related notes and the section entitled Risk Factors.

To facilitate period-to-period comparisons, certain amounts in the 2008 consolidated financial statements have been reclassified to conform to the 2009 presentation. Such reclassifications had no effect on the Company s consolidated net income. Additionally, the Company adopted FSP No. FAS 115-2 and FAS 124-2, Recognition and Presentation of Other-Than-Temporary Impairments, effective for its interim period ending March 31, 2009. See Note 8, Investment Information Other-Than-Temporary Impairments for further details.

**2. Recent Accounting Pronouncements**

In June 2009, the FASB issued SFAS No. 167, Amendments to FASB Interpretation No. 46R ( SFAS No. 167 ). The amendments to the consolidation guidance affect all entities currently within the scope of FASB Interpretation No. 46 (revised December 2003), Consolidation of Variable Interest Entities ( FIN 46R ), as well as qualifying special-purpose entities ( QSPEs ) that are currently excluded from the scope of FIN 46R. SFAS No.167 amends FIN 46R to require an analysis to determine whether a variable interest gives a company a controlling financial interest in a variable interest entity. This statement requires an ongoing reassessment of all variable interest entities and eliminates the quantitative approach previously required for determining whether a company is the primary beneficiary. This statement is effective for fiscal years beginning after November 15, 2009. Accordingly, the Company will adopt SFAS No. 167 on January 1, 2010. The Company is currently evaluating the impact that SFAS No. 167 may have on its financial condition and results of operations.



## Edgar Filing: ARCH CAPITAL GROUP LTD. - Form 10-Q

In June 2009, the FASB issued SFAS No. 166, Accounting for Transfers of Financial Assets an amendment of FASB Statement No. 140 ( SFAS No.166 ). SFAS No. 166 removes the concept of a qualifying special-purpose entity from SFAS No. 140, Accounting for Transfers and Servicing of Financial Assets and Extinguishment of Liabilities ( SFAS No. 140 ) and removes the exception from applying FIN 46R. This statement also clarifies the requirements for isolation and limitations on portions of financial assets that are eligible for sale accounting and enhances disclosures about transfers of financial assets and a transferor s continuing involvement with transferred financial assets. SFAS No.166 is effective prospectively to transfers of financial assets occurring in fiscal years beginning after November 15, 2009. Accordingly, the Company will

**ARCH CAPITAL GROUP LTD. AND SUBSIDIARIES**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)**

adopt SFAS No. 166 on January 1, 2010. The Company is currently evaluating the impact that SFAS No. 166 may have on its financial condition and results of operations.

In June 2009, the FASB approved the FASB Accounting Standards Codification (the Codification) as the single source of authoritative nongovernmental U.S. GAAP launched on July 1, 2009. The Codification does not change current U.S. GAAP, but is intended to simplify user access to all authoritative U.S. GAAP by providing all the authoritative literature related to a particular topic in one place. All existing accounting standard documents will be superseded and all other accounting literature not included in the Codification will be considered nonauthoritative. The Codification is effective for interim and annual periods ending after September 15, 2009. The Codification is effective for the Company in the interim period ending September 30, 2009, and it does not expect the adoption to have a material impact on its consolidated financial position or results of operations.

In May 2009, the FASB issued SFAS No. 165, Subsequent Events (SFAS No. 165), which establishes general standards for accounting for and disclosure of events that occur after the balance sheet date but before the financial statements are issued or are available to be issued. The pronouncement requires the disclosure of the date through which an entity has evaluated subsequent events and the basis for that date, whether that date represents the date the financial statements were issued or were available to be issued. SFAS No. 165 is effective with interim and annual financial periods ending after June 15, 2009. The adoption did not impact the Company's consolidated financial position or results of operations. See Note 15, Subsequent Events.

In April 2009, the FASB issued FSP No. FAS 115-2 and FAS 124-2, Recognition and Presentation of Other-Than-Temporary Impairments (FSP FAS 115-2/124-2). FSP FAS 115-2/124-2 requires entities to separate an other-than-temporary impairment of a debt security into two components when there are credit related losses associated with the impaired debt security for which the Company asserts that it does not have the intent to sell the security, and it is more likely than not that it will not be required to sell the security before recovery of its cost basis. The amount of the other-than-temporary impairment related to a credit loss is recognized in earnings, and the amount of the other-than-temporary impairment related to other factors (e.g., interest rates, market conditions, etc.) is recorded as a component of other comprehensive income (loss). FSP FAS 115-2/124-2 is effective for periods ending after June 15, 2009, with early adoption permitted for periods ending after March 15, 2009. The Company elected to adopt FSP FAS 115-2/124-2 effective for its interim period ending March 31, 2009. See Note 8, Investment Information Other Than Temporary Impairments.

In April 2009, the FASB issued FSP No. FAS 157-4, Determining Fair Value When Volume and Level of Activity for the Asset or Liability Have Significantly Decreased and Identifying Transactions that are Not Orderly (FSP FAS 157-4). FSP FAS 157-4 also amended SFAS No. 157, Fair Value Measurements, to expand certain disclosure requirements. FSP FAS 157-4 is effective for periods ending after June 15, 2009, with early adoption permitted for periods ending after March 15, 2009. The Company elected to adopt FSP FAS 157-4 effective for its interim period ending March 31, 2009, and its adoption did not have a material impact on the Company's consolidated financial condition or results of operations. See Note 8, Investment Information Fair Value.

In April 2009, the FASB issued FSP No. FAS 107-1 and APB 28-1, Interim Disclosures about Fair Value of Financial Instruments (FSP FAS 107-1/APB 28-1). FSP FAS 107-1/APB 28-1 requires disclosures about fair value of financial instruments in interim and annual financial statements. FSP FAS 107-1/APB 28-1 is effective for periods ending after June 15, 2009, with early adoption permitted for periods ending after March 15, 2009. The Company elected to adopt FSP FAS 107-1/APB 28-1 effective for its interim period ending March 31, 2009, and has included the required disclosures in its notes to consolidated financial statements where applicable.



**ARCH CAPITAL GROUP LTD. AND SUBSIDIARIES**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)**

**3. Share Transactions**

*Share Repurchases*

The board of directors of ACGL has authorized the investment of up to \$1.5 billion in ACGL's common shares through a share repurchase program. Repurchases under the program may be effected from time to time in open market or privately negotiated transactions through February 2010. During the six months ended June 30, 2009, ACGL repurchased \$1.6 million of common shares through the share repurchase program. Since the inception of the share repurchase program through June 30, 2009, ACGL has repurchased 15.3 million common shares for an aggregate purchase price of \$1.05 billion. As a result of the share repurchase transactions to date, weighted average shares outstanding for the 2009 second quarter and six months ended June 30, 2009 were reduced by 15.3 million shares. Weighted average shares outstanding for the 2008 second quarter and six months ended June 30, 2008 were reduced by 11.9 million and 10.6 million shares, respectively.

At June 30, 2009, \$448.3 million of repurchases were available under the share repurchase program. The timing and amount of the repurchase transactions under this program will depend on a variety of factors, including market conditions and corporate and regulatory considerations. In connection with the share repurchase program, the Warburg Pincus funds waived their rights relating to share repurchases under its shareholders agreement with ACGL for all repurchases of common shares by ACGL under the share repurchase program in open market transactions and certain privately negotiated transactions.

*Non-Cumulative Preferred Shares*

During 2006, ACGL completed two public offerings of non-cumulative preferred shares. On February 1, 2006, \$200.0 million principal amount of 8.0% series A non-cumulative preferred shares ( Series A Preferred Shares ) were issued with net proceeds of \$193.5 million and, on May 24, 2006, \$125.0 million principal amount of 7.875% series B non-cumulative preferred shares ( Series B Preferred Shares ) and together with the Series A Preferred Shares, the Preferred Shares ) were issued with net proceeds of \$120.9 million. The net proceeds of the offerings were used to support the underwriting activities of ACGL's insurance and reinsurance subsidiaries. ACGL has the right to redeem all or a portion of each series of Preferred Shares at a redemption price of \$25.00 per share on or after (1) February 1, 2011 for the Series A Preferred Shares and (2) May 15, 2011 for the Series B Preferred Shares. Dividends on the Preferred Shares are non-cumulative. Consequently, in the event dividends are not declared on the Preferred Shares for any dividend period, holders of Preferred Shares will not be entitled to receive a dividend for such period, and such undeclared dividend will not accrue and will not be payable. Holders of Preferred Shares will be entitled to receive dividend payments only when, as and if declared by ACGL's board of directors or a duly authorized committee of the board of directors. Any such dividends will be payable from the date of original issue on a non-cumulative basis, quarterly in arrears. To the extent declared, these dividends will accumulate, with respect to each dividend period, in an amount per share equal to 8.0% of the \$25.00 liquidation preference per annum for the Series A Preferred Shares and 7.875% of the \$25.00 liquidation preference per annum for the Series B Preferred Shares. During the six months ended June 30, 2009 and 2008, the Company paid \$12.9 million to holders of the Preferred Shares. At June 30, 2009, the Company had declared an aggregate of \$3.3 million of dividends to be paid to holders of the Preferred Shares.

*Share-Based Compensation*

During the 2009 second quarter, the Company made a stock grant of 367,825 stock appreciation rights and stock options and 361,075 restricted shares and units to certain employees. During the 2008 second quarter, the Company made a stock grant of 333,175 stock appreciation rights and stock options and 328,575 restricted shares and units to certain employees. The stock appreciation rights and stock options were valued at the grant date using the Black-Scholes option pricing model. The weighted average grant-date fair value of the stock appreciation rights and options and restricted shares and units granted during the 2009 second quarter were

**ARCH CAPITAL GROUP LTD. AND SUBSIDIARIES**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)**

approximately \$17.64 and \$57.63 per share, respectively. Such values will be amortized over the respective substantive vesting period. The weighted average grant-date fair value of the stock appreciation rights and options and restricted shares and units granted during the 2008 second quarter were approximately \$19.07 and \$69.30 per share, respectively. Such values are being amortized over the respective substantive vesting period.

**4. Debt and Financing Arrangements**

*Senior Notes*

On May 4, 2004, ACGL completed a public offering of \$300 million principal amount of 7.35% senior notes ( Senior Notes ) due May 1, 2034 and received net proceeds of \$296.4 million. ACGL used \$200 million of the net proceeds to repay all amounts outstanding under a revolving credit agreement. The Senior Notes are ACGL's senior unsecured obligations and rank equally with all of its existing and future senior unsecured indebtedness. Interest payments on the Senior Notes are due on May 1st and November 1st of each year. ACGL may redeem the Senior Notes at any time and from time to time, in whole or in part, at a make-whole redemption price. For the six months ended June 30, 2009 and 2008, interest expense on the Senior Notes was \$11.0 million. The market value of the Senior Notes at June 30, 2009 and December 31, 2008 was \$237.4 million and \$246.1 million, respectively.

*Letter of Credit and Revolving Credit Facilities*

As of June 30, 2009, the Company had a \$300 million unsecured revolving loan and letter of credit facility and a \$1.0 billion secured letter of credit facility (the Credit Agreement ). Under the terms of the agreement, Arch Reinsurance Company ( Arch Re U.S. ) is limited to issuing \$100 million of unsecured letters of credit as part of the \$300 million unsecured revolving loan. Borrowings of revolving loans may be made by ACGL and Arch Re U.S. at a variable rate based on LIBOR or an alternative base rate at the option of the Company. Secured letters of credit are available for issuance on behalf of the Company's insurance and reinsurance subsidiaries. Issuance of letters of credit and borrowings under the Credit Agreement are subject to the Company's compliance with certain covenants and conditions, including absence of a material adverse change. These covenants require, among other things, that the Company maintain a debt to total capital ratio of not greater than 0.35 to 1 and shareholders' equity in excess of \$1.95 billion plus 25% of future aggregate net income for each quarterly period (not including any future net losses) beginning after June 30, 2006 and 25% of future aggregate proceeds from the issuance of common or preferred equity and that the Company's principal insurance and reinsurance subsidiaries maintain at least a B++ rating from A.M. Best. In addition, certain of the Company's subsidiaries which are party to the Credit Agreement are required to maintain minimum shareholders' equity levels. The Company was in compliance with all covenants contained in the Credit Agreement at June 30, 2009. The Credit Agreement expires on August 30, 2011.

Including the secured letter of credit portion of the Credit Agreement and another letter of credit facility (together, the LOC Facilities ), the Company has access to letter of credit facilities for up to a total of \$1.45 billion. The principal purpose of the LOC Facilities is to issue, as required, evergreen standby letters of credit in favor of primary insurance or reinsurance counterparties with which the Company has entered into reinsurance arrangements to ensure that such counterparties are permitted to take credit for reinsurance obtained from the Company's reinsurance subsidiaries in United States jurisdictions where such subsidiaries are not licensed or otherwise admitted as an insurer, as required

## Edgar Filing: ARCH CAPITAL GROUP LTD. - Form 10-Q

under insurance regulations in the United States, and to comply with requirements of Lloyd's of London in connection with qualifying quota share and other arrangements. The amount of letters of credit issued is driven by, among other things, the timing and payment of catastrophe losses, loss development of existing reserves, the payment pattern of such reserves, the further expansion of the Company's business and the loss experience of such business. When issued, certain letters of credit are secured by a portion of the Company's investment portfolio. In addition, the LOC Facilities also require the maintenance of certain covenants, which the Company was in compliance with at June 30, 2009. At such date, the Company had \$711.2 million in outstanding letters of credit under the LOC Facilities, which were secured by investments

**ARCH CAPITAL GROUP LTD. AND SUBSIDIARIES**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)**

with a market value of \$848.2 million. In May 2008, the Company borrowed \$100.0 million under the Credit Agreement at a Company-selected variable interest rate that is based on 1 month, 3 month or 6 month reset option terms and their corresponding term LIBOR rates plus 27.5 basis points. The proceeds from such borrowings, which are repayable in August 2011, were contributed as additional share capital to Arch Reinsurance Ltd. ( Arch Re Bermuda ) and used to fund the investment in Gulf Re (see Note 7).

**5. Segment Information**

The Company classifies its businesses into two underwriting segments insurance and reinsurance and corporate and other (non-underwriting). The Company's insurance and reinsurance operating segments each have segment managers who are responsible for the overall profitability of their respective segments and who are directly accountable to the Company's chief operating decision makers, the President and Chief Executive Officer of ACGL and the Chief Financial Officer of ACGL. The chief operating decision makers do not assess performance, measure return on equity or make resource allocation decisions on a line of business basis. The Company determined its reportable operating segments using the management approach described in SFAS No. 131, Disclosures about Segments of an Enterprise and Related Information.

Management measures segment performance based on underwriting income or loss. The Company does not manage its assets by segment and, accordingly, investment income is not allocated to each underwriting segment. In addition, other revenue and expense items are not evaluated by segment. The accounting policies of the segments are the same as those used for the preparation of the Company's consolidated financial statements. Intersegment business is allocated to the segment accountable for the underwriting results.

The insurance segment consists of the Company's insurance underwriting subsidiaries which primarily write on both an admitted and non-admitted basis. The insurance segment consists of eleven product lines: casualty; construction; executive assurance; healthcare; national accounts casualty; professional liability; programs; property, energy marine and aviation; surety; travel and accident; and other (consisting of excess workers compensation, employers liability and collateral protection business).

The reinsurance segment consists of the Company's reinsurance underwriting subsidiaries. The reinsurance segment generally seeks to write significant lines on specialty property and casualty reinsurance contracts. Classes of business include: casualty; marine and aviation; other specialty; property catastrophe; property excluding property catastrophe (losses on a single risk, both excess of loss and pro rata); and other (consisting of non-traditional and casualty clash business).

Corporate and other (non-underwriting) includes net investment income, other income (loss), other expenses incurred by the Company, interest expense, net realized gains or losses, net impairment losses recognized in earnings, equity in net income (loss) of investment funds accounted for using the equity method, net foreign exchange gains or losses, income taxes and dividends on the Company's non-cumulative preferred shares.





## ARCH CAPITAL GROUP LTD. AND SUBSIDIARIES

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)

The following tables set forth an analysis of the Company's underwriting income by segment, together with a reconciliation of underwriting income to net income available to common shareholders:

(U.S. dollars in thousands)	Insurance	Three Months Ended June 30, 2009		Total
		Reinsurance		
Gross premiums written (1)	\$ 636,645	\$ 278,389	\$	911,920
Net premiums written (1)	419,318	274,536		693,854
Net premiums earned (1)	\$ 417,454	\$ 281,804	\$	699,258
Fee income	795	22		817
Losses and loss adjustment expenses	(287,350)	(111,508)		(398,858)
Acquisition expenses, net	(58,748)	(65,066)		(123,814)
Other operating expenses	(70,836)	(16,943)		(87,779)
Underwriting income	\$ 1,315	\$ 88,309		89,624
Net investment income				100,485
Net realized losses				(11,793)
Net impairment losses recognized in earnings				(20,863)
Equity in net income of investment funds accounted for using the equity method				75,890
Other income				4,950
Other expenses				(11,515)
Interest expense				(5,712)
Net foreign exchange losses				(53,658)
Income before income taxes				167,408
Income tax expense				(8,818)
<b>Net income</b>				<b>158,590</b>
Preferred dividends				(6,461)
<b>Net income available to common shareholders</b>			\$	<b>152,129</b>
<b>Underwriting Ratios</b>				
Loss ratio	68.8%	39.6%		57.0%
Acquisition expense ratio (2)	13.9%	23.1%		17.6%
Other operating expense ratio	17.0%	6.0%		12.6%
Combined ratio	99.7%	68.7%		87.2%

(1) Certain amounts included in the gross premiums written of each segment are related to intersegment transactions. Accordingly, the sum of gross premiums written for each segment does not agree to the total gross premiums written as shown in the table above due to the elimination of intersegment transactions in the total. The insurance segment and reinsurance segment results include nil and \$3.1 million, respectively, of gross and net premiums written and \$0.4 million and \$3.6 million, respectively, of net premiums earned assumed through intersegment transactions.

(2) The acquisition expense ratio is adjusted to include policy-related fee income.



## ARCH CAPITAL GROUP LTD. AND SUBSIDIARIES

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)

(U.S. dollars in thousands)	Three Months Ended June 30, 2008		Total
	Insurance	Reinsurance	
Gross premiums written (1)	\$ 621,663	\$ 273,318	\$ 886,926
Net premiums written (1)	421,501	264,617	686,118
Net premiums earned (1)	\$ 416,585	\$ 289,090	\$ 705,675
Fee income	880	358	1,238
Losses and loss adjustment expenses	(262,633)	(141,992)	(404,625)
Acquisition expenses, net	(55,400)	(63,826)	(119,226)
Other operating expenses	(71,566)	(20,091)	(91,657)
Underwriting income	\$ 27,866	\$ 63,539	91,405
Net investment income			117,120
Net realized losses			(1,920)
Net impairment losses recognized in earnings			(10,749)
Equity in net income of investment funds accounted for using the equity method			19,583
Other income			4,968
Other expenses			(10,921)
Interest expense			(5,788)
Net foreign exchange gains			298
Income before income taxes			203,996
Income tax expense			(5,253)
<b>Net income</b>			<b>198,743</b>
Preferred dividends			(6,461)
<b>Net income available to common shareholders</b>			<b>\$ 192,282</b>
<b>Underwriting Ratios</b>			
Loss ratio	63.0%	49.1%	57.3%
Acquisition expense ratio (2)	13.1%	22.1%	16.8%
Other operating expense ratio	17.2%	6.9%	13.0%
Combined ratio	93.3%	78.1%	87.1%

(1) Certain amounts included in the gross premiums written of each segment are related to intersegment transactions. Accordingly, the sum of gross premiums written for each segment does not agree to the total gross premiums written as shown in the table above due to the elimination of intersegment transactions in the total. The insurance segment and reinsurance segment results include \$0.1 million and \$8.0 million, respectively, of gross and net premiums written and \$0.1 million and \$8.5 million, respectively, of net premiums earned assumed through intersegment transactions.

(2) The acquisition expense ratio is adjusted to include certain fee income.

## ARCH CAPITAL GROUP LTD. AND SUBSIDIARIES

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)

(U.S. dollars in thousands)	Insurance	Six Months Ended June 30, 2009 Reinsurance	Total
Gross premiums written (1)	\$ 1,275,054	\$ 668,518	\$ 1,936,891
Net premiums written (1)	860,904	655,813	1,516,717
Net premiums earned (1)	\$ 818,551	\$ 581,271	\$ 1,399,822
Fee income	1,665	77	1,742
Losses and loss adjustment expenses	(557,365)	(242,035)	(799,400)
Acquisition expenses, net	(116,371)	(133,901)	(250,272)
Other operating expenses	(133,744)	(35,135)	(168,879)
Underwriting income	\$ 12,736	\$ 170,277	183,013
Net investment income			196,367
Net realized losses			(16,957)
Net impairment losses recognized in earnings			(56,997)
Equity in net income of investment funds accounted for using the equity method			66,309
Other income			8,901
Other expenses			(17,531)
Interest expense			(11,424)
Net foreign exchange losses			(28,453)
Income before income taxes			323,228
Income tax expense			(18,308)
<b>Net income</b>			<b>304,920</b>
Preferred dividends			(12,922)
<b>Net income available to common shareholders</b>			<b>\$ 291,998</b>
<b>Underwriting Ratios</b>			
Loss ratio	68.1%	41.6%	57.1%
Acquisition expense ratio (2)	14.0%	23.0%	17.8%
Other operating expense ratio	16.3%	6.0%	12.1%
Combined ratio	98.4%	70.6%	87.0%

(1) Certain amounts included in the gross premiums written of each segment are related to intersegment transactions. Accordingly, the sum of gross premiums written for each segment does not agree to the total gross premiums written as shown in the table above due to the elimination of intersegment transactions in the total. The insurance segment and reinsurance segment results include \$0.1 million and \$6.6 million, respectively, of gross and net premiums written and \$0.9 million and \$8.3 million, respectively, of net premiums earned assumed through intersegment transactions.

(2) The acquisition expense ratio is adjusted to include policy-related fee income.

## ARCH CAPITAL GROUP LTD. AND SUBSIDIARIES

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)

(U.S. dollars in thousands)	Insurance	Six Months Ended June 30, 2008 Reinsurance	Total
Gross premiums written (1)	\$ 1,248,011	\$ 707,145	\$ 1,940,078
Net premiums written (1)	824,265	673,195	1,497,460
Net premiums earned (1)	\$ 835,685	\$ 578,224	\$ 1,413,909
Fee income	1,762	544	2,306
Losses and loss adjustment expenses	(549,936)	(259,106)	(809,042)
Acquisition expenses, net	(107,289)	(126,576)	(233,865)
Other operating expenses	(145,203)	(38,329)	(183,532)
Underwriting income	\$ 35,019	\$ 154,757	189,776
Net investment income			239,313
Net realized gains			46,766
Net impairment losses recognized in earnings			(23,460)
Equity in net income (loss) of investment funds accounted for using the equity method			(2,730)
Other income			9,004
Other expenses			(16,233)
Interest expense			(11,312)
Net foreign exchange losses			(23,289)
Income before income taxes			407,835
Income tax expense			(13,209)
<b>Net income</b>			<b>394,626</b>
Preferred dividends			(12,922)
<b>Net income available to common shareholders</b>			<b>\$ 381,704</b>
<b>Underwriting Ratios</b>			
Loss ratio	65.8%	44.8%	57.2%
Acquisition expense ratio (2)	12.6%	21.9%	16.4%
Other operating expense ratio	17.4%	6.6%	13.0%
Combined ratio	95.8%	73.3%	86.6%

(1) Certain amounts included in the gross premiums written of each segment are related to intersegment transactions. Accordingly, the sum of gross premiums written for each segment does not agree to the total gross premiums written as shown in the table above due to the elimination of intersegment transactions in the total. The insurance segment and reinsurance segment results include \$0.1 million and \$15.0 million, respectively, of gross and net premiums written and \$0.2 million and \$17.2 million, respectively, of net premiums earned assumed through intersegment transactions.

(2) The acquisition expense ratio is adjusted to include certain fee income.

## ARCH CAPITAL GROUP LTD. AND SUBSIDIARIES

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)

Set forth below is summary information regarding net premiums written and earned by major line of business and net premiums written by client location for the insurance segment:

INSURANCE SEGMENT (U.S. dollars in thousands)	2009		Three Months Ended June 30,		2008	
	Amount	% of Total	Amount	% of Total	Amount	% of Total
<b>Net premiums written (1)</b>						
Property, energy, marine and aviation	\$ 86,385	20.6	\$ 89,674	21.3		
Programs	72,279	17.2	73,202	17.4		
Professional liability	57,773	13.8	63,583	15.1		
Construction	56,190	13.4	50,105	11.9		
Executive assurance	52,919	12.6	43,740	10.4		
Casualty	27,217	6.5	31,161	7.4		
Travel and accident	19,557	4.7	15,948	3.8		
Healthcare	9,667	2.3	11,027	2.6		
Surety	9,254	2.2	10,206	2.4		
National accounts casualty	7,582	1.8	9,416	2.2		
Other (2)	20,495	4.9	23,439	5.5		
<b>Total</b>	<b>\$ 419,318</b>	<b>100.0</b>	<b>\$ 421,501</b>	<b>100.0</b>		
<b>Net premiums earned (1)</b>						
Property, energy, marine and aviation	\$ 78,570	18.8	\$ 83,830	20.1		
Programs	71,809	17.2	62,085	14.9		
Professional liability	56,549	13.5	66,200	15.9		
Construction	43,364	10.4	39,225	9.4		
Executive assurance	52,288	12.5	44,496	10.7		
Casualty	31,246	7.5	38,292	9.2		
Travel and accident	18,198	4.4	15,994	3.8		
Healthcare	10,830	2.6	13,137	3.2		
Surety	12,141	2.9	12,057	2.9		
National accounts casualty	13,079	3.1	9,752	2.3		
Other (2)	29,380	7.1	31,517	7.6		
<b>Total</b>	<b>\$ 417,454</b>	<b>100.0</b>	<b>\$ 416,585</b>	<b>100.0</b>		
<b>Net premiums written by client location (1)</b>						
United States	\$ 339,375	80.9	\$ 330,154	78.3		
Europe	48,126	11.5	56,657	13.4		
Other	31,817	7.6	34,690	8.3		
<b>Total</b>	<b>\$ 419,318</b>	<b>100.0</b>	<b>\$ 421,501</b>	<b>100.0</b>		
<b>Net premiums written by underwriting location (1)</b>						
United States	\$ 315,466	75.2	\$ 318,227	75.5		
Europe	78,305	18.7	79,854	18.9		
Other	25,547	6.1	23,420	5.6		
<b>Total</b>	<b>\$ 419,318</b>	<b>100.0</b>	<b>\$ 421,501</b>	<b>100.0</b>		

(1) Insurance segment results include premiums written and earned assumed through intersegment transactions of nil and \$0.4 million, respectively, for the 2009 second quarter and premiums written and earned of \$0.1 million for the 2008 second quarter. Insurance segment results exclude premiums written and earned ceded through intersegment transactions of \$3.1 million and \$3.6 million, respectively, for the 2009 second quarter and \$8.0 million and \$8.5 million, respectively, for the 2008 second quarter.

(2) Includes excess workers compensation, employers liability, and collateral protection business.



## ARCH CAPITAL GROUP LTD. AND SUBSIDIARIES

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)

INSURANCE SEGMENT (U.S. dollars in thousands)	2009		Six Months Ended June 30,		2008	
	Amount	% of Total	Amount	% of Total	Amount	% of Total
<b>Net premiums written (1)</b>						
Property, energy, marine and aviation	\$ 192,414	22.4	\$ 186,911	22.7		
Programs	147,086	17.1	127,785	15.5		
Professional liability	109,781	12.8	117,664	14.3		
Executive assurance	102,998	12.0	85,909	10.4		
Construction	92,761	10.8	89,585	10.9		
Casualty	53,756	6.2	59,704	7.2		
Travel and accident	37,091	4.3	32,601	4.0		
National accounts casualty	31,809	3.7	22,471	2.7		
Healthcare	20,886	2.4	22,024	2.7		
Surety	20,612	2.4	21,073	2.6		
Other (2)	51,710	5.9	58,538	7.0		
<b>Total</b>	<b>\$ 860,904</b>	<b>100.0</b>	<b>\$ 824,265</b>	<b>100.0</b>		
<b>Net premiums earned (1)</b>						
Property, energy, marine and aviation	\$ 152,410	18.6	\$ 168,288	20.1		
Programs	138,478	16.9	119,072	14.2		
Professional liability	114,783	14.0	135,010	16.2		
Executive assurance	100,104	12.2	88,904	10.6		
Construction	83,784	10.2	81,942	9.8		
Casualty	63,944	7.8	80,598	9.6		
Travel and accident	31,354	3.8	31,479	3.8		
National accounts casualty	27,518	3.4	17,675	2.1		
Healthcare	21,758	2.7	26,582	3.2		
Surety	25,532	3.1	25,556	3.1		
Other (2)	58,886	7.3	60,579	7.3		
<b>Total</b>	<b>\$ 818,551</b>	<b>100.0</b>	<b>\$ 835,685</b>	<b>100.0</b>		
<b>Net premiums written by client location (1)</b>						
United States	\$ 656,419	76.2	\$ 609,409	73.9		
Europe	140,522	16.3	142,957	17.3		
Other	63,963	7.5	71,899	8.8		
<b>Total</b>	<b>\$ 860,904</b>	<b>100.0</b>	<b>\$ 824,265</b>	<b>100.0</b>		
<b>Net premiums written by underwriting location (1)</b>						
United States	\$ 636,295	73.9	\$ 605,436	73.5		
Europe	183,618	21.3	181,865	22.1		
Other	40,991	4.8	36,964	4.4		
<b>Total</b>	<b>\$ 860,904</b>	<b>100.0</b>	<b>\$ 824,265</b>	<b>100.0</b>		

(1) Insurance segment results include premiums written and earned assumed through intersegment transactions of \$0.1 million and \$0.9 million, respectively, for the 2009 period and premiums written and earned of \$0.1 million and \$0.2 million, respectively, for the 2008 period. Insurance segment results exclude premiums written and earned ceded through intersegment transactions of \$6.6 million and \$8.3 million, respectively, for the 2009 period and \$15.0 million and \$17.2 million, respectively, for the 2008 period.

- (2) Includes excess workers compensation, employers liability, and collateral protection business.

## ARCH CAPITAL GROUP LTD. AND SUBSIDIARIES

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)

The following table sets forth the reinsurance segment's net premiums written and earned by major line of business and type of business, together with net premiums written by client location:

REINSURANCE SEGMENT (U.S. dollars in thousands)	2009		Three Months Ended June 30,		2008	
	Amount	% of Total	Amount	% of Total	Amount	% of Total
<b>Net premiums written (1)</b>						
Property catastrophe	\$ 91,981	33.5	\$ 52,797	20.0		
Property excluding property catastrophe (2)	90,569	33.0	85,748	32.4		
Casualty (3)	72,490	26.4	86,974	32.9		
Marine and aviation	15,391	5.6	17,975	6.8		
Other specialty	3,304	1.2	20,693	7.8		
Other	801	0.3	430	0.1		
Total	\$ 274,536	100.0	\$ 264,617	100.0		
<b>Net premiums earned (1)</b>						
Property catastrophe	\$ 58,763	20.9	\$ 51,496	17.8		
Property excluding property catastrophe (2)	87,304	31.0	67,445	23.3		
Casualty (3)	84,078	29.8	106,199	36.7		
Marine and aviation	25,063	8.9	26,946	9.3		
Other specialty	25,912	9.2	36,058	12.5		
Other	684	0.2	946	0.4		
Total	\$ 281,804	100.0	\$ 289,090	100.0		
<b>Net premiums written (1)</b>						
Pro rata	\$ 140,939	51.3	\$ 168,025	63.5		
Excess of loss	133,597	48.7	96,592	36.5		
Total	\$ 274,536	100.0	\$ 264,617	100.0		
<b>Net premiums earned (1)</b>						
Pro rata	\$ 175,665	62.3	\$ 195,070	67.5		
Excess of loss	106,139	37.7	94,020	32.5		
Total	\$ 281,804	100.0	\$ 289,090	100.0		
<b>Net premiums written by client location (1)</b>						
United States	\$ 193,190	70.4	\$ 153,106	57.9		
Europe	39,782	14.5	58,372	22.1		
Bermuda	32,665	11.9	40,784	15.4		
Other	8,899	3.2	12,355	4.6		
Total	\$ 274,536	100.0	\$ 264,617	100.0		
<b>Net premiums written by underwriting location (1)</b>						
Bermuda	\$ 184,892	67.3	\$ 160,228	60.6		
United States	79,152	28.8	92,629	35.0		
Other	10,492	3.9	11,760	4.4		
Total	\$ 274,536	100.0	\$ 264,617	100.0		

---

(1) Reinsurance segment results include premiums written and earned assumed through intersegment transactions of \$3.1 million and \$3.6 million, respectively, for the 2009 second quarter and \$8.0 million and \$8.5 million, respectively, for the 2008 second quarter. Reinsurance segment results exclude premiums written and earned ceded through intersegment transactions of nil and \$0.4 million, respectively, for the 2009 second quarter and premiums written and earned of \$0.1 million for the 2008 second quarter.

(2) Includes facultative business.

(3) Includes professional liability, executive assurance and healthcare business.

## ARCH CAPITAL GROUP LTD. AND SUBSIDIARIES

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)

REINSURANCE SEGMENT (U.S. dollars in thousands)	2009		Six Months Ended June 30,		2008	
	Amount	% of Total	Amount	% of Total	Amount	% of Total
<b>Net premiums written (1)</b>						
Property excluding property catastrophe (2)	\$ 209,657	32.0	\$ 181,670		\$ 181,670	27.0
Property catastrophe	183,884	28.0	159,021		159,021	23.6
Casualty (3)	171,922	26.2	192,961		192,961	28.7
Other specialty	44,016	6.7	96,373		96,373	14.3
Marine and aviation	43,914	6.7	40,139		40,139	6.0
Other	2,420	0.4	3,031		3,031	0.4
Total	\$ 655,813	100.0	\$ 673,195		\$ 673,195	100.0
<b>Net premiums earned (1)</b>						
Property excluding property catastrophe (2)	\$ 183,535	31.6	\$ 130,786		\$ 130,786	22.6
Property catastrophe	117,364	20.2	101,777		101,777	17.6
Casualty (3)	170,024	29.3	213,847		213,847	37.0
Other specialty	59,362	10.2	74,542		74,542	12.9
Marine and aviation	49,893	8.6	54,377		54,377	9.4
Other	1,093	0.1	2,895		2,895	0.5
Total	\$ 581,271	100.0	\$ 578,224		\$ 578,224	100.0
<b>Net premiums written (1)</b>						
Pro rata	\$ 322,161	49.1	\$ 383,444		\$ 383,444	57.0
Excess of loss	333,652	50.9	289,751		289,751	43.0
Total	\$ 655,813	100.0	\$ 673,195		\$ 673,195	100.0
<b>Net premiums earned (1)</b>						
Pro rata	\$ 370,183	63.7	\$ 387,146		\$ 387,146	67.0
Excess of loss	211,088	36.3	191,078		191,078	33.0
Total	\$ 581,271	100.0	\$ 578,224		\$ 578,224	100.0
<b>Net premiums written by client location (1)</b>						
United States	\$ 423,158	64.5	\$ 370,285		\$ 370,285	55.0
Europe	141,283	21.5	202,292		202,292	30.0
Bermuda	70,232	10.7	74,844		74,844	11.1
Other	21,140	3.3	25,774		25,774	3.9
Total	\$ 655,813	100.0	\$ 673,195		\$ 673,195	100.0
<b>Net premiums written by underwriting location (1)</b>						
Bermuda	\$ 380,492	58.0	\$ 380,897		\$ 380,897	56.6
United States	225,345	34.4	247,109		247,109	36.7
Other	49,976	7.6	45,189		45,189	6.7
Total	\$ 655,813	100.0	\$ 673,195		\$ 673,195	100.0

(1) Reinsurance segment results include premiums written and earned assumed through intersegment transactions of \$6.6 million and \$8.3 million, respectively, for the 2009 period and \$15.0 million and \$17.2 million, respectively, for the 2008 period. Reinsurance segment results exclude premiums written and earned ceded through intersegment transactions of \$0.1 million and \$0.9 million, respectively, for the 2009 period

Edgar Filing: ARCH CAPITAL GROUP LTD. - Form 10-Q

and premiums written and earned of \$0.1 million and \$0.2 million, respectively, for the 2008 period.

- (2) Includes facultative business.
- (3) Includes professional liability, executive assurance and healthcare business.

## ARCH CAPITAL GROUP LTD. AND SUBSIDIARIES

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)

## 6. Reinsurance

In the normal course of business, the Company's insurance subsidiaries cede a substantial portion of their premium through pro rata and excess of loss reinsurance agreements on a treaty or facultative basis. The Company's reinsurance subsidiaries participate in common account retrocessional arrangements for certain pro rata treaties. Such arrangements reduce the effect of individual or aggregate losses to all companies participating on such treaties, including the reinsurers, such as the Company's reinsurance subsidiaries, and the ceding company. In addition, the Company's reinsurance subsidiaries may purchase retrocessional coverage as part of their risk management program. Reinsurance recoverables are recorded as assets, predicated on the reinsurers' ability to meet their obligations under the reinsurance agreements. If the reinsurers are unable to satisfy their obligations under the agreements, the Company's insurance or reinsurance subsidiaries would be liable for such defaulted amounts.

The effects of reinsurance on the Company's written and earned premiums and losses and loss adjustment expenses with unaffiliated reinsurers were as follows:

(U.S. dollars in thousands)	Three Months Ended June 30,		Six Months Ended June 30,	
	2009	2008	2009	2008
<b>Premiums Written</b>				
Direct	\$ 623,603	\$ 579,006	\$ 1,244,049	\$ 1,198,492
Assumed	288,317	307,920	692,842	741,586
Ceded	(218,066)	(200,808)	(420,174)	(442,618)
Net	\$ 693,854	\$ 686,118	\$ 1,516,717	\$ 1,497,460
<b>Premiums Earned</b>				
Direct	\$ 607,670	\$ 615,216	\$ 1,195,430	\$ 1,246,030
Assumed	308,124	354,712	640,691	720,076
Ceded	(216,536)	(264,253)	(436,299)	(552,197)
Net	\$ 699,258	\$ 705,675	\$ 1,399,822	\$ 1,413,909
<b>Losses and Loss Adjustment Expenses</b>				
Direct	\$ 399,926	\$ 355,680	\$ 751,419	\$ 776,651
Assumed	126,582	186,099	273,727	327,348
Ceded	(127,650)	(137,154)	(225,746)	(294,957)
Net	\$ 398,858	\$ 404,625	\$ 799,400	\$ 809,042

The Company monitors the financial condition of its reinsurers and attempts to place coverages only with substantial, financially sound carriers. At June 30, 2009, approximately 89.3% of the Company's reinsurance recoverables on paid and unpaid losses (not including prepaid reinsurance premiums) of \$1.79 billion were due from carriers which had an A.M. Best rating of A- or better and the largest reinsurance recoverables from any one carrier was less than 6.5% of the Company's total shareholders' equity. At December 31, 2008, approximately 88.5% of the Company's reinsurance recoverables on paid and unpaid losses (not including prepaid reinsurance premiums) of \$1.79 billion were due from carriers which had an A.M. Best rating of A- or better and the largest reinsurance recoverables from any one carrier was less than 7.3% of the Company's total shareholders' equity.

On December 29, 2005, Arch Re Bermuda entered into a quota share reinsurance treaty with Flatiron Re Ltd. ( Flatiron ), a Bermuda reinsurance company, pursuant to which Flatiron assumed a 45% quota share (the Treaty ) of certain lines of property and marine business underwritten by Arch Re Bermuda for unaffiliated third parties for the 2006 and 2007 underwriting years (January 1, 2006 to December 31, 2007). Effective June 28, 2006, the parties amended the Treaty to increase the percentage ceded to Flatiron from 45% to 70% of all covered business bound by Arch Re Bermuda from (and including) June 28, 2006 until (and including) August



**ARCH CAPITAL GROUP LTD. AND SUBSIDIARIES**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)**

15, 2006 provided such business did not incept beyond September 30, 2006. The ceding percentage for all business bound outside of this period continued to be 45%. On December 31, 2007, the Treaty expired by its terms. At June 30, 2009, \$1.7 million of premiums ceded to Flatiron were unearned.

Flatiron is required to contribute funds into a trust for the benefit of Arch Re Bermuda (the Trust). Effective June 28, 2006, the parties amended the Treaty to provide that, through the earning of all written premium, the amount required to be on deposit in the Trust, together with certain other amounts, will be an amount equal to a calculated amount estimated to cover ceded losses arising from in excess of two 1-in-250 year events for the applicable forward twelve-month period (the Requisite Funded Amount). If the actual amounts on deposit in the Trust, together with certain other amounts (the Funded Amount), do not at least equal the Requisite Funded Amount, Arch Re Bermuda will, among other things, recapture unearned premium reserves and reassume losses that would have been ceded in respect of such unearned premiums. No assurances can be given that actual losses will not exceed the Requisite Funded Amount or that Flatiron will make, or will have the ability to make, the required contributions into the Trust.

Arch Re Bermuda pays to Flatiron a reinsurance premium in the amount of the ceded percentage of the original gross written premium on the business reinsured less a ceding commission, which includes a reimbursement of direct acquisition expenses as well as a commission to Arch Re Bermuda for generating the business. The Treaty also provides for a profit commission to Arch Re Bermuda based on the underwriting results for the 2006 and 2007 underwriting years on a cumulative basis. For the 2009 second quarter, \$0.5 million of premiums written, \$6.0 million of premiums earned and (\$1.6) million of losses and loss adjustment expenses were ceded to Flatiron by Arch Re Bermuda, compared to \$7.0 million of premiums written, \$45.9 million of premiums earned and \$15.7 million of losses and loss adjustment expenses for the 2008 second quarter. For the six months ended June 30, 2009, \$4.0 million of premiums written, \$20.5 million of premiums earned and \$2.0 million of losses and loss adjustment expenses were ceded to Flatiron by Arch Re Bermuda, compared to \$25.4 million of premiums written, \$104.7 million of premiums earned and \$27.5 million of losses and loss adjustment expenses for the 2008 period. Reinsurance recoverables from Flatiron, which is not rated by A.M. Best, were \$131.1 million at June 30, 2009, compared to \$148.7 million at December 31, 2008. As noted above, Flatiron is required to contribute funds into a trust for the benefit of Arch Re Bermuda. The recoverable from Flatiron was fully collateralized through such trust at June 30, 2009 and December 31, 2008.

**7. Investment in Joint Venture**

In May 2008, the Company provided \$100.0 million of funding to Gulf Reinsurance Limited (Gulf Re), a newly formed reinsurer based in the Dubai International Financial Centre, pursuant to the joint venture agreement with Gulf Investment Corporation GSC (GIC). Under the agreement, Arch Re Bermuda and GIC each own 50% of Gulf Re, which commenced underwriting activities in June 2008. Gulf Re will initially target the six member states of the Gulf Cooperation Council, which include Bahrain, Kuwait, Oman, Qatar, Saudi Arabia and the United Arab Emirates. The joint venture will write a broad range of property and casualty reinsurance, including aviation, energy, commercial transportation, marine, engineered risks and property, on both a treaty and facultative basis. The initial capital of the joint venture consisted of \$200.0 million with an additional \$200.0 million commitment to be funded equally by the Company and GIC depending on the joint venture's business needs. The Company accounts for its investment in Gulf Re, shown as Investment in joint venture, using the equity method and records its equity in the operating results of Gulf Re in Other income on a quarter lag basis.



## ARCH CAPITAL GROUP LTD. AND SUBSIDIARIES

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)

## 8. Investment Information

The following table summarizes the Company's invested assets:

(U.S. dollars in thousands)	June 30, 2009	December 31, 2008
Fixed maturities available for sale, at market value	\$ 8,944,110	\$ 8,122,221
Fixed maturities pledged under securities lending agreements, at market value (1)	559,385	626,501
Total fixed maturities	9,503,495	8,748,722
Short-term investments available for sale, at market value	660,859	479,586
Short-term investments pledged under securities lending agreements, at market value (1)		101,564
Other investments	115,260	109,601
Investment funds accounted for using the equity method	370,165	301,027
Total investments (1)	10,649,779	9,740,500
Securities transactions entered into but not settled at the balance sheet date	(239,736)	(18,236)
Total investments, net of securities transactions	\$ 10,410,043	\$ 9,722,264

(1) In securities lending transactions, the Company receives collateral in excess of the market value of the fixed maturities and short-term investments pledged under securities lending agreements. For purposes of this table, the Company has excluded the collateral received at June 30, 2009 and December 31, 2008 of \$556.5 million and \$730.2 million, respectively, which is reflected as investment of funds received under securities lending agreements, at market value and included the \$559.4 million and \$728.1 million, respectively, of fixed maturities and short-term investments pledged under securities lending agreements, at market value.

## ARCH CAPITAL GROUP LTD. AND SUBSIDIARIES

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)

*Fixed Maturities and Fixed Maturities Pledged Under Securities Lending Agreements*

The following table summarizes the Company's fixed maturities and fixed maturities pledged under securities lending agreements:

(U.S. dollars in thousands)	Estimated Market Value	Gross Unrealized Gains	Gross Unrealized Losses	Amortized Cost	OTTI Unrealized Losses (1)
<b>June 30, 2009:</b>					
Corporate bonds	\$ 2,885,694	\$ 65,137	\$ (42,771)	\$ 2,863,328	\$ (22,714)
Mortgage backed securities	1,622,276	21,324	(104,187)	1,705,139	(75,010)
U.S. government and government agencies	1,289,603	20,917	(12,888)	1,281,574	(614)
Commercial mortgage backed securities	1,302,208	26,455	(25,932)	1,301,685	(5,689)
Asset backed securities	805,921	17,483	(21,747)	810,185	(8,176)
Municipal bonds	858,065	29,595	(2,796)	831,266	(198)
Non-U.S. government securities	739,728	46,625	(8,222)	701,325	(647)
Total	\$ 9,503,495	\$ 227,536	\$ (218,543)	\$ 9,494,502	\$ (113,048)
<b>December 31, 2008:</b>					
Corporate bonds	\$ 2,019,373	\$ 51,131	\$ (98,979)	\$ 2,067,221	
Mortgage backed securities	1,581,736	23,306	(125,759)	1,684,189	
U.S. government and government agencies	1,463,897	77,762	(14,159)	1,400,294	
Commercial mortgage backed securities	1,219,737	16,128	(68,212)	1,271,821	
Asset backed securities	970,041	1,121	(70,762)	1,039,682	
Municipal bonds	965,966	26,815	(1,730)	940,881	
Non-U.S. government securities	527,972	33,690	(31,884)	526,166	
Total	\$ 8,748,722	\$ 229,953	\$ (411,485)	\$ 8,930,254	

(1) Represents the total other-than-temporary impairments ( OTTI ) recognized in accumulated other comprehensive income ( AOCI ) and included in the gross unrealized losses column. See discussion below regarding the adoption of FSP FAS 115-2/124-2.

The contractual maturities of the Company's fixed maturities and fixed maturities pledged under securities lending agreements are shown below. Expected maturities, which are management's best estimates, will differ from contractual maturities because borrowers may have the right to call or prepay obligations with or without call or prepayment penalties.

(U.S. dollars in thousands)

	June 30, 2009	December 31, 2008
Maturity		

Edgar Filing: ARCH CAPITAL GROUP LTD. - Form 10-Q

	Estimated Market Value	Amortized Cost	Estimated Market Value	Amortized Cost
Due in one year or less	\$ 146,618	\$ 146,858	\$ 173,168	\$ 169,187
Due after one year through five years	3,329,051	3,256,831	2,451,062	2,452,344
Due after five years through 10 years	1,948,949	1,915,691	1,726,742	1,686,575
Due after 10 years	348,472	358,113	626,236	626,456
	5,773,090	5,677,493	4,977,208	4,934,562
Mortgage backed securities	1,622,276	1,705,139	1,581,736	1,684,189
Commercial mortgage backed securities	1,302,208	1,301,685	1,219,737	1,271,821
Asset backed securities	805,921	810,185	970,041	1,039,682
Total	\$ 9,503,495	\$ 9,494,502	\$ 8,748,722	\$ 8,930,254

## ARCH CAPITAL GROUP LTD. AND SUBSIDIARIES

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)

The following table provides an analysis of the length of time each of those fixed maturities, fixed maturities pledged under securities lending agreements, equity securities and short-term investments with an unrealized loss has been in a continual unrealized loss position:

(U.S. dollars in thousands)	Less than 12 Months		12 Months or More		Total	
	Estimated Market Value	Gross Unrealized Losses	Estimated Market Value	Gross Unrealized Losses	Estimated Market Value	Gross Unrealized Losses
<b>June 30, 2009:</b>						
Corporate bonds	\$ 643,447	\$ (26,512)	\$ 134,918	\$ (16,259)	\$ 778,365	\$ (42,771)
Mortgage backed securities	664,504	(70,863)	98,424	(33,324)	762,928	(104,187)
U.S. government and government agencies	316,853	(12,888)			316,853	(12,888)
Commercial mortgage backed securities	346,462	(7,429)	189,538	(18,503)	536,000	(25,932)
Asset backed securities	130,279	(16,171)	37,896	(5,576)	168,175	(21,747)
Municipal bonds	114,598	(2,324)	7,498	(472)	122,096	(2,796)
Non-U.S. government securities	281,854	(8,157)	5,905	(95)	287,759	(8,222)
Total	2,497,997	(144,344)	474,179	(74,199)	2,972,176	(218,543)
Other investments	2,859	(315)	24,982	(9,850)	27,841	(10,165)
Short-term investments	7,159	(167)			7,159	(167)
Total	\$ 2,508,015	\$ (144,826)	\$ 499,161	\$ (84,049)	\$ 3,007,176	\$ (228,875)
<b>December 31, 2008:</b>						
Corporate bonds	\$ 870,093	\$ (89,446)	\$ 30,608	\$ (9,533)	\$ 900,701	\$ (98,979)
Mortgage backed securities	417,373	(105,154)	23,295	(20,605)	440,668	(125,759)
U.S. government and government agencies	356,719	(14,159)			356,719	(14,159)
Commercial mortgage backed securities	714,497	(68,210)	52	(2)	714,549	(68,212)
Asset backed securities	888,908	(63,845)	26,185	(6,917)	915,093	(70,762)
Municipal bonds	93,072	(1,730)			93,072	(1,730)
Non-U.S. government securities	223,314	(31,882)	142	(2)	223,456	(31,884)
Total	3,563,976	(374,426)	80,282	(37,059)	3,644,258	(411,485)
Other investments	20,510	(3,649)	13,715	(20,919)	34,225	(24,568)
Short-term investments	33,080	(2,535)			33,080	(2,535)
Total	\$ 3,617,566	\$ (380,610)	\$ 93,997	\$ (57,978)	\$ 3,711,563	\$ (438,588)

*Other-Than-Temporary Impairments*

*Adoption of FSP FAS 115-2/124-2*

In April 2009, the FASB issued FSP No. FAS 115-2 and FAS 124-2, Recognition and Presentation of Other-Than-Temporary Impairments ( FSP FAS 115-2/124-2 ). FSP FAS 115-2/124-2 requires entities to separate an other-than-temporary impairment ( OTTI ) of a debt security into two components when there are credit related losses associated with the impaired debt security for which the Company asserts that it does not have the intent to sell the security, and it is more likely than not that it will not be required to sell the security before recovery of its cost basis. Prior to January 1, 2009, the Company had to determine whether it had the intent and ability to hold the investment for a sufficient period of time for the value to recover. The Company's process for identifying declines in the market value of investments that were considered other-than-temporary involved consideration of several factors. These factors included (i) an analysis of the liquidity, business

**ARCH CAPITAL GROUP LTD. AND SUBSIDIARIES**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)**

prospects and overall financial condition of the issuer, (ii) the time period in which there was a significant decline in value, and (iii) the significance of the decline. When the analysis of such factors resulted in the Company's conclusion that declines in market values were other-than-temporary, the cost of the securities was written down to market value and the reduction in value was reflected as a realized loss. Effective under FSP FAS 115-2/124-2, the amount of the OTTI related to a credit loss is recognized in earnings, and the amount of the OTTI related to other factors (*e.g.*, interest rates, market conditions, etc.) is recorded as a component of other comprehensive income (loss). In instances where no credit loss exists but it is more likely than not that the Company will have to sell the debt security prior to the anticipated recovery, the decline in market value below amortized cost is recognized as an OTTI in earnings. In periods after the recognition of an OTTI on debt securities, the Company accounts for such securities as if they had been purchased on the measurement date of the OTTI at an amortized cost basis equal to the previous amortized cost basis less the OTTI recognized in earnings. For debt securities for which OTTI were recognized in earnings, the difference between the new amortized cost basis and the cash flows expected to be collected will be accreted or amortized into net investment income. FSP FAS 115-2/124-2 is effective for periods ending after June 15, 2009, with early adoption permitted for periods ending after March 15, 2009. The Company elected to adopt FSP FAS 115-2/124-2 effective for its interim period ended March 31, 2009.

FSP FAS 115-2/124-2 requires that the Company record, as of the beginning of the interim period of adoption, a cumulative effect adjustment to reclassify the noncredit component of a previously recognized OTTI from retained earnings to other comprehensive income (loss). For purposes of calculating the cumulative effect adjustment, the Company reviewed OTTI it had recorded through realized losses on securities held at December 31, 2008, which were \$171.1 million, and estimated the portion related to credit losses (*i.e.*, where the present value of cash flows expected to be collected are lower than the amortized cost basis of the security) and the portion related to all other factors. The Company determined that \$109.1 million of the OTTI previously recorded related to specific credit losses and \$62.0 million related to all other factors. Under FSP FAS 115-2/124-2, the Company increased the amortized cost basis of these debt securities by \$62.0 million and recorded a cumulative effect adjustment, net of tax, in its shareholders' equity section. The cumulative effect adjustment had no effect on total shareholders' equity as it increased retained earnings and reduced accumulated other comprehensive income.

**2009 and 2008 Periods**

The Company performed quarterly reviews of its investments in the 2009 and 2008 periods in order to determine whether declines in market value below the amortized cost basis were considered other-than-temporary in accordance with applicable guidance.

For the 2009 second quarter, the Company recorded \$20.7 million of OTTI of which \$20.9 million was related to credit losses and recognized as net impairment losses recognized in earnings, with a reduction of \$0.2 million related to all other factors (*e.g.*, interest rates, market conditions, etc.) and recorded as an unrealized component of accumulated other comprehensive income (loss). Of the \$20.9 million related to credit losses, substantially all related to credit losses for which a portion of the OTTI was recognized in accumulated other comprehensive income (loss).

For the six months ended June 30, 2009, the Company recorded \$113.6 million of OTTI of which \$57.0 million was related to credit losses and recognized as net impairment losses recognized in earnings, with the remaining \$56.6 million related to all other factors and recorded as an unrealized component of accumulated other comprehensive income (loss). Of the \$57.0 million related to credit losses, \$42.6 million related to credit losses for which a portion of the OTTI was recognized in accumulated other comprehensive income (loss) while \$14.4 million related to investments for which the total OTTI was recognized in earnings (see description below).





## ARCH CAPITAL GROUP LTD. AND SUBSIDIARIES

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)

The following table provides a rollforward of the amount related to credit losses recognized in earnings for which a portion of an OTTI was recognized in accumulated other comprehensive income for the 2009 second quarter and six months ended June 30, 2009:

(U.S. dollars in thousands)

<b>Three Months Ended June 30, 2009:</b>	
Beginning balance at April 1, 2009	\$ 57,256
Additions for the amount related to the credit loss for which an OTTI was not previously recognized	2,699
Additional increases to the amount related to the credit loss for which an OTTI was previously recognized	18,134
Reductions for increases in cash flows expected to be collected that are recognized over the remaining life of the security	
Reductions for securities sold during the period (realized)	(2,381)
Ending balance at June 30, 2009	\$ 75,708
<b>Six Months Ended June 30, 2009:</b>	
Beginning balance at January 1, 2009	\$ 35,474
Additions for the amount related to the credit loss for which an OTTI was not previously recognized	15,346
Additional increases to the amount related to the credit loss for which an OTTI was previously recognized	27,269
Reductions for increases in cash flows expected to be collected that are recognized over the remaining life of the security	
Reductions for securities sold during the period (realized)	(2,381)
Ending balance at June 30, 2009	\$ 75,708

At June 30, 2009, the Company did not have the intent to sell such securities, and determined that it is more likely than not that the Company will not be required to sell the securities before recovery of their cost basis. A description of the methodology and significant inputs used to measure the amount of OTTI related to credit losses of \$20.9 million and \$57.0 million, respectively, in the 2009 second quarter and six months ended June 30, 2009 is as follows:

- Corporate bonds** the Company recorded \$0.8 million of OTTI related to credit losses in the 2009 second quarter, and \$3.8 million for the six months ended June 30, 2009. The Company reviewed the business prospects, credit ratings, estimated loss given default factors and incorporated available information received from asset managers and rating agencies for each security. The amortized cost basis of the corporate bonds were adjusted down, if required, to the expected recovery value calculated in the OTTI review process;
- Asset backed securities** the Company recorded \$17.8 million of OTTI related to credit losses in the 2009 second quarter, and \$23.4 million for the six months ended June 30, 2009. The Company utilized underlying data, where available, for each security provided by asset managers and additional information from credit agencies in order to determine an expected recovery value for each security. The analysis provided by the asset managers on home equity asset backed securities includes expected cash flow projections under base case and stress case scenarios which modify expected default expectations and loss severities and slow down prepayment assumptions. The significant inputs in the models include the expected default rates, delinquency rates, foreclosure costs, etc. In the 2009 first and second quarters, the expected recovery values were reduced on a number of asset backed securities backed by sub-prime or Alt-A collateral due to reductions in the expected recovery values on such securities in each period. These reductions followed the quarterly review of information received which indicated increases in

expected default rates, foreclosure costs and other factors. On an ongoing basis, the Company reviews the process used by each asset manager in developing their analysis and,

**ARCH CAPITAL GROUP LTD. AND SUBSIDIARIES**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)**

following such reviews, the Company determines what the expected recovery values are for each security, which incorporates both base case and stress case scenarios. For non-home equity asset backed securities, the Company used reports and analysis from asset managers and rating agencies in order to determine an expected recovery value for such securities. The amortized cost basis of the asset backed securities were adjusted down, if required, to the expected recovery value calculated in the OTTI review process;

- **Mortgage backed securities** the Company recorded \$2.3 million of OTTI related to credit losses in the 2009 second quarter, and \$13.4 million for the six months ended June 30, 2009. The Company utilized underlying data, where available, for each security provided by asset managers and additional information from credit agencies in order to determine an expected recovery value for each security. The analysis provided by the asset managers includes expected cash flow projections under base case and stress case scenarios which modify expected default expectations and loss severities and slow down prepayment assumptions. The significant inputs in the models include the expected default rates, delinquency rates, foreclosure costs, etc. In the 2009 first quarter, the expected recovery values were reduced on a number of mortgage backed securities due to reductions in the expected recovery values on such securities in each period. In the 2009 second quarter, the declines in expected recovery values were, in general, more moderate than in the 2009 first quarter. These reductions followed the quarterly review of information received which indicated increases in expected default expectations and foreclosure costs. On an ongoing basis, the Company reviews the process used by each asset manager in developing their analysis and, following such reviews, the Company determines what the expected recovery values are for each security, which incorporates both base case and stress case scenarios. The amortized cost basis of the mortgage backed securities were adjusted down, if required, to the expected recovery value calculated in the OTTI review process;

- **Investment of funds received under securities lending agreements** the Company recorded nil OTTI related to credit losses in the 2009 second quarter, and \$2.1 million for the six months ended June 30, 2009. At June 30, 2009, the reinvested collateral included sub-prime securities with a market value of \$24.2 million and an average credit quality of AA+ from Standard & Poor's and Ba3 from Moody's. The Company utilized analysis from its securities lending program manager in order to determine an expected recovery value for certain securities which are on a watch-list. The analysis provided expected cash flow projections for the securities using similar criteria as described in the mortgage backed securities section above. The amortized cost basis of the investment of funds received under securities lending agreements was adjusted down, if required, to the expected recovery value calculated in the OTTI review process;

- **Other investments** the Company recorded nil OTTI related to credit losses in the 2009 second quarter, and \$14.3 million for the six months ended June 30, 2009. During the 2009 first quarter, the Company's investment in a Euro-denominated bank loan fund was written down to zero as the fund was required to wind down and begin the liquidation process during the period. The fund operated with leverage and was unable to successfully deleverage its balance sheet and restructure.

The Company believes that the \$56.6 million of OTTI included in accumulated other comprehensive income for the six months ended June 30, 2009 on the securities which were considered by the Company to be impaired was due to market and sector-related factors, including limited liquidity and wide credit spreads. The Company reduced such amount by \$0.2 million in the 2009 second quarter, reflecting the increases in expected credit losses noted above on securities which were deemed OTTI in prior periods.

For the 2008 second quarter and six months ended June 30, 2008, the Company recorded \$10.7 million and \$23.5 million, respectively, of OTTI as a charge against earnings. Such amounts were recorded prior to the adoption of FSP FAS 115-2/124-2 and included a portion related to credit losses and a portion related to all other factors.



**ARCH CAPITAL GROUP LTD. AND SUBSIDIARIES**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)**

*Securities Lending Agreements*

The Company operates a securities lending program under which certain of its fixed income portfolio securities are loaned to third parties, primarily major brokerage firms, for short periods of time through a lending agent. Such securities have been reclassified as Fixed maturities and short-term investments pledged under securities lending agreements. The Company maintains legal control over the securities it lends, retains the earnings and cash flows associated with the loaned securities and receives a fee from the borrower for the temporary use of the securities. Collateral received, primarily in the form of cash, is required at a rate of 102% of the market value of the loaned securities (or 105% of the market value of the loaned securities when the collateral and loaned securities are denominated in non-U.S. currencies) including accrued investment income and is monitored and maintained by the lending agent. Such collateral is reinvested and is reflected as Investment of funds received under securities lending agreements, at market value. At June 30, 2009, the market value and amortized cost of fixed maturities and short-term investments pledged under securities lending agreements were \$559.4 million and \$562.8 million, respectively. At December 31, 2008, the market value and amortized cost of fixed maturities and short-term investments pledged under securities lending agreements were \$728.1 million and \$717.2 million, respectively.

At June 30, 2009, the market value and amortized cost of the reinvested collateral, shown as Investment of funds received under securities lending agreements, totaled \$556.5 million and \$570.8 million, respectively, compared to \$730.2 million and \$750.3 million, respectively, at December 31, 2008. At June 30, 2009, the reinvested collateral included sub-prime securities with a market value of \$24.2 million and an average credit quality of AA+ from Standard & Poor's and Ba3 from Moody's, compared to \$45.7 million at December 31, 2008 with an average credit quality of AAA from Standard & Poor's and AA+ from Moody's.

*Investment-Related Derivatives*

The Company's investment strategy allows for the use of derivative securities. Derivative instruments may be used to enhance investment performance, replicate investment positions or manage market exposures and duration risk that would be allowed under the Company's investment guidelines if implemented in other ways. The market values of those derivatives are based on quoted market prices. At June 30, 2009 and December 31, 2008, the notional value of the net long position for Treasury note futures was \$148.9 million and \$556.3 million, respectively. At June 30, 2009, the notional value of the net long position of Eurodollar futures was \$1.47 billion, compared to nil at December 31, 2008. At June 30, 2009 and December 31, 2008, the notional value of the net long position for U.K. and German government futures was nil and \$363.3 million (at December 31, 2008 foreign currency rates), respectively. At June 30, 2009, the notional value of the net long position of gold futures was \$27.8 million, compared to nil at December 31, 2008. For the 2009 second quarter and six months ended June 30, 2009, the Company recorded net realized losses of \$9.1 million and \$9.5 million, respectively, related to changes in the market value of all futures contracts, compared to net realized losses of \$11.0 million and \$16.8 million, respectively, for the 2008 second quarter and six months ended June 30, 2008. The derivative open margin position at each balance sheet date is included in other investments. The open margin position at June 30, 2009 was a liability of \$0.4 million, compared to a liability of \$0.9 million at December 31, 2008.

In addition, certain of the Company's corporate bonds are managed in a global bond portfolio which, under their guidelines, incorporates the use of foreign currency forward contracts which are intended to hedge against foreign currency movements on the portfolio's non-U.S. Dollar denominated holdings. At June 30, 2009, the market value of the foreign currency forward contracts, which are included in other investments, was a negative \$6.1 million, compared to a negative \$10.8 million at December 31, 2008.



## ARCH CAPITAL GROUP LTD. AND SUBSIDIARIES

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)

*Other Investments*

The following table details the Company's other investments:

(U.S. dollars in thousands)	June 30, 2009		December 31, 2008	
	Estimated Market Value	Cost	Estimated Market Value	Cost
Fixed income mutual funds	\$ 49,505	\$ 54,410	\$ 39,858	\$ 63,618
Privately held securities and other	65,755	61,124	69,743	62,240
Total	\$ 115,260	\$ 115,534	\$ 109,601	\$ 125,858

Other investments include: (i) mutual funds which invest in fixed maturity securities and (ii) privately held securities and other which include the Company's investment in Aeolus LP (see Note 11). During the six months ended June 30, 2009, the Company recorded a \$14.3 million OTTI provision in earnings on a Euro-denominated bank loan fund which was written down to zero as the fund was forced to wind down and enter liquidation during the period.

*Investment Funds Accounted for Using the Equity Method*

The Company recorded \$75.9 million of net income related to investment funds accounted for using the equity method for the 2009 second quarter, compared to \$19.6 million for the 2008 second quarter. For the six months ended June 30, 2009, the Company recorded \$66.3 million of equity in net income related to investment funds accounted for using the equity method, compared to \$2.7 million of equity in net losses for the 2008 period. Due to the ownership structure of these investment funds, which invest in fixed maturity securities, the Company uses the equity method. In applying the equity method, these investments are initially recorded at cost and are subsequently adjusted based on the Company's proportionate share of the net income or loss of the funds (which include changes in the market value of the underlying securities in the funds). Such investments are generally recorded on a one month lag with some investments reported for on a three month lag based on the availability of reports from the investment funds. Changes in the carrying value of such investments are recorded in net income as "Equity in net income (loss) of investment funds accounted for using the equity method" while changes in the carrying value of the Company's other fixed income investments are recorded as an unrealized gain or loss component of accumulated other comprehensive income in shareholders' equity. As such, fluctuations in the carrying value of the investment funds accounted for using the equity method may increase the volatility of the Company's reported results of operations. Investment funds accounted for using the equity method totaled \$370.2 million at June 30, 2009, compared to \$301.0 million at December 31, 2008. The Company's investment commitments relating to investment funds accounted for using the equity method totaled approximately \$6.9 million at June 30, 2009.



## ARCH CAPITAL GROUP LTD. AND SUBSIDIARIES

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)

*Restricted Assets*

The Company is required to maintain assets on deposit, which primarily consist of fixed maturities, with various regulatory authorities to support its insurance and reinsurance operations. The Company has investments in segregated portfolios which are primarily used to provide collateral or guarantees for letters of credit to third parties (see Note 4). In addition, the Company maintains assets on deposit which are available to settle insurance and reinsurance liabilities to third parties. The following table details the value of restricted assets:

(U.S. dollars in thousands)	June 30, 2009	December 31, 2008
Assets used for collateral or guarantees	\$ 980,829	\$ 804,934
Deposits with U.S. regulatory authorities	273,003	264,988
Trust funds	138,581	153,182
Deposits with non-U.S. regulatory authorities	61,612	57,336
Total restricted assets	\$ 1,454,025	\$ 1,280,440

In addition, certain of the Company's operating subsidiaries maintain assets in trust accounts as collateral for insurance and reinsurance transactions with affiliated companies. At June 30, 2009 and December 31, 2008, such amounts approximated \$4.37 billion and \$4.03 billion, respectively.

*Net Investment Income*

The components of net investment income were derived from the following sources:

(U.S. dollars in thousands)	Three Months Ended June 30,		Six Months Ended June 30,	
	2009	2008	2009	2008
Fixed maturities	\$ 103,349	\$ 110,883	\$ 200,307	\$ 218,133
Short-term investments	583	5,486	1,823	12,601
Other (1)	1,472	4,393	3,037	15,214
Gross investment income	105,404	120,762	205,167	245,948
Investment expenses	(4,919)	(3,642)	(8,800)	(6,635)
Net investment income	\$ 100,485	\$ 117,120	\$ 196,367	\$ 239,913

(1) Primarily consists of interest income on operating cash accounts, other investments and securities lending transactions.



## ARCH CAPITAL GROUP LTD. AND SUBSIDIARIES

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)

*Net Realized Gains (Losses)*

Net realized gains (losses) were as follows, excluding the other-than-temporary impairment provisions discussed above:

(U.S. dollars in thousands)	Three Months Ended June 30,		Six Months Ended June 30,	
	2009	2008	2009	2008
Fixed maturities	\$ 4,138	\$ 6,606	\$ 10,308	\$ 72,073
Other investments	(104)	(2,103)	(18,690)	(5,216)
Other (1)	(15,827)	(6,423)	(8,575)	(20,091)
Net realized gains (losses)	\$ (11,793)	\$ (1,920)	\$ (16,957)	\$ 46,766

(1) Primarily consists of net realized gains or losses related to investment-related derivatives and foreign currency forward contracts.

Proceeds from the sales of fixed maturities during the 2009 second quarter were \$6.10 billion, compared to \$3.52 billion for the 2008 second quarter. Gross gains of \$64.4 million and \$44.2 million were realized on those transactions during the 2009 and 2008 second quarters, respectively, while gross losses were \$60.3 million and \$37.6 million, respectively. Proceeds from the sales of fixed maturities during the six months ended June 30, 2009 were \$9.48 billion, compared to \$7.04 billion for the 2008 period. Gross gains of \$135.9 million and \$130.1 million were realized on those transactions during the six month periods ended June 30, 2009 and 2008, respectively, while gross losses were \$125.6 million and \$58.0 million, respectively. Realized gains or losses on fixed maturities include changes in the market value of certain hybrid securities pursuant to SFAS No. 155, Accounting for Certain Hybrid Financial Instruments (an amendment of FASB Statements No. 133 and 140). The fair market values of such securities at June 30, 2009 were approximately \$59.3 million, compared to \$43.7 million at December 31, 2008. The Company recorded realized gains of \$5.8 million and \$9.8 million on such securities for the 2009 second quarter and six month periods ended June 30, 2009, respectively, compared to realized gains of \$2.5 million and nil for the 2008 second quarter and six month periods ended June 30, 2008, respectively.

*Fair Value*

SFAS No. 157, Fair Value Measurements (SFAS No. 157) addresses how companies should measure fair value when they are required to use a fair value measure for recognition or disclosure purposes under GAAP and provides a common definition of fair value to be used throughout GAAP. SFAS No. 157 defines fair value as the price that would be received to sell an asset or paid to transfer a liability in an orderly fashion between market participants at the measurement date. SFAS No. 157 establishes a three-level valuation hierarchy for the disclosure of fair value measurements. The valuation hierarchy is based upon the transparency of inputs to the valuation of an asset or liability as of the measurement date. The level in the hierarchy within which a given fair value measurement falls is determined based on the lowest level input that is significant to the measurement (Level 1 being the highest priority and Level 3 being the lowest priority).



The three levels are defined as follows:

- Level 1: Inputs to the valuation methodology are observable inputs that reflect quoted prices (unadjusted) for *identical* assets or liabilities in *active markets*
- Level 2: Inputs to the valuation methodology include quoted prices for similar assets and liabilities in active markets, and inputs that are observable for the asset or liability, either directly or indirectly, for substantially the full term of the financial instrument
- Level 3: Inputs to the valuation methodology are unobservable and significant to the fair value measurement

Following is a description of the valuation methodologies used for securities measured at fair value, as well as the general classification of such securities pursuant to the valuation hierarchy.

The Company determines the existence of an active market based on its judgment as to whether transactions for the financial instrument occur in such market with sufficient frequency and volume to provide reliable pricing information. The independent pricing sources obtain market quotations and actual transaction prices for securities that have quoted prices in active markets. The Company uses quoted values and other data provided by nationally recognized independent pricing sources as inputs into its process for determining fair values of its fixed maturity investments. To validate the techniques or models used by pricing sources, the Company's review process includes, but is not limited to: (i) quantitative analysis (*e.g.*, comparing the quarterly return for each managed portfolio to its target benchmark, with significant differences identified and investigated); (ii) a review of the average number of prices obtained in the pricing process and the range of resulting market values; (iii) initial and ongoing evaluation of methodologies used by outside parties to calculate fair value including a review of deep dive reports on selected securities which indicated the use of observable inputs in the pricing process; (iv) comparing the fair value estimates to its knowledge of the current market; (v) a comparison of the pricing services' fair values to other pricing services' fair values for the same investments; and (vi) back-testing, which includes randomly selecting purchased or sold securities and comparing the executed prices to the fair value estimates from the pricing service. At June 30, 2009, the Company obtained an average of 2.55 quotes per investment, compared to 2.6 quotes at December 31, 2008. Where multiple quotes or prices were obtained, a price source hierarchy was maintained in order to determine which price source provided the fair value (*i.e.*, a price obtained from a pricing service with more seniority in the hierarchy will be used from a less senior one in all cases). The hierarchy prioritizes pricing services based on availability and reliability and assigns the highest priority to index providers. Based on the above review, the Company will challenge any prices for a security or portfolio which are considered not to be representative of fair value. The Company did not adjust the prices or quotes provided by the pricing services at June 30, 2009 or December 31, 2008.

The independent pricing sources obtain market quotations and actual transaction prices for securities that have quoted prices in active markets. Each source has its own proprietary method for determining the fair value of securities that are not actively traded. In general, these methods involve the use of "matrix pricing" in which the independent pricing source uses observable market inputs including, but not limited to, investment yields, credit risks and spreads, benchmarking of like securities, broker-dealer quotes, reported trades and sector groupings to determine a reasonable fair market value. In addition, pricing vendors use model processes, such as an Option Adjusted Spread model, to develop prepayment and interest rate scenarios. The Option Adjusted Spread model is commonly used to estimate fair value for securities such as mortgage backed and asset backed securities. In certain circumstances, when fair market values are unavailable from these independent pricing sources, quotes are obtained directly from broker-dealers who are active in the corresponding markets. Such quotes are subject to the validation procedures noted above. Of the \$10.2 billion of financial assets and liabilities measured at fair value, approximately \$1.02 billion, or 10%, were priced using non-binding broker-dealer quotes.

**ARCH CAPITAL GROUP LTD. AND SUBSIDIARIES**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)**

In April 2009, the FASB issued FSP No. FAS 157-4, *Determining Fair Value When Volume and Level of Activity for the Asset or Liability Have Significantly Decreased and Identifying Transactions that are Not Orderly* ( FSP FAS 157-4 ). FSP FAS 157-4 affirms that the objective of fair value when the market for an asset is not active is the price that would be received to sell the asset in an orderly transaction, and clarifies and includes additional factors for determining whether there has been a significant decrease in market activity for an asset when the market for that asset is not active. Under FSP FAS 157-4, if an entity determines that there has been a significant decrease in the volume and level of activity for the asset or the liability in relation to the normal market activity for the asset or liability (or similar assets or liabilities), then transactions or quoted prices may not accurately reflect fair value. In addition, if there is evidence that the transaction for the asset or liability is not orderly, the entity shall place little, if any weight on that transaction price as an indicator of fair value. FSP FAS 157-4 also amended SFAS No. 157 to expand certain disclosure requirements. FSP FAS 157-4 is effective for periods ending after June 15, 2009, with early adoption permitted for periods ending after March 15, 2009. The Company elected to adopt FSP FAS 157-4 effective for its interim period ending March 31, 2009, and its adoption did not have a material impact on the Company's consolidated financial condition or results of operations.

The Company reviews its securities measured at fair value and discusses the proper classification of such investments with investment advisors and others. Upon adoption of SFAS No. 157 and at June 30, 2009, the Company determined that Level 1 securities included highly liquid, recent issue U.S. Treasuries and certain of its short-term investments held in highly liquid money market-type funds where it believes that quoted prices are available in an active market.

Where the Company believes that quoted market prices are not available or that the market is not active, fair values are estimated by using quoted prices of securities with similar characteristics, pricing models or matrix pricing and are generally classified as Level 2 securities. The Company determined that Level 2 securities included corporate bonds, mortgage backed securities, municipal bonds, asset backed securities, certain U.S. government and government agencies, non-U.S. government securities, certain short-term securities and certain other investments.

The Company determined that three Euro-denominated corporate bonds which invest in underlying portfolios of fixed income securities for which there is a low level of transparency around inputs to the valuation process should be classified within Level 3 of the valuation hierarchy. In addition, the Company determined that two mutual funds, included in other investments, which invest in underlying portfolios of fixed income securities for which there is a low level of transparency around inputs to the valuation process should be classified within Level 3 of the valuation hierarchy. These items were reclassified as Level 3 during the 2008 fourth quarter due to the significant dislocation in the credit markets during October and November 2008. The Company believes that the market for such investments, which are primarily investments in an underlying portfolio of structured bank loans, deteriorated in response to market conditions. As such, the inputs to the valuation process for these investments were determined to be less observable than in prior periods. The Company reviews the classification of its investments each quarter. In addition, Level 3 securities include a small number of premium-tax bonds.

## ARCH CAPITAL GROUP LTD. AND SUBSIDIARIES

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)

The following table presents the Company's financial assets and liabilities measured at fair value by SFAS No. 157 hierarchy:

(U.S. dollars in thousands)	Fair Value Measurement Using:			
	Estimated Market Value	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
<b>June 30, 2009:</b>				
Fixed maturities: (1)				
Corporate bonds (2)	\$ 2,885,694	\$	\$ 2,727,243	\$ 158,451
Mortgage backed securities	1,622,276		1,622,276	
Commercial mortgage backed securities	1,302,208		1,302,208	
U.S. government and government agencies	1,289,603	358,552	931,051	
Municipal bonds	858,065		858,065	
Asset backed securities	805,921		805,921	
Non-U.S. government securities	739,728		739,728	
Total	9,503,495	358,552	8,986,492	158,451
Short-term investments (1)	660,859	648,085	12,774	
Other investments (3)	48,895		7,784	41,111
Total	\$ 10,213,249	\$ 1,006,637	\$ 9,007,050	\$ 199,562
<b>December 31, 2008:</b>				
Fixed maturities: (1)				
Corporate bonds (2)	\$ 2,019,373	\$	\$ 1,876,802	\$ 142,571
Mortgage backed securities	1,581,736		1,581,736	
U.S. government and government agencies	1,463,897	241,851	1,222,046	
Commercial mortgage backed securities	1,219,737		1,219,737	
Asset backed securities	970,041		970,041	
Municipal bonds	965,966		965,966	
Non-U.S. government securities	527,972		527,972	
Total	8,748,722	241,851	8,364,300	142,571
Short-term investments (1)	581,150	474,504	106,646	
Other investments (3)	36,913		(3,426)	40,339
Total	\$ 9,366,785	\$ 716,355	\$ 8,467,520	\$ 182,910

(1) In securities lending transactions, the Company receives collateral in excess of the fair value of the fixed maturities and short-term investments pledged under securities lending agreements. For purposes of this table, the Company has excluded the collateral received at June 30, 2009 and December 31, 2008 of \$556.5 million and \$730.2 million, respectively, which is reflected as investment of funds received under securities lending agreements, at market value and included the \$559.4 million and \$728.1 million, respectively, of fixed maturities and short-term investments pledged under securities lending agreements, at market value.

(2) Consists of (i) three corporate bonds which invest in underlying portfolios of fixed income securities for which there is a low level of transparency around inputs and (ii) a small number of premium-tax bonds.

- (3) Excludes the Company's investment in Aeolus LP, which is accounted for using the equity method.



## ARCH CAPITAL GROUP LTD. AND SUBSIDIARIES

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)

The following table presents a reconciliation of the beginning and ending balances for all investments measured at fair value on a recurring basis using Level 3 inputs:

(U.S. dollars in thousands)	Fair Value Measurements Using: Significant Unobservable Inputs (Level 3)			Total
	Corporate Bonds	Other Investments		
<b>Three Months Ended June 30, 2009:</b>				
Beginning balance at April 1, 2009	\$ 130,561	\$ 32,759		\$ 163,320
Total gains or (losses) (realized/unrealized)				
Included in earnings (1)	1,710			1,710
Included in other comprehensive income	26,180	8,471		34,651
Purchases, issuances and settlements		(119)		(119)
Transfers in and/or out of Level 3				
Ending balance at June 30, 2009	\$ 158,451	\$ 41,111		\$ 199,562
<b>Three Months Ended June 30, 2008:</b>				
Beginning balance at April 1, 2008	\$ 5,136	\$ 11,145		\$ 16,281
Total gains or (losses) (realized/unrealized)				
Included in earnings (1)	(38)	222		184
Included in other comprehensive income		(1,486)		(1,486)
Purchases, issuances and settlements	1,381	(239)		1,142
Transfers in and/or out of Level 3				
Ending balance at June 30, 2008	\$ 6,479	\$ 9,642		\$ 16,121
<b>Six Months Ended June 30, 2009:</b>				
Beginning balance at January 1, 2009	\$ 142,571	\$ 40,339		\$ 182,910
Total gains or (losses) (realized/unrealized)				
Included in earnings (1)	1,191	(14,307)		(13,116)
Included in other comprehensive income	14,689	15,193		29,882
Purchases, issuances and settlements		(114)		(114)
Transfers in and/or out of Level 3				
Ending balance at June 30, 2009	\$ 158,451	\$ 41,111		\$ 199,562
<b>Six Months Ended June 30, 2008:</b>				
Beginning balance at January 1, 2008	\$ 3,752	\$ 11,504		\$ 15,256
Total gains or (losses) (realized/unrealized)				
Included in earnings (1)	(76)	459		383
Included in other comprehensive income		(1,789)		(1,789)
Purchases, issuances and settlements	2,803	(532)		2,271
Transfers in and/or out of Level 3				
Ending balance at June 30, 2008	\$ 6,479	\$ 9,642		\$ 16,121

(1) Losses on fixed maturities were recorded as a component of net investment income while losses on other investments were recorded in net realized losses.

## Edgar Filing: ARCH CAPITAL GROUP LTD. - Form 10-Q

The amount of total gains for the 2009 second quarter and six months ended June 30, 2009 included in earnings attributable to the change in unrealized gains or losses relating to assets still held at June 30, 2009 was \$1.7 million and \$1.2 million, respectively. The amount of total gains for the 2008 second quarter and six months ended June 30, 2008 included in earnings attributable to the change in unrealized gains or losses relating to assets still held at June 30, 2008 was \$0.2 million and \$0.4 million, respectively.

## ARCH CAPITAL GROUP LTD. AND SUBSIDIARIES

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)

## 9. Earnings Per Common Share

The following table sets forth the computation of basic and diluted earnings per common share:

(U.S. dollars in thousands, except share data)	Three Months Ended June 30,		Six Months Ended June 30,	
	2009	2008	2009	2008
Net income	\$ 158,590	\$ 198,743	\$ 304,920	\$ 394,626
Preferred dividends	(6,461)	(6,461)	(12,922)	(12,922)
Net income available to common shareholders (numerator)	\$ 152,129	\$ 192,282	\$ 291,998	\$ 381,704
Weighted average common shares and effect of dilutive common share equivalents used in the computation of earnings per common share:				
Weighted average common shares outstanding basic (denominator)	60,417,391	62,995,550	60,365,758	64,145,533
Effect of dilutive common share equivalents:				
Nonvested restricted shares	265,419	248,414	268,266	239,005
Stock options (1)	1,943,507	2,504,155	1,955,832	2,502,434
Weighted average common shares and common share equivalents outstanding diluted (denominator)	62,626,317	65,748,119	62,589,856	66,886,972
Earnings per common share:				
Basic	\$ 2.52	\$ 3.05	\$ 4.84	\$ 5.95
Diluted	\$ 2.43	\$ 2.92	\$ 4.67	\$ 5.71

(1) Certain stock options were not included in the computation of diluted earnings per share where the exercise price of the stock options exceeded the average market price and would have been anti-dilutive or where, when applying the treasury stock method to in-the-money options, the sum of the proceeds, including unrecognized compensation, exceeded the average market price and would have been anti-dilutive. For the 2009 second quarter and six months ended June 30, 2009, the number of stock options excluded were 915,611 and 807,046, respectively. For the 2008 second quarter and six months ended June 30, 2008, the number of stock options excluded were 506,652 and 419,999, respectively.

**ARCH CAPITAL GROUP LTD. AND SUBSIDIARIES**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)**

**10. Income Taxes**

ACGL is incorporated under the laws of Bermuda and, under current Bermuda law, is not obligated to pay any taxes in Bermuda based upon income or capital gains. The Company has received a written undertaking from the Minister of Finance in Bermuda under the Exempted Undertakings Tax Protection Act 1966 that, in the event that any legislation is enacted in Bermuda imposing any tax computed on profits, income, gain or appreciation on any capital asset, or any tax in the nature of estate duty or inheritance tax, such tax will not be applicable to ACGL or any of its operations until March 28, 2016. This undertaking does not, however, prevent the imposition of taxes on any person ordinarily resident in Bermuda or any company in respect of its ownership of real property or leasehold interests in Bermuda.

ACGL and its non-U.S. subsidiaries will be subject to U.S. federal income tax only to the extent that they derive U.S. source income that is subject to U.S. withholding tax or income that is effectively connected with the conduct of a trade or business within the U.S. and is not exempt from U.S. tax under an applicable income tax treaty with the U.S. ACGL and its non-U.S. subsidiaries will be subject to a withholding tax on dividends from U.S. investments and interest from certain U.S. payors (subject to reduction by any applicable income tax treaty). ACGL and its non-U.S. subsidiaries intend to conduct their operations in a manner that will not cause them to be treated as engaged in a trade or business in the United States and, therefore, will not be required to pay U.S. federal income taxes (other than U.S. excise taxes on insurance and reinsurance premium and withholding taxes on dividends and certain other U.S. source investment income). However, because there is uncertainty as to the activities which constitute being engaged in a trade or business within the United States, there can be no assurances that the U.S. Internal Revenue Service will not contend successfully that ACGL or its non-U.S. subsidiaries are engaged in a trade or business in the United States. If ACGL or any of its non-U.S. subsidiaries were subject to U.S. income tax, ACGL's shareholders' equity and earnings could be materially adversely affected. ACGL has subsidiaries and branches that operate in various jurisdictions around the world that are subject to tax in the jurisdictions in which they operate. The significant jurisdictions in which ACGL's subsidiaries and branches are subject to tax are the United States, United Kingdom, Ireland, Canada, Switzerland, Germany and Denmark.

The Company's income tax provision resulted in an effective tax rate on income before income taxes of 5.3% and 5.7%, respectively, for the 2009 second quarter and six months ended June 30, 2009, compared to 2.6% and 3.2%, respectively, for the 2008 second quarter and six months ended June 30, 2008. The Company's effective tax rate, which is based upon the expected annual effective tax rate, may fluctuate from period to period based on the relative mix of income reported by jurisdiction due primarily to the varying tax rates in each jurisdiction.

The United States also imposes an excise tax on insurance and reinsurance premiums paid to non-U.S. insurers or reinsurers with respect to risks located in the United States. The rates of tax, unless reduced by an applicable U.S. tax treaty, are four percent for non-life insurance premiums and one percent for life insurance and all reinsurance premiums. The Company incurs federal excise taxes on certain of its reinsurance transactions, including amounts ceded through intercompany transactions. For the 2009 second quarter the Company incurred \$3.0 million of federal excise taxes, compared to \$3.1 million for the 2008 period. For the six months ended June 30, 2009, the Company incurred \$6.3 million of federal excise taxes, compared to \$6.4 million for the 2008 period. Such amounts are reflected as acquisition expenses in the Company's consolidated statements of income.

**11. Transactions with Related Parties**

## Edgar Filing: ARCH CAPITAL GROUP LTD. - Form 10-Q

The Company made an investment of \$50.0 million in Aeolus LP ( Aeolus ) in 2006. Aeolus operates as an unrated reinsurance platform that provides property catastrophe protection to insurers and reinsurers on both an ultimate net loss and industry loss warranty basis. In return for its investment, included in Other investments on the Company's balance sheet, the Company received an approximately 4.9% preferred interest

**ARCH CAPITAL GROUP LTD. AND SUBSIDIARIES**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)**

in Aeolus and a pro rata share of certain founders' interests. The Company made its investment in Aeolus on the same economic terms as a fund affiliated with Warburg Pincus, which has invested \$350 million in Aeolus. Funds affiliated with Warburg Pincus owned 6.5% of the Company's outstanding voting shares as of June 30, 2009. In addition, one of the founders of Aeolus is Peter Appel, former President and CEO and a former director of the Company. During the 2009 first quarter, the Company received a distribution of \$14.0 million from Aeolus as part of a repurchase agreement. Following such receipt, the Company's preferred interest percentage decreased to approximately 4.4%.

**12. Contingencies Relating to the Sale of Prior Reinsurance Operations**

On May 5, 2000, the Company sold the prior reinsurance operations of Arch Re U.S. pursuant to an agreement entered into as of January 10, 2000 with White Mountains Reinsurance Company of America, formerly known as Folksamerica Reinsurance Company, and a related holding company (collectively, WTM Re). WTM Re assumed Arch Re U.S.'s liabilities under the reinsurance agreements transferred in the asset sale and Arch Re U.S. transferred to WTM Re assets estimated in an aggregate amount equal in book value to the book value of the liabilities assumed. The WTM Re transaction was structured as a transfer and assumption agreement (and not reinsurance) and, accordingly, the loss reserves (and any related reinsurance recoverables) relating to the transferred business are not included as assets or liabilities on the Company's balance sheet. WTM Re assumed Arch Re U.S.'s rights and obligations under the reinsurance agreements transferred in the asset sale. The reinsureds under such agreements were notified that WTM Re had assumed Arch Re U.S.'s obligations and that, unless the reinsureds object to the assumption, Arch Re U.S. will be released from its obligations to those reinsureds. None of such reinsureds objected to the assumption. However, Arch Re U.S. will continue to be liable under those reinsurance agreements if the notice is found not to be an effective release by the reinsureds. WTM Re has agreed to indemnify the Company for any losses arising out of the reinsurance agreements transferred to WTM Re in the asset sale. However, in the event that WTM Re refuses or is unable to perform its obligations to the Company, Arch Re U.S. may incur losses relating to the reinsurance agreements transferred in the asset sale. WTM Re's A.M. Best rating was A- (Excellent) at June 30, 2009. WTM Re reported policyholders' surplus of \$708.8 million at December 31, 2008.

Under the terms of the agreement, in 2000, the Company had also purchased reinsurance protection covering the Company's transferred aviation business to reduce the net financial loss to WTM Re on any large commercial airline catastrophe to \$5.4 million, net of reinstatement premiums. Although the Company believes that any such net financial loss will not exceed \$5.4 million, the Company has agreed to reimburse WTM Re if a loss is incurred that exceeds \$5.4 million for aviation losses under certain circumstances prior to May 5, 2003. The Company also made representations and warranties to WTM Re about the Company and the business transferred to WTM Re for which the Company retains exposure for certain periods, and made certain other agreements. In addition, the Company retained its tax and employee benefit liabilities and other liabilities not assumed by WTM Re, including all liabilities not arising under reinsurance agreements transferred to WTM Re in the asset sale and all liabilities (other than liabilities arising under reinsurance agreements) arising out of or relating to a certain managing underwriting agency. Although WTM Re has not asserted that any amount is currently due under any of the indemnities provided by the Company under the asset purchase agreement, WTM Re has previously indicated a potential indemnity claim under the agreement in the event of the occurrence of certain future events. Based on all available information, the Company has denied the validity of any such potential claim.

**ARCH CAPITAL GROUP LTD. AND SUBSIDIARIES**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)**

**13. Commitments and Contingencies**

*Variable Interest Entities*

On December 29, 2005, Arch Re Bermuda entered into a quota share reinsurance treaty with Flatiron, a Bermuda reinsurance company, pursuant to which Flatiron is assuming a 45% quota share (the Treaty) of certain lines of property and marine business underwritten by Arch Re Bermuda for unaffiliated third parties for the 2006 and 2007 underwriting years (January 1, 2006 to December 31, 2007). On December 31, 2007, the Treaty expired by its terms. As a result of the terms of the Treaty, the Company has determined that Flatiron is a variable interest entity. However, Arch Re Bermuda is not the primary beneficiary of Flatiron and, as such, the Company is not required to consolidate the assets, liabilities and results of operations of Flatiron per FIN 46R. See Note 6, Reinsurance for information on the Treaty with Flatiron.

**14. Legal Proceedings**

The Company, in common with the insurance industry in general, is subject to litigation and arbitration in the normal course of its business. As of June 30, 2009, the Company was not a party to any material litigation or arbitration other than as a part of the ordinary course of business in relation to claims and reinsurance recoverable matters, none of which is expected by management to have a significant adverse effect on the Company's results of operations and financial condition and liquidity.

**15. Subsequent Events**

The Company has completed its subsequent events evaluation for the period subsequent to the balance sheet date of June 30, 2009 through August 7, 2009, the date the consolidated financial statements were issued.

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

Arch Capital Group Ltd. (ACGL and, together with its subsidiaries, we or us) is a Bermuda public limited liability company with over \$4.4 billion in capital at June 30, 2009 and, through operations in Bermuda, the United States, Europe and Canada, writes insurance and reinsurance on a worldwide basis. While we are positioned to provide a full range of property and casualty insurance and reinsurance lines, we focus on writing specialty lines of insurance and reinsurance. It is our belief that our underwriting platform, our experienced management team and our strong capital base that is unencumbered by significant pre-2002 risks have enabled us to establish a strong presence in the insurance and reinsurance markets.

The worldwide insurance and reinsurance industry is highly competitive and has traditionally been subject to an underwriting cycle in which a hard market (high premium rates, restrictive underwriting standards, as well as terms and conditions, and underwriting gains) is eventually followed by a soft market (low premium rates, relaxed underwriting standards, as well as broader terms and conditions, and underwriting losses). Insurance market conditions may affect, among other things, the demand for our products, our ability to increase premium rates, the terms and conditions of the insurance policies we write, changes in the products offered by us or changes in our business strategy.

The financial results of the insurance and reinsurance industry are influenced by factors such as the frequency and/or severity of claims and losses, including natural disasters or other catastrophic events, variations in interest rates and financial markets, changes in the legal, regulatory and judicial environments, inflationary pressures and general economic conditions. These factors influence, among other things, the demand for insurance or reinsurance, the supply of which is generally related to the total capital of competitors in the market.

In general, market conditions improved during 2002 and 2003 in the insurance and reinsurance marketplace. This reflected improvement in pricing, terms and conditions following significant industry losses arising from the events of September 11, 2001, as well as the recognition that intense competition in the late 1990s led to inadequate pricing and overly broad terms, conditions and coverages. Such industry developments resulted in poor financial results and erosion of the industry's capital base. Consequently, many established insurers and reinsurers reduced their participation in, or exited from, certain markets and, as a result, premium rates escalated in many lines of business. These developments provided relatively new insurers and reinsurers, like us, with an opportunity to provide needed underwriting capacity. Beginning in late 2003 and continuing through 2005, additional capacity emerged in many classes of business and, consequently, premium rate increases decelerated significantly and, in many classes of business, premium rates decreased. The weather-related catastrophic events that occurred in the second half of 2005 caused significant industry losses and led to a strengthening of rating agency capital requirements for catastrophe-exposed business. The 2005 events also resulted in substantial improvements in market conditions in property and certain marine lines of business and slowed declines in premium rates in other lines. During 2006 and 2007, excellent industry results led to a significant increase in capacity and, accordingly, competition intensified in 2007 and prices, in general, declined in all lines of business, including property. More recently, we increased our writings in property and certain marine lines of business in order to take advantage of improved market conditions and these lines represented a larger proportion of our overall book of business in 2008 and 2009 than in prior periods.

***Current Outlook***

During the second half of 2008, the financial markets experienced significant adverse credit events and a loss of liquidity, which have reduced the amount and availability of capital in the insurance industry. In addition, certain of our competitors have experienced significant financial difficulties. We believe that the impacts of such events, along with the recent catastrophic activity, have begun to affect market conditions positively and may lead to rate strengthening in a number of specialty lines. However, the current economic conditions also could





have a material impact on the frequency and severity of claims and therefore could negatively impact our underwriting returns. In addition, volatility in the financial markets could continue to significantly affect our investment returns, reported results and shareholders equity. We consider the potential impact of economic trends in the estimation process for establishing unpaid losses and loss adjustment expenses ( LAE ) and in determining our investment strategies.

We continue to believe that the most attractive area from a pricing point of view remains U.S. catastrophe-related property business. We expect that our writings in property and marine lines of business will continue to represent a significant proportion of our overall book of business in future periods, which could increase the volatility of our results of operations. We seek to limit the probable maximum pre-tax loss to a specific level for severe catastrophic events. Currently, we generally seek to limit the probable maximum pre-tax loss to approximately 25% of total shareholders equity for a severe catastrophic event in any geographic zone that could be expected to occur once in every 250 years, although we reserve the right to change this threshold at any time. As of July 1, 2009, the probable maximum pre-tax loss for a catastrophic event in any geographic zone arising from a 1-in-250 year event was approximately \$813 million, compared to \$763 million as of January 1, 2009. There can be no assurances that we will not suffer pre-tax losses greater than 25% of our total shareholders equity from one or more catastrophic events due to several factors, including the inherent uncertainties in estimating the frequency and severity of such events and the margin of error in making such determinations resulting from potential inaccuracies and inadequacies in the data provided by clients and brokers, the modeling techniques and the application of such techniques or as a result of a decision to change the percentage of shareholders equity exposed to a single catastrophic event. In addition, actual losses may increase if reinsurers dispute or fail to meet their obligations to us or the reinsurance protections purchased by us are exhausted or are otherwise unavailable. See Risk Factors Risk Relating to Our Industry and Management s Discussion and Analysis of Financial Condition and Results of Operations Natural and Man-Made Catastrophic Events contained in our Annual Report on Form 10-K for the year ended December 31, 2008.

#### CRITICAL ACCOUNTING POLICIES, ESTIMATES AND RECENT ACCOUNTING PRONOUNCEMENTS

Critical accounting policies, estimates and recent accounting pronouncements are discussed in Management s Discussion and Analysis of Financial Condition and Results of Operations contained in our Annual Report on Form 10-K for the year ended December 31, 2008, updated where applicable in the notes accompanying our consolidated financial statements.

#### RESULTS OF OPERATIONS

##### Three Months Ended June 30, 2009 and 2008

The following table sets forth net income available to common shareholders and earnings per common share data:

(U.S. dollars in thousands, except share data)	Three Months Ended	
	2009	2008
Net income available to common shareholders	\$ 152,129	\$ 192,282
Diluted net income per common share	\$ 2.43	\$ 2.92
Diluted weighted average common shares and common share equivalents outstanding	62,626,317	65,748,119

Net income available to common shareholders was \$152.1 million for the 2009 second quarter, compared to \$192.3 million for the 2008 second quarter. The decrease in net income was primarily due to: (i) a lower level of investment returns consisting of net investment income and net realized gains or losses; (ii) an increase in net

impairment losses; and (iii) an increase in net foreign exchange gains or losses. The impact of these items was offset positively by an increase in the equity in net income (loss) of investment funds accounted for using the equity method. Our net income available to common shareholders for the 2009 second quarter represented a 17.4% annualized return on average common equity, compared to 21.2% for the 2008 second quarter. For purposes of computing return on average common equity, average common equity has been calculated as the average of common shareholders equity outstanding at the beginning and ending of each period.

Diluted weighted average common shares and common share equivalents outstanding, used in the calculation of net income per common share, were 62.6 million in the 2009 second quarter, compared to 65.7 million in the 2008 second quarter. The lower level of weighted average shares outstanding in the 2009 second quarter was primarily due to the impact of share repurchases. As a result of the share repurchase transactions to date, weighted average shares outstanding for the 2009 second quarter were reduced by 15.3 million shares, compared to 11.9 million shares for the 2008 second quarter.

### *Segment Information*

We classify our businesses into two underwriting segments — insurance and reinsurance — and corporate and other (non-underwriting). SFAS No. 131, *Disclosures About Segments of an Enterprise and Related Information*, requires certain disclosures about operating segments in a manner that is consistent with how management evaluates the performance of the segment. For a description of our underwriting segments, refer to Note 5, *Segment Information*, of the notes accompanying our consolidated financial statements. Management measures segment performance based on underwriting income or loss.

#### *Insurance Segment*

The following table sets forth our insurance segment's underwriting results:

	<b>Three Months Ended</b>	
	<b>June 30,</b>	
	<b>2009</b>	<b>2008</b>
Gross premiums written	\$ 636,645	\$ 621,663
Net premiums written	419,318	421,501
Net premiums earned	\$ 417,454	\$ 416,585
Fee income	795	880
Losses and loss adjustment expenses	(287,350)	(262,633)
Acquisition expenses, net	(58,748)	(55,400)
Other operating expenses	(70,836)	(71,566)
Underwriting income	\$ 1,315	\$ 27,866
<b>Underwriting Ratios</b>		
Loss ratio	68.8%	63.0%
Acquisition expense ratio (1)	13.9%	13.1%
Other operating expense ratio	17.0%	17.2%
Combined ratio	99.7%	93.3%

(1) The acquisition expense ratio is adjusted to include certain fee income.

The insurance segment's underwriting income was \$1.3 million for the 2009 second quarter, compared to \$27.9 million for the 2008 second quarter. The combined ratio for the insurance segment was 99.7% for the 2009 second quarter, compared to 93.3% for the 2008 second quarter. The components of the insurance segment's underwriting income are discussed below.

*Premiums Written.* Gross premiums written by the insurance segment in the 2009 second quarter were 2.4% higher than in the 2008 second quarter, with growth in executive assurance, construction and property business. The increase in executive assurance business primarily resulted from renewal rate increases, while the increases in construction and property business primarily resulted from new business. Such amounts were partially offset by reductions in casualty and professional liability business as the insurance segment continued to maintain underwriting discipline in response to the current market environment. Net premiums written declined by 0.5%, reflecting changes in the mix of business, reinstatement premiums and the impact of changes in reinsurance structure. For information regarding net premiums written produced by major line of business and geographic location, refer to Note 5, Segment Information, of the notes accompanying our consolidated financial statements.

*Net Premiums Earned.* Net premiums earned by the insurance segment in the 2009 second quarter were 0.2% lower than in the 2008 second quarter, and reflect changes in net premiums written over the previous five quarters, including the mix and type of business written.

*Losses and Loss Adjustment Expenses.* The loss ratio for the insurance segment was 68.8% in the 2009 second quarter, compared to 63.0% in the 2008 second quarter. The insurance segment's loss ratio in the 2009 second quarter included increases in expected loss ratios across a number of lines of business, primarily due to the anticipated impact of rate changes, and changes in the mix of business. In addition, the 2009 second quarter loss ratio also reflected a higher level of large loss activity than the 2008 second quarter. The 2009 second quarter loss ratio reflected a 4.5 reduction related to estimated net favorable development in prior year loss reserves, compared to a 5.6 point reduction in the 2008 second quarter. The estimated net favorable development in the 2009 second quarter was primarily in medium-tail lines and mainly resulted from better than expected claims emergence. The loss ratio for the 2009 second quarter did not include significant current period catastrophic event activity, compared to 1.7 points in the 2008 second quarter.

The insurance segment has in effect a reinsurance program which provides coverage for certain property-catastrophe related losses occurring during 2009 equal to a maximum of 80% of the first \$275 million in excess of a \$75 million retention per occurrence. The insurance segment had in effect a reinsurance program which provides coverage for certain property-catastrophe related losses occurring during 2008 equal to a maximum of 70% of the first \$275 million in excess of a \$75 million retention per occurrence.

*Underwriting Expenses.* The insurance segment's underwriting expense ratio was 30.9% in the 2009 second quarter, compared to 30.3% in the 2008 second quarter. The acquisition expense ratio was 13.9% for the 2009 second quarter, compared to 13.1% for the 2008 second quarter. The acquisition expense ratio is influenced by, among other things, (1) the amount of ceding commissions received from unaffiliated reinsurers, (2) the amount of business written on a surplus lines (non-admitted) basis and (3) mix of business. In addition, the 2009 second quarter acquisition expense ratio reflected a reduction of 0.1 points related to estimated net favorable development in prior year loss reserves, compared to an increase of 0.9 points in the 2008 second quarter. The comparison of the 2009 second quarter and 2008 second quarter acquisition expense ratios reflects changes in the form of reinsurance ceded and the mix of business. The insurance segment's other operating expense ratio was 17.0% for the 2009 second quarter, compared to 17.2% in the 2008 second quarter. The operating expense ratio for the 2009 second quarter included 0.9 points related to an expansion of the insurance segment's presence in the executive assurance and professional liability lines of business. We expect that this initiative will negatively impact the insurance segment's operating expense ratio over the balance of 2009. In addition, the 2009 second quarter operating expense ratio reflects the benefits of the insurance segment's expense management plan implemented in 2008, which included office relocation and personnel and other expense saving initiatives.

*Reinsurance Segment*

The following table sets forth our reinsurance segment's underwriting results:

	<b>Three Months Ended</b>	
	<b>June 30,</b>	
	<b>2009</b>	<b>2008</b>
Gross premiums written	\$ 278,389	\$ 273,318
Net premiums written	274,536	264,617
Net premiums earned	\$ 281,804	\$ 289,090
Fee income	22	358
Losses and loss adjustment expenses	(111,508)	(141,992)
Acquisition expenses, net	(65,066)	(63,826)
Other operating expenses	(16,943)	(20,091)
Underwriting income	\$ 88,309	\$ 63,539
<b>Underwriting Ratios</b>		
Loss ratio	39.6%	49.1%
Acquisition expense ratio	23.1%	22.1%
Other operating expense ratio	6.0%	6.9%
Combined ratio	68.7%	78.1%

The reinsurance segment's underwriting income was \$88.3 million for the 2009 second quarter, compared to \$63.5 million for the 2008 second quarter. The combined ratio for the reinsurance segment was 68.7% for the 2009 second quarter, compared to 78.1% for the 2008 second quarter. The components of the reinsurance segment's underwriting income are discussed below.

*Premiums Written.* Gross premiums written by the reinsurance segment in the 2009 second quarter were 1.9% higher than in the 2008 second quarter, primarily due to an increase in property catastrophe business due to the renewal of a two-year treaty. In addition, growth in property facultative business was partially offset by decreases in other specialty and casualty business. The decrease in other specialty business was primarily due to the non-renewal of a non-standard auto treaty, while the lower level of casualty business resulted from the non-renewal of a number of contracts.

Ceded premiums written by the reinsurance segment were 1.4% of gross premiums written for the 2009 second quarter, compared to 3.2% for the 2008 second quarter. In the 2009 second quarter, Arch Reinsurance Ltd. ( Arch Re Bermuda ) ceded \$0.5 million of premiums written, or 0.2%, under a quota share reinsurance treaty to Flatiron Re Ltd. ( Flatiron ), compared to \$7.0 million, or 2.6%, in the 2008 second quarter. Commission income from the treaty (in excess of the reimbursement of direct acquisition expenses) reduced the reinsurance segment's acquisition expense ratio by 0.7 points in the 2009 second quarter, compared to 2.3 points in the 2008 second quarter. On December 31, 2007, the quota share reinsurance treaty with Flatiron expired by its terms.

Net premiums written by the reinsurance segment in the 2009 second quarter were 3.7% higher than in the 2008 second quarter, primarily due to the items noted above. For information regarding net premiums written produced by major line of business and geographic location, refer to Note 5, Segment Information, of the notes accompanying our consolidated financial statements.

*Net Premiums Earned.* Net premiums earned in the 2009 second quarter were 2.5% lower than in the 2008 second quarter, and reflect changes in net premiums written over the previous five quarters, including the mix and type of business written.



*Losses and Loss Adjustment Expenses.* The reinsurance segment's loss ratio was 39.6% in the 2009 second quarter, compared to 49.1% for the 2008 second quarter. The loss ratio for the 2009 second quarter benefited from a higher level of property and short-tail business and a minimal level of catastrophic activity in the period. Net premiums earned in property and other short-tail lines were approximately 69.9% of the total for the 2009 second quarter, compared to 62.9% in the 2008 second quarter. The loss ratio for the 2009 second quarter reflected a 15.4 point reduction related to estimated net favorable development in prior year loss reserves, compared to a 13.5 point reduction in the 2008 second quarter. The estimated net favorable development in the 2009 second quarter primarily resulted from better than anticipated claims emergence in older underwriting years in longer tail lines and also reflected the commutation of a non-standard auto treaty in short-tail lines. The 2008 second quarter loss ratio included 5.8 points of current period catastrophic event activity.

Prior to April 2006, the reinsurance segment had in effect a catastrophe reinsurance program which provided coverage for certain catastrophe-related losses worldwide. The coverage was not renewed upon expiration. While our reinsurance operations may purchase industry loss warranty contracts and other reinsurance which is intended to limit their exposure, the non-renewal of the catastrophe reinsurance program and the quota share reinsurance treaty with Flatiron increases the risk retention of our reinsurance operations and, as a result, may increase the volatility in our results of operations in future periods.

*Underwriting Expenses.* The underwriting expense ratio for the reinsurance segment was 29.1% in the 2009 second quarter, compared to 29.0% in the 2008 second quarter. The acquisition expense ratio for the 2009 second quarter was 23.1%, compared to 22.1% for the 2008 second quarter, with the increase in the 2009 second quarter primarily due to the lower level of commission income from the Treaty with Flatiron noted above. In addition, the 2009 second quarter acquisition expense ratio reflected 0.2 points related to estimated net favorable development in prior year loss reserves, compared to 1.2 points in the 2008 second quarter. The comparison of the 2009 second quarter and 2008 second quarter acquisition expense ratios is influenced by, among other things, the mix and type of business written and earned and the level of ceding commission income. The reinsurance segment's other operating expense ratio was 6.0% for the 2009 second quarter, compared to 6.9% for the 2008 second quarter. Roughly half of the decrease in the operating expense ratio was related to a non-recurring expense recovery in the 2009 second quarter, with the balance primarily due to the impact of growth in the reinsurance segment's property facultative business.

### ***Net Investment Income***

Net investment income for the 2009 second quarter was \$100.5 million, compared to \$117.1 million in the 2008 second quarter. The lower level of net investment income in the 2009 second quarter, compared to the 2008 second quarter, was primarily driven by a decline in yields on our invested assets and also reflected (i) a reduction in the portfolio's effective duration, (ii) a decrease in income from our securities lending program, and (iii) our share repurchase program discussed below. The pre-tax investment income yield was 3.91% for the 2009 second quarter, compared to 4.80% for the 2008 second quarter. The pre-tax investment income yields were calculated based on amortized cost. Yields on future investment income may vary based on financial market conditions, investment allocation decisions and other factors.

**Net Realized Gains or Losses**

Net realized losses were as follows, excluding other-than-temporary impairment provisions:

(U.S. dollars in thousands)	Three Months Ended	
	2009	2008
	June 30,	
Fixed maturities	\$ 4,138	\$ 6,606
Other investments	(104)	(2,103)
Other (1)	(15,827)	(6,423)
Net realized losses	\$ (11,793)	\$ (1,920)

(1) Primarily consists of net losses related to investment-related derivatives and foreign currency forward contracts.

Currently, our portfolio is actively managed to maximize total return within certain guidelines. In assessing returns under this approach, we include net investment income, net realized gains and losses and the change in unrealized gains and losses generated by our investment portfolio. The effect of financial market movements on the investment portfolio will directly impact net realized gains and losses as the portfolio is adjusted and rebalanced. Total return on our portfolio under management, as reported to us by our investment advisors, for the 2009 second quarter was 3.89%, compared to (0.09%) for the 2008 second quarter. Excluding foreign exchange, total return was 3.20% for the 2009 second quarter, compared to (0.07%) for the 2008 second quarter.

**Net Impairment Losses Recognized in Earnings**

We review our investment portfolio each quarter to determine if declines in market value are other-than-temporary. The process for identifying declines in the market value of investments that are other-than-temporary involves consideration of several factors. These factors include (i) an analysis of the liquidity, business prospects and overall financial condition of the issuer, (ii) the time period in which there was a significant decline in value, and (iii) the significance of the decline. For the 2009 second quarter, we recorded \$20.7 million of other-than-temporary impairments ( OTTI ) of which \$20.9 million was recognized as credit related impairments in earnings, with the remaining \$0.2 million related to other factors (e.g., interest rates, market conditions, etc.) recorded as an unrealized component of accumulated other comprehensive income (loss). The OTTI recorded in the 2009 second quarter primarily resulted from reductions in estimated recovery values on certain mortgage-backed and asset-backed securities following the review of such securities. We recorded \$10.7 million of OTTI as a charge against earnings in the 2008 second quarter. Such amount was recorded prior to the adoption of FSP No. FAS 115-2 and FAS 124-2, Recognition and Presentation of Other-Than-Temporary Impairments, and included a portion related to credit losses and a portion related to all other factors.

**Equity in Net Income (Loss) of Investment Funds Accounted for Using the Equity Method**

We recorded \$75.9 million of net income related to investment funds accounted for using the equity method in the 2009 second quarter, compared to \$19.6 million for the 2008 second quarter. Due to the ownership structure of these investment funds, which invest in fixed maturity securities, we use the equity method. In applying the equity method, these investments are initially recorded at cost and are subsequently

## Edgar Filing: ARCH CAPITAL GROUP LTD. - Form 10-Q

adjusted based on our proportionate share of the net income or loss of the funds (which include changes in the market value of the underlying securities in the funds). Fluctuations in the carrying value of the investment funds accounted for using the equity method may increase the volatility of our reported results of operations. Investment funds accounted for using the equity method totaled \$370.2 million at June 30, 2009, compared to \$301.0 million at December 31, 2008. At June 30, 2009, our portfolio included \$431.4 million of investments in U.S. and Euro-denominated bank loan funds, of which 58.8% are reflected in the investment funds accounted for using the equity method noted above.

**Other Expenses**

Other expenses, which are included in our other operating expenses and part of corporate and other (non-underwriting), were \$11.5 million for the 2009 second quarter, compared to \$10.9 million for the 2008 second quarter. Such amounts primarily represent certain holding company costs necessary to support our worldwide insurance and reinsurance operations, share based compensation expense and costs associated with operating as a publicly traded company.

**Net Foreign Exchange Gains or Losses**

Net foreign exchange losses for the 2009 second quarter of \$53.7 million consisted of net unrealized losses of \$52.2 million and net realized losses of \$1.5 million, compared to net foreign exchange gains for the 2008 second quarter of \$0.3 million, which consisted of net unrealized gains of \$1.1 million and net realized losses of \$0.8 million. The 2009 second quarter net foreign exchange losses resulted from the significant weakening of the U.S. Dollar against the British Pound, Euro and other major currencies during the period. Net unrealized foreign exchange gains or losses result from the effects of revaluing our net insurance liabilities required to be settled in foreign currencies at each balance sheet date. We hold investments in foreign currencies which are intended to mitigate our exposure to foreign currency fluctuations in our net insurance liabilities. However, changes in the value of such investments due to foreign currency rate movements are reflected as a direct increase or decrease to shareholders' equity and are not included in the statements of income.

**Six Months Ended June 30, 2009 and 2008**

The following table sets forth net income available to common shareholders and earnings per common share data:

(U.S. dollars in thousands, except share data)	Six Months Ended June 30,	
	2009	2008
Net income available to common shareholders	\$ 291,998	\$ 381,704
Diluted net income per common share	\$ 4.67	\$ 5.71
Diluted weighted average common shares and common share equivalents outstanding	62,589,856	66,886,972

Net income available to common shareholders was \$292.0 million for the 2009 period, compared to \$381.7 million for the 2008 period. The decrease in net income was primarily due to a lower level of investment returns consisting of net investment income and net realized gains or losses and an increase in net impairment losses. The impact of these items was offset positively by an increase in the equity in net income (loss) of investment funds accounted for using the equity method. Our net income available to common shareholders for the 2009 period represented a 17.1% annualized return on average common equity, compared to 21.0% for the 2008 period. For purposes of computing return on average common equity, average common equity has been calculated as the average of common shareholders' equity outstanding at the beginning and ending of each period.

## Edgar Filing: ARCH CAPITAL GROUP LTD. - Form 10-Q

Diluted weighted average common shares and common share equivalents outstanding, used in the calculation of net income per common share, were 62.6 million in the 2009 period, compared to 66.9 million in the 2008 period. The lower level of weighted average shares outstanding in the 2009 period was primarily due to the impact of share repurchases. As a result of the share repurchase transactions to date, weighted average shares outstanding for the 2009 period were reduced by 15.3 million shares, compared to 10.6 million shares for the 2008 period.

**Segment Information***Insurance Segment*

The following table sets forth our insurance segment's underwriting results:

	Six Months Ended June 30,	
	2009	2008
Gross premiums written	\$ 1,275,054	\$ 1,248,011
Net premiums written	860,904	824,265
Net premiums earned	\$ 818,551	\$ 835,685
Fee income	1,665	1,762
Losses and loss adjustment expenses	(557,365)	(549,936)
Acquisition expenses, net	(116,371)	(107,289)
Other operating expenses	(133,744)	(145,203)
Underwriting income	\$ 12,736	\$ 35,019
<b>Underwriting Ratios</b>		
Loss ratio	68.1%	65.8%
Acquisition expense ratio (1)	14.0%	12.6%
Other operating expense ratio	16.3%	17.4%
Combined ratio	98.4%	95.8%

(1) The acquisition expense ratio is adjusted to include certain fee income.

The insurance segment's underwriting income was \$12.7 million for the 2009 period, compared to \$35.0 million for the 2008 period. The combined ratio for the insurance segment was 98.4% for the 2009 period, compared to 95.8% for the 2008 period. The components of the insurance segment's underwriting income are discussed below.

*Premiums Written.* Gross premiums written by the insurance segment in the 2009 period were 2.2% higher than in the 2008 period, with growth in programs, national accounts casualty and executive assurance business. The increase in programs and national accounts casualty business primarily resulted from new business while the increase in executive assurance business primarily resulted from renewal rate increases. Such amounts were partially offset by reductions in casualty, surety, and professional liability business as the insurance segment continued to maintain underwriting discipline in response to the current market environment. The higher net premiums written growth rate of 4.4% primarily resulted from changes in reinsurance usage and the impact of changes in the mix of business. For information regarding net premiums written produced by major line of business and geographic location, refer to Note 5, Segment Information, of the notes accompanying our consolidated financial statements.

*Net Premiums Earned.* Net premiums earned by the insurance segment in the 2009 period were 2.1% lower than in the 2008 period, and reflect changes in net premiums written over the previous five quarters, including the mix and type of business written.

*Losses and Loss Adjustment Expenses.* The loss ratio for the insurance segment was 68.1% in the 2009 period, compared to 65.8% in the 2008 period. The insurance segment's 2009 period loss ratio included increases in expected loss ratios across a number of lines of business, primarily due to the anticipated impact of rate changes, and changes in the mix of business. In addition, the 2009 period loss ratio also reflected a higher level of large loss activity than the 2008 period. The 2009 period loss ratio reflected a 3.4 point reduction related to estimated net favorable development in prior year loss reserves, compared to a 3.5 point reduction in the 2008 period. The estimated net favorable development in the 2009 period was primarily in medium-tail lines and

mainly resulted from better than expected claims emergence. The loss ratio for the 2009 period did not include significant current period catastrophic event activity, compared to 3.3 points in the 2008 period.

*Underwriting Expenses.* The insurance segment's underwriting expense ratio was 30.3% in the 2009 period, compared to 30.0% in the 2008 period. The acquisition expense ratio was 14.0% for the 2009 period, compared to 12.6% for the 2008 period. The acquisition expense ratio is influenced by, among other things, (1) the amount of ceding commissions received from unaffiliated reinsurers, (2) the amount of business written on a surplus lines (non-admitted) basis and (3) mix of business. In addition, the 2009 period acquisition expense ratio reflected an increase of 0.1 points related to the estimated net favorable development in prior year loss reserves, compared to 0.5 points in the 2008 period. The comparison of the 2009 period and 2008 period acquisition expense ratios reflects changes in the form of reinsurance ceded and the mix of business. The insurance segment's other operating expense ratio was 16.3% for the 2009 period, compared to 17.4% in the 2008 period. The operating expense ratio for the 2009 period included 0.4 points related to an expansion of the insurance segment's presence in the executive assurance and professional liability lines of business. We expect that this initiative will negatively impact the insurance segment's operating expense ratio over the balance of 2009. In addition, the 2009 period operating expense ratio reflects the benefits of non-recurring adjustments in compensation costs in the 2009 period, as well as the insurance segment's expense management plan implemented in 2008, which included office relocation and personnel and other expense saving initiatives.

#### *Reinsurance Segment*

The following table sets forth our reinsurance segment's underwriting results:

	<b>Six Months Ended June 30,</b>	
	<b>2009</b>	<b>2008</b>
Gross premiums written	\$ 668,518	\$ 707,145
Net premiums written	655,813	673,195
Net premiums earned	\$ 581,271	\$ 578,224
Fee income	77	544
Losses and loss adjustment expenses	(242,035)	(259,106)
Acquisition expenses, net	(133,901)	(126,576)
Other operating expenses	(35,135)	(38,329)
Underwriting income	\$ 170,277	\$ 154,757
<b>Underwriting Ratios</b>		
Loss ratio	41.6%	44.8%
Acquisition expense ratio	23.0%	21.9%
Other operating expense ratio	6.0%	6.6%
Combined ratio	70.6%	73.3%

The reinsurance segment's underwriting income was \$170.3 million for the 2009 period, compared to \$154.8 million for the 2008 period. The combined ratio for the reinsurance segment was 70.6% for the 2009 period, compared to 73.3% for the 2008 period. The components of the reinsurance segment's underwriting income are discussed below.



## Edgar Filing: ARCH CAPITAL GROUP LTD. - Form 10-Q

*Premiums Written.* Gross premiums written by the reinsurance segment in the 2009 period were 5.5% lower than in the 2008 period, primarily due to reductions in casualty and other specialty business written in the 2009 period. The decrease in other specialty was primarily due to the non-renewal of a non-standard auto treaty, while the lower level of casualty business resulted from the impact of non-renewals of a number of contracts. The decreases were partially offset by increases in property catastrophe business, primarily due to the renewal of

a two-year treaty, and a \$21.4 million increase in writings by the reinsurance segment's property facultative operation.

Ceded premiums written by the reinsurance segment were 1.9% of gross premiums written for the 2009 period, compared to 4.8% for the 2008 period. In the 2009 period, Arch Re Bermuda ceded \$4.0 million of premiums written, or 0.6%, under a quota share reinsurance treaty to Flatiron, compared to \$25.4 million, or 3.6%, in the 2008 period. Commission income from the treaty (in excess of the reimbursement of direct acquisition expenses) reduced the reinsurance segment's acquisition expense ratio by 0.7 points in the 2009 period, compared to 2.8 points in the 2008 period.

Net premiums written by the reinsurance segment in the 2009 period were 2.6% lower than in the 2008 period, primarily due to the items noted above. For information regarding net premiums written produced by major line of business and geographic location, refer to Note 5, Segment Information, of the notes accompanying our consolidated financial statements.

*Net Premiums Earned.* Net premiums earned in the 2009 period were 0.5% higher than in the 2008 period, and reflect changes in net premiums written over the previous five quarters, including the mix and type of business written.

*Losses and Loss Adjustment Expenses.* The reinsurance segment's loss ratio was 41.6% in the 2009 period, compared to 44.8% for the 2008 period. The loss ratio for the 2009 period benefited from a higher level of property and short-tail business and a minimal level of catastrophic activity in the period. Net premiums earned in property and other short-tail lines were approximately 70.6% of the total for the 2009 period, compared to 62.5% in the 2008 period. The 2009 period loss ratio included 1.4 points of current period catastrophic event activity, compared to 3.9 points for the 2008 period. The loss ratio for the 2009 period reflected a 14.7 point reduction related to estimated net favorable development in prior year loss reserves, compared to a 15.6 point reduction in the 2008 period. The estimated net favorable development in the 2009 period primarily resulted from better than anticipated claims emergence in older underwriting years in longer and short-tail lines and also reflected the commutation of a non-standard auto treaty in the period.

*Underwriting Expenses.* The underwriting expense ratio for the reinsurance segment was 29.0% in the 2009 period, compared to 28.5% in the 2008 period. The acquisition expense ratio for the 2009 period was 23.0%, compared to 21.9% for the 2008 period, with the increase in the 2009 second quarter primarily due to the lower level of commission income from the Treaty with Flatiron noted above. In addition, the 2009 period acquisition expense ratio reflected 0.5 points related to estimated net favorable development in prior year loss reserves, compared to 0.6 points in the 2008 period. The comparison of the 2009 period and 2008 period acquisition expense ratios is influenced by, among other things, the mix and type of business written and earned and the level of ceding commission income. The reinsurance segment's other operating expense ratio was 6.0% for the 2009 period, compared to 6.6% for the 2008 period. Roughly half of the decrease in the operating expense ratio was related to a non-recurring expense recovery in the 2009 period, with the balance primarily due to the impact of growth in the reinsurance segment's property facultative business and a higher level of net premiums earned in the 2009 period.

#### ***Net Investment Income***

Net investment income for the 2009 period was \$196.4 million, compared to \$239.3 million in the 2008 period. The lower level of net investment income in the 2009 period, compared to the 2008 period, was primarily driven by a decline in yields on our invested assets and also reflected (i) a reduction in the portfolio's effective duration, (ii) a decrease in income from our securities lending program, (iii) reductions to the cost basis of treasury inflation protected securities (TIPS) in the 2009 first quarter which resulted from a decline in the consumer price index (CPI), and (iv) our share repurchase program discussed below. In addition, the 2008 period included \$3.4 million of interest income related to a

favorable arbitration decision. The pre-tax

investment income yield was 3.87% for the 2009 period, compared to 4.84% (excluding the arbitration interest) for the 2008 period. The pre-tax investment income yields were calculated based on amortized cost.

***Net Realized Gains or Losses***

Net realized gains (losses) were as follows, excluding other-than-temporary impairment provisions:

(U.S. dollars in thousands)	Six Months Ended	
	June 30,	
	2009	2008
Fixed maturities	\$ 10,308	\$ 72,073
Other investments	(18,690)	(5,216)
Other (1)	(8,575)	(20,091)
Net realized gains (losses)	\$ (16,957)	\$ 46,766

(1) Primarily consists of net realized losses related to investment-related derivatives and foreign currency forward contracts.

Total return on our portfolio under management, as reported to us by our investment advisors, for the 2009 period was 5.03%, compared to 0.86% for the 2008 period. Excluding foreign exchange, total return was 4.46% for the 2009 period, compared to 0.63% for the 2008 period.

***Net Impairment Losses Recognized in Earnings***

For the 2009 period, we recorded \$113.6 million of OTTI of which \$57.0 million was recognized as credit related impairments in earnings, with the remaining \$56.6 million related to other factors (e.g., interest rates, market conditions, etc.) recorded as an unrealized component of accumulated other comprehensive income (loss). The OTTI recorded in the 2009 period primarily resulted from reductions in estimated recovery values on certain mortgage-backed and asset-backed securities following the review of such securities. We recorded \$23.5 million of OTTI as a charge against earnings in the 2008 period. Such amount was recorded prior to the adoption of FSP No. FAS 115-2 and FAS 124-2, Recognition and Presentation of Other-Than-Temporary Impairments, and included a portion related to credit losses and a portion related to all other factors.

***Equity in Net Income (Loss) of Investment Funds Accounted for Using the Equity Method***

We recorded \$66.3 million of net income related to investment funds accounted for using the equity method in the 2009 period, compared to net losses of \$2.7 million for the 2008 period.

***Other Expenses***

Other expenses, which are included in our other operating expenses and part of corporate and other (non-underwriting), were \$17.5 million for the 2009 period, compared to \$16.2 million for the 2008 period. Such amounts primarily represent certain holding company costs necessary to support our worldwide insurance and reinsurance operations, share based compensation expense and costs associated with operating as a publicly traded company.

***Net Foreign Exchange Gains or Losses***

Net foreign exchange losses for the 2009 period of \$28.5 million consisted of net unrealized losses of \$26.2 million and net realized losses of \$2.3 million, compared to net foreign exchange losses for the 2008 period of \$23.3 million, which consisted of net unrealized losses of \$21.2 million and net realized losses of \$2.1 million.

**FINANCIAL CONDITION, LIQUIDITY AND CAPITAL RESOURCES****Financial Condition***Investable Assets*

The finance and investment committee of our board of directors establishes our investment policies and sets the parameters for creating guidelines for our investment managers. The finance and investment committee reviews the implementation of the investment strategy on a regular basis. Our current approach stresses preservation of capital, market liquidity and diversification of risk. While maintaining our emphasis on preservation of capital and liquidity, we expect our portfolio to become more diversified and, as a result, we may expand into areas which are not currently part of our investment strategy. Our Chief Investment Officer administers the investment portfolio, oversees our investment managers, formulates investment strategy in conjunction with our finance and investment committee and directly manages certain portions of our fixed income portfolio.

On a consolidated basis, our aggregate investable assets totaled \$10.75 billion at June 30, 2009, compared to \$9.97 billion at December 31, 2008, as detailed in the table below:

	<b>June 30, 2009</b>	<b>December 31, 2008</b>
Fixed maturities available for sale, at market value	\$ 8,944,110	\$ 8,122,221
Fixed maturities pledged under securities lending agreements, at market value (1)	559,385	626,501
Total fixed maturities	9,503,495	8,748,722
Short-term investments available for sale, at market value	660,859	479,586
Short-term investments pledged under securities lending agreements, at market value (1)		101,564
Cash	336,693	251,739
Other investments (2)		
Fixed income mutual funds	49,505	39,858
Privately held securities and other	65,755	69,743
Investment funds accounted for using the equity method (3)	370,165	301,027
Total cash and investments (1)	10,986,472	9,992,239
Securities transactions entered into but not settled at the balance sheet date	(239,736)	(18,236)
Total investable assets	\$ 10,746,736	\$ 9,974,003

(1) In our securities lending transactions, we receive collateral in excess of the market value of the fixed maturities and short-term investments pledged under securities lending agreements. For purposes of this table, we have excluded the investment of collateral received and reinvested at June 30, 2009 and December 31, 2008 of \$556.5 million and \$730.2 million, respectively, which is reflected as investment of funds received under securities lending agreements, at market value and included the \$559.4 million and \$728.1 million, respectively, of fixed maturities and short-term investments pledged under securities lending agreements, at market value.

(2) Other investments include (i) mutual funds which invest in fixed maturity securities and international equity index funds; and (ii) privately held securities and other which include our investment in Aeolus LP and other privately held securities.

(3) Our investment portfolio includes certain funds that invest in fixed maturity securities which, due to the ownership structure of the funds, are accounted for by us using the equity method. In applying the equity method, these investments are initially recorded at cost and are subsequently adjusted based on our proportionate share of the net income or loss of the funds (which include changes in the market value of the underlying securities in the funds). Changes in the carrying value of such investments are recorded as Equity in net income (loss) of investment funds accounted for using the equity method rather than as an unrealized gain or loss component of accumulated other comprehensive income in shareholders' equity as are changes in the carrying value of our other fixed income investments.

Edgar Filing: ARCH CAPITAL GROUP LTD. - Form 10-Q

At June 30, 2009, our fixed income portfolio, which includes fixed maturity securities and short-term investments, had a AA+ average Standard & Poor's quality rating, an average effective duration of 3.02 years, and an average yield to maturity (imbedded book yield), before investment expenses, of 4.06%. At December 31, 2008, our fixed income portfolio had a AA+ average Standard & Poor's quality rating, an average effective duration of 3.62 years, and an average yield to maturity (imbedded book yield), before investment expenses, of 4.55%. At June 30, 2009, approximately \$6.0 billion, or 55.8%, of our total investments and cash was internally managed, compared to \$5.3 billion, or 52.2%, at December 31, 2008.

The following table summarizes our fixed maturities and fixed maturities pledged under securities lending agreements:

(U.S. dollars in thousands)	Estimated Market Value	Gross Unrealized Gains	Gross Unrealized Losses	Amortized Cost	OTTI Unrealized Losses (1)
<b>June 30, 2009:</b>					
Corporate bonds	\$ 2,885,694	\$ 65,137	\$ (42,771)	\$ 2,863,328	\$ (22,714)
Mortgage backed securities	1,622,276	21,324	(104,187)	1,705,139	(75,010)
U.S. government and government agencies	1,289,603	20,917	(12,888)	1,281,574	(614)
Commercial mortgage backed securities	1,302,208	26,455	(25,932)	1,301,685	(5,689)
Asset backed securities	805,921	17,483	(21,747)	810,185	(8,176)
Municipal bonds	858,065	29,595	(2,796)	831,266	(198)
Non-U.S. government securities	739,728	46,625	(8,222)	701,325	(647)
Total	\$ 9,503,495	\$ 227,536	\$ (218,543)	\$ 9,494,502	\$ (113,048)
<b>December 31, 2008:</b>					
Corporate bonds	\$ 2,019,373	\$ 51,131	\$ (98,979)	\$ 2,067,221	
Mortgage backed securities	1,581,736	23,306	(125,759)	1,684,189	
U.S. government and government agencies	1,463,897	77,762	(14,159)	1,400,294	
Commercial mortgage backed securities	1,219,737	16,128	(68,212)	1,271,821	
Asset backed securities	970,041	1,121	(70,762)	1,039,682	
Municipal bonds	965,966	26,815	(1,730)	940,881	
Non-U.S. government securities	527,972	33,690	(31,884)	526,166	
Total	\$ 8,748,722	\$ 229,953	\$ (411,485)	\$ 8,930,254	

(1) Represents the total other-than-temporary impairments ( OTTI ) in accumulated other comprehensive income ( AOCI ) and included in the gross unrealized losses column.

The credit quality distribution of our fixed maturities and fixed maturities pledged under securities lending agreements is shown below:

Rating (1)	June 30, 2009		December 31, 2008	
	Estimated Market Value	% of Total	Estimated Market Value	% of Total
AAA	\$ 7,163,333	75.4	\$ 6,756,503	77.2
AA	1,013,732	10.7	815,512	9.3
A	734,015	7.7	750,947	8.6
BBB	267,107	2.8	195,319	2.2
BB	65,242	0.7	52,349	0.6
B	178,196	1.9	126,688	1.5



Edgar Filing: ARCH CAPITAL GROUP LTD. - Form 10-Q

Lower than B	29,446	0.3	9,549	0.1
Not rated	52,424	0.5	41,855	0.5
Total	\$ 9,503,495	100.0	\$ 8,748,722	100.0

---

(1) Ratings as assigned by the major rating agencies.

Edgar Filing: ARCH CAPITAL GROUP LTD. - Form 10-Q

At June 30, 2009 and December 31, 2008, below-investment grade securities comprised approximately 3.4% and 2.7%, respectively, of our fixed maturities and fixed maturities pledged under securities lending agreements. In accordance with our investment strategy, we invest in high yield fixed income securities which are included in Corporate bonds. Upon issuance, these securities are typically rated below investment grade (i.e., rating assigned by the major rating agencies of BB or less). At June 30, 2009 and December 31, 2008, corporate bonds represented 81% and 94%, respectively, of the total below investment grade securities at market value, with the remainder primarily in mortgage backed securities.

The following table provides information on the severity of the unrealized loss position as a percentage of amortized cost for all fixed maturities and fixed maturities pledged under securities lending agreements which were in an unrealized loss position at June 30, 2009 and December 31, 2008:

Severity of Unrealized Loss	June 30, 2009			December 31, 2008		
	Estimated Market Value	Gross Unrealized Losses	% of Total Gross Unrealized Losses	Estimated Market Value	Gross Unrealized Losses	% of Total Gross Unrealized Losses
0-10%	\$ 2,461,985	\$ (49,874)	22.8	\$ 2,672,702	\$ (104,517)	25.4
10-20%	260,648	(45,675)	20.9	526,450	(87,438)	21.3
20-30%	137,391	(43,632)	20.0	247,798	(82,966)	20.2
30-40%	75,206	(37,446)	17.1	122,190	(65,626)	15.9
40-50%	19,385	(16,664)	7.6	55,459	(45,032)	10.9
50-60%	13,276	(15,449)	7.1	16,798	(19,741)	4.8
60-70%	3,048	(5,273)	2.4	1,680	(2,886)	0.7
70-80%	949	(2,719)	1.3	1,181	(3,279)	0.8
80-90%	237	(1,139)	0.5			
90-93%	51	(672)	0.3			
Total	\$ 2,972,176	\$ (218,543)	100.0	\$ 3,644,258	\$ (411,485)	100.0

The following table provides information on the severity of the unrealized loss position as a percentage of amortized cost for non-investment grade fixed maturities and fixed maturities pledged under securities lending agreements which were in an unrealized loss position at June 30, 2009 and December 31, 2008:

Severity of Unrealized Loss	June 30, 2009			December 31, 2008		
	Estimated Market Value	Gross Unrealized Losses	% of Total Gross Unrealized Losses	Estimated Market Value	Gross Unrealized Losses	% of Total Gross Unrealized Losses
0-10%	\$ 60,878	\$ (3,040)	1.4	\$ 33,362	\$ (1,970)	0.5
10-20%	32,887	(6,442)	2.9	107,828	(14,293)	3.5
20-30%	22,340	(7,605)	3.5	17,781	(6,091)	1.5
30-40%	23,182	(12,204)	5.6	10,709	(5,578)	1.3
40-50%	2,196	(1,948)	0.9	15,311	(11,899)	2.9
50-60%	1,437	(1,538)	0.7	2,605	(3,179)	0.7
60-70%				71	(107)	0.0
70-80%	58	(148)	0.1	100	(254)	0.1
80-90%	97	(424)	0.2			
90-93%	51	(672)	0.3			
Total	\$ 143,126	\$ (34,021)	15.6	\$ 187,767	\$ (43,371)	10.5

Edgar Filing: ARCH CAPITAL GROUP LTD. - Form 10-Q

We determine estimated recovery values for our fixed maturities and fixed maturities pledged under securities lending agreements following a review of the business prospects, credit ratings, estimated loss given

default factors and information received from asset managers and rating agencies for each security. For structured securities, we utilize underlying data, where available, for each security provided by asset managers and additional information from credit agencies in order to determine an expected recovery value for each security. The analysis provided by the asset managers includes expected cash flow projections under base case and stress case scenarios which modify expected default expectations and loss severities and slow down prepayment assumptions. In the tables above, securities at June 30, 2009 which were in an unrealized loss position of greater than 40% of amortized cost were primarily in asset backed and mortgage backed securities where the estimated market value for the securities was lower than our expected recovery value.

The following table summarizes our top ten exposures to fixed income corporate issuers at June 30, 2009:

(U.S. dollars in thousands)	Estimated Market Value		Total
	Government Guaranteed (1)	Not Guaranteed	
JPMorgan Chase & Co.	\$ 84,879	\$ 76,587	\$ 161,466
Bank of America Corp.	58,955	44,544	103,499
Citigroup Inc.	53,096	37,641	90,737
GMAC LLC	79,840		79,840
Societe Financement de l Economie	65,310		65,310
General Electric Capital Corp.	15,164	46,892	62,056
Anz National (Int l) Limited	57,217		57,217
Morgan Stanley	38,230	15,176	53,406
Verizon Communications Inc.		52,361	52,361
Japan Bank for Int l Cooperation	52,214		52,214
Total	\$ 504,905	\$ 273,201	\$ 778,106

(1) Securities of U.S.-domiciled issuers are guaranteed by the Federal Deposit Insurance Corporation ( FDIC ), a U.S. government agency, under the Temporary Liquidity Guarantee Program. Societe Financement de l Economie, Anz National (Int l) Limited and Japan Bank for Int l Cooperation are guaranteed by foreign governments.

As of June 30, 2009, we held insurance enhanced municipal bonds, net of prerefunded bonds that are escrowed in U.S. government obligations, in the amount of \$324.8 million, which represented 3.0% of our total invested assets. These securities had an average rating of Aa2 by Moody s and AA by Standard & Poor s. Giving no effect to the insurance enhancement, the overall credit quality of our insured municipal bond portfolio was an average underlying rating of Aa3 by Moody s and AA by Standard & Poor s. The ratings were obtained from the individual rating agencies and were assigned a numerical amount with 1 being the highest rating. The average ratings were calculated using the weighted average market values of the individual bonds. The average rating with and without the insurance enhancement are substantially the same at June 30, 2009, indicating the low level of credit given for the insurance enhancement in the market. In addition, in cases where the claims paying ratings of the guarantors are lower than the underlying rating of the municipal bond, no adjustment to the underlying rating of the municipal bond is made. Guarantors of our insurance enhanced municipal bonds, net of prerefunded bonds that are escrowed in U.S. government obligations, included National Public Finance Guarantee (f.k.a. MBIA Insurance Corporation) (\$150.1 million), Financial Security Assurance Inc. (acquired by Assured Guaranty Ltd. on July 1) (\$83.3 million), Ambac Financial Group, Inc. (\$43.8 million), Financial Guaranty Insurance Company (\$25.3 million) and the Texas Permanent School Fund (\$22.2 million). We do not have a significant exposure to insurance enhanced asset-backed or mortgage-backed securities. We do not have any significant investments in companies which guarantee securities at June 30, 2009.

Edgar Filing: ARCH CAPITAL GROUP LTD. - Form 10-Q

The following table provides information on our mortgage backed securities ( MBS ) and commercial mortgage backed securities ( CMBS ) at June 30, 2009, excluding amounts guaranteed by the U.S. government:

(U.S. dollars in thousands)	Issuance Year	Amortized Cost	Average Credit Quality	Total	Estimated Market Value % of Amortized Cost	% of Investable Assets
<b>MBS:</b>						
Non-agency MBS	2002	\$ 4,842	AAA	\$ 4,520	93.3%	0.0%
	2003	4,111	AAA	3,665	89.2%	0.0%
	2004	36,070	AA+	28,661	79.5%	0.3%
	2005	96,839	AA	64,227	66.3%	0.6%
	2006	72,390	A+	50,672	70.0%	0.5%
	2007	102,402	BBB	73,956	72.2%	0.7%
	2008	27,883	AAA	23,924	85.8%	0.2%
	2009	45,489	AAA	45,413	99.8%	0.4%
Total non-agency MBS		\$ 390,026	AA-	\$ 295,038	75.6%	2.7%
<b>CMBS:</b>						
Non-agency CMBS	1998	\$ 3,761	AAA	\$ 3,402	90.5%	0.0%
	1999	65,440	AAA	64,910	99.2%	0.6%
	2000	128,617	AAA	130,574	101.5%	1.2%
	2001	113,398	AAA	116,484	102.7%	1.1%
	2002	66,656	AAA	66,916	100.4%	0.6%
	2003	93,209	AAA	93,008	99.8%	0.9%
	2004	75,045	AAA	71,211	94.9%	0.7%
	2005	85,890	AAA	78,248	91.1%	0.7%
	2006	78,456	AAA	75,906	96.7%	0.7%
	2007	39,214	AAA	36,782	93.8%	0.3%
Total non-agency CMBS		\$ 749,686	AAA	\$ 737,441	98.4%	6.9%

**Additional Statistics:**

	Non-Agency MBS	Non-Agency CMBS (1)
Weighted average loan age (months)	41	82
Weighted average life (months) (2)	55	23
Weighted average loan-to-value % (3)	70.0%	63.0%
Total delinquencies (4)	13.9%	2.1%
Current credit support % (5)	19.2%	29.7%

(1) Loans defeased with government/agency obligations represented approximately 22% of the collateral underlying our CMBS holdings.

(2) The weighted average life for MBS is based on the interest rates in effect at June 30, 2009. The weighted average life for CMBS reflects the average life of the collateral underlying our CMBS holdings.

(3) The range of loan-to-values on MBS is 37% to 91% while the range of loan-to-values on CMBS is 43% to 76%.

(4) Total delinquencies includes 60 days and over.

(5) Current credit support % represents the percentage for a collateralized mortgage obligation ( CMO ) or CMBS class/tranche from other subordinate classes in the same CMO or CMBS deal.

Edgar Filing: ARCH CAPITAL GROUP LTD. - Form 10-Q

The following table provides information on our asset backed securities ( ABS ) at June 30, 2009:

(U.S. dollars in thousands)	Amortized Cost	Average Credit Quality	Total	Estimated Market Value % of Amortized Cost	% of Investable Assets
<b>Sector:</b>					
Autos (1)	\$ 218,880	AAA	\$ 219,516	100.3%	2.0%
Credit cards (2)	339,427	AAA	346,888	102.2%	3.2%
Rate reduction bonds (3)	139,666	AAA	143,667	102.9%	1.3%
Student loans (4)	40,617	AAA	40,246	99.1%	0.4%
Equipment (5)	29,536	AAA	29,828	101.0%	0.3%
Other	8,625	AAA	7,260	84.2%	0.1%
	776,751	AAA	787,405	101.4%	7.3%
Home equity (6)	\$ 23,409	AAA	\$ 14,792	63.2%	0.2%
	6,126	AA	2,091	34.1%	0.0%
	405	A	120	29.6%	0.0%
	921	B	619	67.2%	0.0%
	2,367	CCC	836	35.3%	0.0%
	206	D	58	28.2%	0.0%
	33,434	AA+	18,516	55.4%	0.2%
Total ABS	\$ 810,185	AAA	\$ 805,921	99.5%	7.5%

The effective duration of the total ABS was 1.0 years at June 30, 2009

- 
- (1) The weighted average credit support % on autos is 17.6%.
  - (2) The weighted average credit support % on credit cards is 13.6%.
  - (3) The weighted average credit support % on rate reduction bonds is 1.5%.
  - (4) The weighted average credit support % on student loans is 5.3%.
  - (5) The weighted average credit support % on equipment is 6.2%.
  - (6) The weighted average credit support % on home equity is 32.1%.

At June 30, 2009, our fixed income portfolio included \$58.4 million par value in sub-prime securities with an estimated market value of \$19.8 million and an average credit quality of AA+. Such amounts were primarily in the home equity sector of our asset backed securities with the balance in other ABS, MBS and CMBS sectors. We define sub-prime mortgage-backed securities as investments in which the underlying loans primarily exhibit one or more of the following characteristics: low FICO scores, above-prime interest rates, high loan-to-value ratios or high debt-to-income ratios. In addition, the portfolio of collateral backing our securities lending program contains \$24.2 million estimated market value of sub-prime securities with an average credit quality of AA+ from Standard & Poor's and Ba3 from Moody's.

## Edgar Filing: ARCH CAPITAL GROUP LTD. - Form 10-Q

Certain of our investments, primarily those included in other investments and investment funds accounted for using the equity method on our balance sheet, may use leverage to achieve a higher rate of return. While leverage presents opportunities for increasing the total return of such investments, it may increase losses as well. Accordingly, any event that adversely affects the value of the underlying securities held by such investments would be magnified to the extent leverage is used and our potential losses from such investments would be magnified. In addition, the structures used to generate leverage may lead to such investment funds being required to meet covenants based on market valuations and asset coverage. Market valuation declines in the funds could force the sale of investments into a depressed market, which may result in significant additional losses. Alternatively, the funds may attempt to deleverage by raising additional equity or potentially changing the terms of the established financing arrangements. We may choose to participate in the additional funding of



such investments. Our investment commitments related to investment funds accounted for using the equity method, totaled approximately \$6.9 million.

Our investment strategy allows for the use of derivative instruments. We utilize various derivative instruments such as futures contracts as part of the management of our stock index fund investments and to replicate equity investment positions. Derivative instruments may be used to enhance investment performance, replicate investment positions or manage market exposures and duration risk that would be allowed under our investment guidelines if implemented in other ways. See Note 8, Investment Information Investment-Related Derivatives, of the notes accompanying our consolidated financial Statements for additional disclosures concerning derivatives.

Other investments totaled \$115.3 million at June 30, 2009, compared to \$109.6 million at December 31, 2008. Investment funds accounted for using the equity method totaled \$370.2 million at June 30, 2009, compared to \$301.0 million at December 31, 2008. See Note 8, Investment Information Other Investments and Investment Information Investment Funds Accounted for Using the Equity Method of the notes accompanying our consolidated financial statements for further details.

SFAS No. 157, Fair Value Measurements ( SFAS No. 157 ) addresses how companies should measure fair value when they are required to use a fair value measure for recognition or disclosure purposes under GAAP and provides a common definition of fair value to be used throughout GAAP. SFAS No. 157 defines fair value as the price that would be received to sell an asset or paid to transfer a liability in an orderly fashion between market participants at the measurement date. SFAS No. 157 establishes a three-level valuation hierarchy for the disclosure of fair value measurements. The valuation hierarchy is based upon the transparency of inputs to the valuation of an asset or liability as of the measurement date. The level in the hierarchy within which a given fair value measurement falls is determined based on the lowest level input that is significant to the measurement (Level 1 being the highest priority and Level 3 being the lowest priority).

The three levels are defined as follows:

- Level 1: Inputs to the valuation methodology are observable inputs that reflect quoted prices (unadjusted) for *identical* assets or liabilities in *active markets*
- Level 2: Inputs to the valuation methodology include quoted prices for similar assets and liabilities in active markets, and inputs that are observable for the asset or liability, either directly or indirectly, for substantially the full term of the financial instrument
- Level 3: Inputs to the valuation methodology are unobservable and significant to the fair value measurement

Following is a description of the valuation methodologies used for securities measured at fair value, as well as the general classification of such securities pursuant to the valuation hierarchy.

We use quoted values and other data provided by nationally recognized independent pricing sources as inputs into the process for determining fair values of our fixed maturity investments. To validate the techniques or models used by pricing sources, our review process includes, but is not limited to: (i) quantitative analysis (*e.g.*, comparing the quarterly return for each managed portfolio to its target benchmark, with significant differences identified and investigated); (ii) a review of the average number of prices obtained in the pricing process and the range of resulting market values; (iii) initial and ongoing evaluation of methodologies used by outside parties to calculate fair value including a review of deep dive reports on selected securities which indicated the use of observable inputs in the pricing process; (iv) comparing the fair value estimates to

Edgar Filing: ARCH CAPITAL GROUP LTD. - Form 10-Q

our knowledge of the current market; (v) a comparison of the pricing services' fair values to other pricing services' fair values for the same investments; and (vi) back-testing, which includes randomly selecting purchased or sold

securities and comparing the executed prices to the fair value estimates from the pricing service. At June 30, 2009, we obtained an average of 2.55 quotes per investment, compared to 2.6 quotes at December 31, 2008. Where multiple quotes or prices were obtained, a price source hierarchy was maintained in order to determine which price source provided the fair value (i.e., a price obtained from a pricing service with more seniority in the hierarchy will be used from a less senior one in all cases). The hierarchy prioritizes pricing services based on availability and reliability and assigns the highest priority to index providers. Based on the above review, we will challenge any prices for a security or portfolio which are considered not to be representative of fair value. We did not adjust the prices or quotes provided by the pricing services at June 30, 2009 or December 31, 2008.

The independent pricing sources obtain market quotations and actual transaction prices for securities that have quoted prices in active markets. Each source has its own proprietary method for determining the fair value of securities that are not actively traded. In general, these methods involve the use of matrix pricing in which the independent pricing source uses observable market inputs including, but not limited to, investment yields, credit risks and spreads, benchmarking of like securities, broker-dealer quotes, reported trades and sector groupings to determine a reasonable fair market value. In addition, pricing vendors use model processes, such as an Option Adjusted Spread model, to develop prepayment and interest rate scenarios. The Option Adjusted Spread model is commonly used to estimate fair value for securities such as mortgage backed and asset backed securities. In certain circumstances, when fair market values are unavailable from these independent pricing sources, quotes are obtained directly from broker-dealers who are active in the corresponding markets. Such quotes are subject to the validation procedures noted above. Of the \$10.2 billion of financial assets and liabilities measured at fair value, approximately \$1.02 billion, or 10%, were priced using non-binding broker-dealer quotes.

We review our securities measured at fair value and discuss the proper classification of such investments with investment advisors and others. Upon adoption of SFAS No. 157 and at June 30, 2009, we determined that Level 1 securities included highly liquid, recent issue U.S. Treasuries and certain of our short-term investments held in highly liquid money market-type funds where it believes that quoted prices are available in an active market.

Where we believe that quoted market prices are not available or that the market is not active, fair values are estimated by using quoted prices of securities with similar characteristics, pricing models or matrix pricing and are generally classified as Level 2 securities. We determined that Level 2 securities included corporate bonds, mortgage backed securities, municipal bonds, asset backed securities, certain U.S. government and government agencies, non-U.S. government securities, certain short-term securities and certain other investments.

We determined that three Euro-denominated corporate bonds which invest in underlying portfolios of fixed income securities for which there is a low level of transparency around inputs to the valuation process should be classified within Level 3 of the valuation hierarchy. In addition, we determined that two mutual funds, included in other investments, which invest in underlying portfolios of fixed income securities for which there is a low level of transparency around inputs to the valuation process should be classified within Level 3 of the valuation hierarchy. These items were reclassified as Level 3 during the 2008 fourth quarter due to the significant dislocation in the credit markets during October and November 2008. We believe that the market for such investments, which are primarily investments in an underlying portfolio of structured bank loans, deteriorated in response to market conditions. As such, the inputs to the valuation process for these investments were determined to be less observable than in prior periods. We review the classification of our investments each quarter. In addition, Level 3 securities include a small number of premium-tax bonds.

See Note 8, Investment Information Fair Value of the notes accompanying our consolidated financial statements for a summary of our financial assets and liabilities measured at fair value at June 30, 2009 by SFAS No. 157 hierarchy.

**Reinsurance Recoverables**

We monitor the financial condition of our reinsurers and attempt to place coverages only with substantial, financially sound carriers. At June 30, 2009, approximately 89.3% of reinsurance recoverables on paid and unpaid losses (not including prepaid reinsurance premiums) of \$1.79 billion were due from carriers which had an A.M. Best rating of A- or better and the largest reinsurance recoverables from any one carrier was less than 6.5% of our total shareholders' equity. At December 31, 2008, approximately 88.5% of reinsurance recoverables on paid and unpaid losses (not including prepaid reinsurance premiums) of \$1.79 billion were due from carriers which had an A.M. Best rating of A- or better and the largest reinsurance recoverables from any one carrier was less than 7.3% of our total shareholders' equity.

Reinsurance recoverables from Flatiron, which is not rated by A.M. Best, were \$131.1 million at June 30, 2009, compared to \$148.7 million at December 31, 2008. Flatiron is required to contribute funds into a trust for the benefit of Arch Re Bermuda. The recoverable from Flatiron was fully collateralized through such trust at June 30, 2009 and December 31, 2008. See Note 6, Reinsurance, of the notes accompanying our consolidated financial Statements for further details on the quota share reinsurance treaty with Flatiron.

**Reserves for Losses and Loss Adjustment Expenses**

We establish reserves for losses and loss adjustment expenses ( Loss Reserves ) which represent estimates involving actuarial and statistical projections, at a given point in time, of our expectations of the ultimate settlement and administration costs of losses incurred. Estimating Loss Reserves is inherently difficult, which is exacerbated by the fact that we are a relatively new company with relatively limited historical experience upon which to base such estimates. We utilize actuarial models as well as available historical insurance industry loss ratio experience and loss development patterns to assist in the establishment of Loss Reserves. Actual losses and loss adjustment expenses paid will deviate, perhaps substantially, from the reserve estimates reflected in our financial statements.

At June 30, 2009 and December 31, 2008, our Loss Reserves, net of unpaid losses and loss adjustment expenses recoverable, by type and by operating segment were as follows:

	June 30, 2009	December 31, 2008
<b>Insurance:</b>		
Case reserves	\$ 1,126,491	\$ 1,043,168
IBNR reserves	2,348,477	2,257,735
Total net reserves	\$ 3,474,968	\$ 3,300,903
<b>Reinsurance:</b>		
Case reserves	\$ 770,504	\$ 661,621
Additional case reserves	64,413	87,820
IBNR reserves	1,758,901	1,887,478
Total net reserves	\$ 2,593,818	\$ 2,636,919
<b>Total:</b>		
Case reserves	\$ 1,896,995	\$ 1,704,789
Additional case reserves	64,413	87,820
IBNR reserves	4,107,378	4,145,213

Edgar Filing: ARCH CAPITAL GROUP LTD. - Form 10-Q

Total net reserves	\$	6,068,786	\$	5,937,822
--------------------	----	-----------	----	-----------

Edgar Filing: ARCH CAPITAL GROUP LTD. - Form 10-Q

At June 30, 2009 and December 31, 2008, the insurance segment's Loss Reserves by major line of business, net of unpaid losses and loss adjustment expenses recoverable, were as follows:

	June 30, 2009	December 31, 2008
Casualty	\$ 650,792	\$ 673,511
Property, energy, marine and aviation	526,651	518,475
Executive assurance	500,613	445,922
Professional liability	477,001	448,769
Programs	426,476	400,245
Construction	418,409	389,931
Healthcare	152,045	148,915
Surety	88,317	79,705
National accounts casualty	72,470	54,974
Travel and accident	26,129	20,638
Other	136,065	119,818
Total net reserves	\$ 3,474,968	\$ 3,300,903

At June 30, 2009 and December 31, 2008, the reinsurance segment's Loss Reserves by major line of business, net of unpaid losses and loss adjustment expenses recoverable, were as follows:

	June 30, 2009	December 31, 2008
Casualty	\$ 1,753,742	\$ 1,739,394
Property excluding property catastrophe	314,947	299,811
Marine and aviation	244,987	238,959
Property catastrophe	127,858	145,211
Other specialty	106,372	163,099
Other	45,912	50,445
Total net reserves	\$ 2,593,818	\$ 2,636,919

**Shareholders Equity**

Our shareholders' equity was \$4.03 billion at June 30, 2009, compared to \$3.43 billion at December 31, 2008. The increase in the 2009 period of \$597.0 million was attributable to net income for the period and an after-tax increase in the fair value of our investment portfolio.

**Book Value per Common Share**

The following table presents the calculation of book value per common share at June 30, 2009 and December 31, 2008:

(U.S. dollars in thousands, except share data)	June 30, 2009	December 31, 2008
Calculation of book value per common share:		
Total shareholders' equity	\$ 4,029,968	\$ 3,432,965
Less preferred shareholders' equity	(325,000)	(325,000)
Common shareholders' equity	\$ 3,704,968	\$ 3,107,965
Common shares outstanding (1)	60,980,806	60,511,974
Book value per common share	\$ 60.76	\$ 51.36

(1) Excludes the effects of 5,457,991 and 5,131,135 stock options and 265,689 and 412,622 restricted stock units outstanding at June 30, 2009 and December 31, 2008, respectively.

**Liquidity and Capital Resources**

ACGL is a holding company whose assets primarily consist of the shares in its subsidiaries. Generally, ACGL depends on its available cash resources, liquid investments and dividends or other distributions from its subsidiaries to make payments, including the payment of debt service obligations and operating expenses it may incur and any dividends or liquidation amounts with respect to the series A non-cumulative and series B non-cumulative preferred shares and common shares. ACGL's readily available cash, short-term investments and marketable securities, excluding amounts held by our regulated insurance and reinsurance subsidiaries, totaled \$5.1 million at June 30, 2009, compared to \$16.8 million at December 31, 2008. During the six months ended June 30, 2009, ACGL received dividends of \$23.9 million from Arch Re Bermuda which were used to fund the share repurchase program described below along with the payment of preferred dividends, interest expense and other corporate expenses.

The ability of our regulated insurance and reinsurance subsidiaries to pay dividends or make distributions or other payments to us is dependent on their ability to meet applicable regulatory standards. Under Bermuda law, Arch Re Bermuda is required to maintain an enhanced capital requirement which must equal or exceed its minimum solvency margin (i.e., the amount by which the value of its general business assets must exceed its general business liabilities) equal to the greatest of (1) \$100.0 million, (2) 50% of net premiums written (being gross premiums written by us less any premiums ceded by us, but we may not deduct more than 25% of gross premiums when computing net premiums written) and (3) 15% of loss and other insurance reserves. Arch Re Bermuda is prohibited from declaring or paying any dividends during any financial year if it is not in compliance with its enhanced capital requirement, minimum solvency margin or minimum liquidity ratio. In addition, Arch Re Bermuda is prohibited from declaring or paying in any financial year dividends of more than 25% of its total statutory capital and surplus (as shown on its previous financial year's statutory balance sheet) unless it files, at least seven days before payment of such dividends, with the Bermuda Monetary Authority an affidavit stating that it will continue to meet the required margins. In addition, Arch Re Bermuda is prohibited, without prior approval of the Bermuda Monetary Authority, from reducing by 15% or more its total statutory capital, as set out in its previous year's statutory financial statements. At December 31, 2008, as determined under Bermuda law, Arch Re Bermuda had statutory capital of \$2.21 billion and statutory capital and surplus of \$3.36 billion. Such amounts include ownership interests in U.S. insurance and reinsurance subsidiaries. Accordingly, Arch Re Bermuda can pay approximately \$834 million to ACGL during 2009 without providing an affidavit to the Bermuda Monetary Authority, as discussed above. In addition to meeting applicable regulatory standards, the ability of our insurance and reinsurance subsidiaries to pay dividends to intermediate parent companies owned by Arch Re Bermuda is also constrained by our dependence on the financial strength





ratings of our insurance and reinsurance subsidiaries from independent rating agencies. The ratings from these agencies depend to a large extent on the capitalization levels of our insurance and reinsurance subsidiaries. We believe that ACGL has sufficient cash resources and available dividend capacity to service its indebtedness and other current outstanding obligations.

Our insurance and reinsurance subsidiaries are required to maintain assets on deposit, which primarily consist of fixed maturities, with various regulatory authorities to support their operations. The assets on deposit are available to settle insurance and reinsurance liabilities to third parties. Our insurance and reinsurance subsidiaries also have investments in segregated portfolios primarily to provide collateral or guarantees for letters of credit to third parties. At June 30, 2009 and December 31, 2008, such amounts approximated \$1.45 billion and \$1.28 billion, respectively. In addition, certain of our operating subsidiaries maintain assets in trust accounts as collateral for insurance and reinsurance transactions with affiliated companies. At June 30, 2009 and December 31, 2008, such amounts approximated \$4.37 billion and \$4.03 billion, respectively.

ACGL, through its subsidiaries, provides financial support to certain of its insurance subsidiaries and affiliates, through certain reinsurance arrangements essential to the ratings of such subsidiaries. Except as described in the preceding sentence, or where express reinsurance, guarantee or other financial support contractual arrangements are in place, each of ACGL's subsidiaries or affiliates is solely responsible for its own liabilities and commitments (and no other ACGL subsidiary or affiliate is so responsible). Any reinsurance arrangements, guarantees or other financial support contractual arrangements that are in place are solely for the benefit of the ACGL subsidiary or affiliate involved and third parties (creditors or insureds of such entity) are not express beneficiaries of such arrangements.

Our insurance and reinsurance operations provide liquidity in that premiums are received in advance, sometimes substantially in advance, of the time losses are paid. The period of time from the occurrence of a claim through the settlement of the liability may extend many years into the future. Sources of liquidity include cash flows from operations, financing arrangements or routine sales of investments.

As part of our investment strategy, we seek to establish a level of cash and highly liquid short-term and intermediate-term securities which, combined with expected cash flow, is believed by us to be adequate to meet our foreseeable payment obligations. However, due to the nature of our operations, cash flows are affected by claim payments that may comprise large payments on a limited number of claims and which can fluctuate from year to year. We believe that our liquid investments and cash flow will provide us with sufficient liquidity in order to meet our claim payment obligations. However, the timing and amounts of actual claim payments related to recorded Loss Reserves vary based on many factors, including large individual losses, changes in the legal environment, as well as general market conditions. The ultimate amount of the claim payments could differ materially from our estimated amounts. Certain lines of business written by us, such as excess casualty, have loss experience characterized as low frequency and high severity. The foregoing may result in significant variability in loss payment patterns. The impact of this variability can be exacerbated by the fact that the timing of the receipt of reinsurance recoverables owed to us may be slower than anticipated by us. Therefore, the irregular timing of claim payments can create significant variations in cash flows from operations between periods and may require us to utilize other sources of liquidity to make these payments, which may include the sale of investments or utilization of existing or new credit facilities or capital market transactions. If the source of liquidity is the sale of investments, we may be forced to sell such investments at a loss, which may be material.

Consolidated net cash provided by operating activities was \$518.5 million for the six months ended June 30, 2009, compared to \$590.8 million for the 2008 period. The lower level of operating cash flows in the 2009 period primarily resulted from an increase in paid losses, as our insurance and reinsurance loss reserves have continued to mature. Cash flow from operating activities are provided by premiums collected, fee income, investment income and collected reinsurance recoverables, offset by losses and loss adjustment expense payments, reinsurance premiums paid, operating costs and current taxes paid.

On a consolidated basis, our aggregate cash and invested assets totaled \$10.75 billion at June 30, 2009, compared to \$9.97 billion at December 31, 2008. The primary goals of our asset liability management process are to satisfy the insurance liabilities, manage the interest rate risk embedded in those insurance liabilities and maintain sufficient liquidity to cover fluctuations in projected liability cash flows, including debt service obligations. Generally, the expected principal and interest payments produced by our fixed income portfolio adequately fund the estimated runoff of our insurance reserves. Although this is not an exact cash flow match in each period, the substantial degree by which the market value of the fixed income portfolio exceeds the expected present value of the net insurance liabilities, as well as the positive cash flow from newly sold policies and the large amount of high quality liquid bonds, provide assurance of our ability to fund the payment of claims and to service our outstanding debt without having to sell securities at distressed prices in an illiquid market or access credit facilities.

We expect that our operational needs, including our anticipated insurance obligations and operating and capital expenditure needs, for the next twelve months, at a minimum, will be met by our balance of cash, short-term investments and our credit facilities, as well as by funds generated from underwriting activities and investment income and proceeds on the sale or maturity of our investments.

We monitor our capital adequacy on a regular basis and will seek to adjust our capital base (up or down) according to the needs of our business. The future capital requirements of our business will depend on many factors, including our ability to write new business successfully and to establish premium rates and reserves at levels sufficient to cover losses. Our ability to underwrite is largely dependent upon the quality of our claims paying and financial strength ratings as evaluated by independent rating agencies. In particular, we require (1) sufficient capital to maintain our financial strength ratings, as issued by several ratings agencies, at a level considered necessary by management to enable our key operating subsidiaries to compete; (2) sufficient capital to enable our underwriting subsidiaries to meet the capital adequacy tests performed by statutory agencies in the U.S. and other key markets; and (3) letters of credit and other forms of collateral that are necessary for our non-U.S. operating companies because they are non-admitted under U.S. state insurance regulations.

As part of our capital management program, we may seek to raise additional capital or may seek to return capital to our shareholders through share repurchases, cash dividends or other methods (or a combination of such methods). Any such determination will be at the discretion of our board of directors and will be dependent upon our profits, financial requirements and other factors, including legal restrictions, rating agency requirements and such other factors as our board of directors deems relevant.

The board of directors of ACGL has authorized the investment of up to \$1.5 billion in ACGL's common shares through a share repurchase program. Such amount consisted of a \$1.0 billion authorization in February 2007 and a \$500.0 million authorization in May 2008. Repurchases under the program may be effected from time to time in open market or privately negotiated transactions through February 2010. During the six months ended June 30, 2009, ACGL repurchased \$1.6 million of common shares through the share repurchase program. Since the inception of the share repurchase program through June 30, 2009, ACGL has repurchased approximately 15.3 million common shares for an aggregate purchase price of \$1.05 billion.

At June 30, 2009, approximately \$448.3 million of share repurchases were available under the program. The timing and amount of the repurchase transactions under this program will depend on a variety of factors, including market conditions and corporate and regulatory considerations. We did not repurchase any shares in the 2009 second quarter under our share repurchase plan. However, we will continue to monitor our share price and, depending upon the upcoming storm season, market conditions and the development of the economy, as well as other factors, we will consider share repurchases under our existing remaining authorization on an opportunistic basis. In connection with the share repurchase program, the Warburg Pincus funds waived their rights relating to share repurchases under the shareholders agreement for all repurchases of common shares by

ACGL under the share repurchase program in open market transactions and certain privately negotiated transactions.

To the extent that our existing capital is insufficient to fund our future operating requirements or maintain such ratings, we may need to raise additional funds through financings or limit our growth. Given the recent severe disruptions in the public debt and equity markets, including among other things, widening of credit spreads, lack of liquidity and bankruptcies, we can provide no assurance that, if needed, we would be able to obtain additional funds through financing on satisfactory terms or at all. Continued adverse developments in the financial markets, such as disruptions, uncertainty or volatility in the capital and credit markets, may result in realized and unrealized capital losses that could have a material adverse effect on our results of operations, financial position and our businesses, and may also limit our access to capital required to operate our business.

If we are not able to obtain adequate capital, our business, results of operations and financial condition could be adversely affected, which could include, among other things, the following possible outcomes: (1) potential downgrades in the financial strength ratings assigned by ratings agencies to our operating subsidiaries, which could place those operating subsidiaries at a competitive disadvantage compared to higher-rated competitors; (2) reductions in the amount of business that our operating subsidiaries are able to write in order to meet capital adequacy-based tests enforced by statutory agencies; and (3) any resultant ratings downgrades could, among other things, affect our ability to write business and increase the cost of bank credit and letters of credit. In addition, under certain of the reinsurance agreements assumed by our reinsurance operations, upon the occurrence of a ratings downgrade or other specified triggering event with respect to our reinsurance operations, such as a reduction in surplus by specified amounts during specified periods, our ceding company clients may be provided with certain rights, including, among other things, the right to terminate the subject reinsurance agreement and/or to require that our reinsurance operations post additional collateral.

In addition to common share capital, we depend on external sources of finance to support our underwriting activities, which can be in the form (or any combination) of debt securities, preference shares, common equity and bank credit facilities providing loans and/or letters of credit. As noted above, equity or debt financing, if available at all, may be on terms that are unfavorable to us. In the case of equity financings, dilution to our shareholders could result, and, in any case, such securities may have rights, preferences and privileges that are senior to those of our outstanding securities.

In August 2006, we entered into a five-year agreement for a \$300.0 million unsecured revolving loan and letter of credit facility and a \$1.0 billion secured letter of credit facility. Under the terms of the agreement, Arch Reinsurance Company ( Arch Re U.S. ) is limited to issuing \$100 million of unsecured letters of credit as part of the \$300 million unsecured revolving loan. See Contractual Obligations and Commercial Commitments Letters of Credit and Revolving Credit Facilities for a discussion of our available facilities, applicable covenants on such facilities and available capacity. It is anticipated that the available facilities will be renewed (or replaced) on expiry, but such renewal (or replacement) will be subject to the availability of credit from banks which we utilize. Given the recent disruptions in the capital markets, we can provide no assurance that we will be able to renew the facilities in August 2011 on satisfactory terms and, if renewed, the costs of the facilities may be significantly higher than the costs of our existing facilities.

During 2006, ACGL completed two public offerings of non-cumulative preferred shares. On February 1, 2006, \$200.0 million principal amount of 8.0% series A non-cumulative preferred shares ( series A preferred shares ) were issued with net proceeds of \$193.5 million and, on May 24, 2006, \$125.0 million principal amount of 7.875% series B non-cumulative preferred shares ( series B preferred shares ) and together with the series A preferred shares, the preferred shares ) were issued with net proceeds of \$120.9 million. The net proceeds of the offerings were used to support the underwriting activities of ACGL's insurance and reinsurance subsidiaries. ACGL has the right to redeem all or a portion of each series of preferred shares at a redemption price of \$25.00 per share on or after (1) February 1, 2011 for the series A preferred shares and (2) May 15, 2011 for the series B preferred shares. Dividends on the preferred shares are non-cumulative. Consequently, in the



event dividends are not declared on the preferred shares for any dividend period, holders of preferred shares will not be entitled to receive a dividend for such period, and such undeclared dividend will not accrue and will not be payable. Holders of preferred shares will be entitled to receive dividend payments only when, as and if declared by ACGL's board of directors or a duly authorized committee of ACGL's board of directors. Any such dividends will be payable from the date of original issue on a non-cumulative basis, quarterly in arrears. To the extent declared, these dividends will accumulate, with respect to each dividend period, in an amount per share equal to 8.0% of the \$25.00 liquidation preference per annum for the series A preferred shares and 7.875% of the \$25.00 liquidation preference per annum for the series B preferred shares. During the six month periods ended June 30, 2009 and 2008, we paid \$12.9 million to holders of the preferred shares and, at June 30, 2009, had declared an aggregate of \$3.3 million of dividends to be paid to holders of the preferred shares.

In March 2009, ACGL and Arch Capital Group (U.S.) Inc. filed a universal shelf registration statement with the SEC. This registration statement allows for the possible future offer and sale by us of various types of securities, including unsecured debt securities, preference shares, common shares, warrants, share purchase contracts and units and depositary shares. The shelf registration statement enables us to efficiently access the public debt and/or equity capital markets in order to meet our future capital needs. The shelf registration statement also allows selling shareholders to resell common shares that they own in one or more offerings from time to time. We will not receive any proceeds from any shares offered by the selling shareholders. This report is not an offer to sell or the solicitation of an offer to buy nor shall there be any sale of these securities in any state in which such offer, solicitation or sale would be unlawful prior to registration or qualification under the securities laws of any such state.

At June 30, 2009, our capital of \$4.43 billion consisted of \$300.0 million of senior notes, representing 6.8% of the total, \$100.0 million of revolving credit agreement borrowings due in August 2011, representing 2.3% of the total, \$325.0 million of preferred shares, representing 7.3% of the total, and common shareholders' equity of \$3.70 billion, representing the balance. At December 31, 2008, ACGL's capital of \$3.83 billion consisted of \$300.0 million of senior notes, representing 7.8% of the total, \$100.0 million of revolving credit agreement borrowings due in August 2011, representing 2.6% of the total, \$325.0 million of preferred shares, representing 8.5% of the total, and common shareholders' equity of \$3.11 billion, representing the balance. The increase in capital during the six months ended June 30, 2009 was primarily attributable to net income and an after-tax increase in the market value of our investment portfolio.

#### **Off-Balance Sheet Arrangements**

Off-balance sheet arrangements are discussed in Management's Discussion and Analysis of Financial Condition and Results of Operations contained in our Annual Report on Form 10-K for the year ended December 31, 2008.

#### **Market Sensitive Instruments and Risk Management**

In accordance with the SEC's Financial Reporting Release No. 48, we performed a sensitivity analysis to determine the effects that market risk exposures could have on the future earnings, fair values or cash flows of our financial instruments as of June 30, 2009. (See section captioned Management's Discussion and Analysis of Financial Condition and Results of Operations Market Sensitive Instruments and Risk Management included in our 2008 Annual Report on Form 10-K.) Market risk represents the risk of changes in the fair value of a financial instrument and is comprised of several components, including liquidity, basis and price risks. At June 30, 2009, material changes in market risk exposures that affect the quantitative and qualitative disclosures presented as of December 31, 2008 were as follows:



**Investment Market Risk**

*Fixed Income Securities.* We invest in interest rate sensitive securities, primarily debt securities. We consider the effect of interest rate movements on the market value of our fixed maturities, fixed maturities pledged under securities lending agreements, short-term investments and certain of our other investments which invest in fixed income securities and the corresponding change in unrealized appreciation. As interest rates rise, the market value of our interest rate sensitive securities falls, and the converse is also true. The following table summarizes the effect that an immediate, parallel shift in the interest rate yield curve would have had on the portfolio at June 30, 2009 and December 31, 2008. Based on historical observations, there is a low probability that all interest rate yield curves would shift in the same direction at the same time. Furthermore, in recent months interest rate movements in many credit sectors have exhibited a much lower correlation to changes in U.S. Treasury yields. Accordingly, the actual effect of interest rate movements may differ materially from the amounts set forth below. For further discussion on investment activity, please refer to Financial Condition, Liquidity and Capital Resources Financial Condition Investable Assets

(U.S. dollars in millions)	Interest Rate Shift in Basis Points				
	-100	-50	0	50	100
<b>June 30, 2009:</b>					
Total market value	\$ 10,646.0	\$ 10,495.6	\$ 10,338.2	\$ 10,185.6	\$ 10,031.1
Market value change from base	2.98%	1.52%		(1.48)%	(2.97)%
Change in unrealized value	\$ 307.8	\$ 157.4		\$ (152.6)	\$ (307.1)
<b>December 31, 2008:</b>					
Total market value	\$ 9,999.5	\$ 9,832.3	\$ 9,641.7	\$ 9,481.8	\$ 9,312.7
Market value change from base	3.71%	1.98%		(1.66)%	(3.41)%
Change in unrealized value	\$ 357.8	\$ 190.6		\$ (159.9)	\$ (329.0)

In addition, we consider the effect of credit spread movements on the market value of our fixed maturities, fixed maturities pledged under securities lending agreements, short-term investments and certain of our other investments and investment funds accounted for using the equity method which invest in fixed income securities and the corresponding change in unrealized appreciation. As credit spreads widen, the market value of our fixed income securities falls, and the converse is also true.

The following table summarizes the effect that an immediate, parallel shift in credit spreads in a static interest rate environment would have had on the portfolio at June 30, 2009 and December 31, 2008:

(U.S. dollars in millions)	Credit Spread Shift in Basis Points				
	-100	-50	0	50	100
<b>June 30, 2009:</b>					
Total market value	\$ 10,576.0	\$ 10,457.1	\$ 10,338.2	\$ 10,219.3	\$ 10,100.4
Market value change from base	2.30%	1.15%		(1.15)%	(2.30)%
Change in unrealized value	\$ 237.8	\$ 118.9		\$ (118.9)	\$ (237.8)
<b>December 31, 2008:</b>					
Total market value	\$ 9,850.0	\$ 9,745.8	\$ 9,641.7	\$ 9,537.6	\$ 9,433.4
Market value change from base	2.16%	1.08%		(1.08)%	(2.16)%
Change in unrealized value	\$ 208.3	\$ 104.1		\$ (104.1)	\$ (208.3)

## Edgar Filing: ARCH CAPITAL GROUP LTD. - Form 10-Q

Another method that attempts to measure portfolio risk is Value-at-Risk ( VaR ). VaR attempts to take into account a broad cross-section of risks facing a portfolio by utilizing relevant securities volatility data skewed towards the most recent months and quarters. VaR measures the amount of a portfolio at risk for outcomes 1.65 standard deviations from the mean based on normal market conditions over a one year time horizon and is expressed as a percentage of the portfolio s initial value. In other words, 95% of the time, should the risks taken



into account in the VaR model perform per their historical tendencies, the portfolio's loss in any one year period is expected to be less than or equal to the calculated VaR, stated as a percentage of the measured portfolio's initial value. As of June 30, 2009, our portfolio's VaR was estimated to be 7.18%, compared to an estimated 8.49% at December 31, 2008.

**Investment-Related Derivatives.** We invest in certain derivative instruments to replicate investment positions and to manage market exposures and duration risk. At June 30, 2009, the notional value of the net long position for Treasury note futures was \$148.9 million, compared to \$556.3 million at December 31, 2008. At June 30, 2009, the notional value of the net long position of Eurodollar futures was \$1.47 billion, compared to nil at December 31, 2008. At June 30, 2009, the notional value of the net long position for U.K. and German government futures was nil, compared to \$363.3 million at December 31, 2008 (at December 31, 2008 foreign currency rates). At June 30, 2009, the notional value of the net long position of gold futures was \$27.8 million, compared to nil at December 31, 2008. A 10% depreciation of the underlying exposure to these derivative instruments at June 30, 2009 and December 31, 2008 would have resulted in a reduction in net income of approximately \$165.0 million and \$92.0 million, respectively, and would have decreased book value per common share by \$2.71 and \$1.52, respectively.

### Foreign Currency Exchange Risk

Foreign currency rate risk is the potential change in value, income and cash flow arising from adverse changes in foreign currency exchange rates. A 10% depreciation of the U.S. Dollar against other currencies under our outstanding contracts at June 30, 2009 and December 31, 2008, net of unrealized appreciation on our securities denominated in currencies other than the U.S. Dollar, would have resulted in unrealized gains of approximately \$10.6 million and \$4.9 million, respectively, and would have increased book value per common share by approximately \$0.17 and \$0.08, respectively. A 10% appreciation of the U.S. Dollar against other currencies under our outstanding contracts at June 30, 2009 and December 31, 2008, net of unrealized depreciation on our securities denominated in currencies other than the U.S. Dollar, would have resulted in unrealized losses of approximately \$10.6 million and \$4.9 million, respectively, and would have decreased book value per common share by approximately \$0.17 and \$0.08, respectively. Historical observations indicate a low probability that all foreign currency exchange rates would shift against the U.S. Dollar in the same direction and at the same time and, accordingly, the actual effect of foreign currency rate movements may differ materially from the amounts set forth above. For further discussion on foreign exchange activity, please refer to Results of Operations.

### Cautionary Note Regarding Forward-Looking Statements

The Private Securities Litigation Reform Act of 1995 ( PLSRA ) provides a safe harbor for forward-looking statements. This report or any other written or oral statements made by or on behalf of us may include forward-looking statements, which reflect our current views with respect to future events and financial performance. All statements other than statements of historical fact included in or incorporated by reference in this report are forward-looking statements. Forward-looking statements, for purposes of the PLSRA or otherwise, can generally be identified by the use of forward-looking terminology such as may, will, expect, intend, estimate, anticipate, believe or continue and similar statements or forward-looking nature or their negative or variations or similar terminology.

Forward-looking statements involve our current assessment of risks and uncertainties. Actual events and results may differ materially from those expressed or implied in these statements. Important factors that could cause actual events or results to differ materially from those indicated in such statements are discussed below, elsewhere in this report and in our periodic reports filed with the SEC, and include:

- our ability to successfully implement our business strategy during soft as well as hard markets;



## Edgar Filing: ARCH CAPITAL GROUP LTD. - Form 10-Q

- acceptance of our business strategy, security and financial condition by rating agencies and regulators, as well as by brokers and our insureds and reinsureds;
- our ability to maintain or improve our ratings, which may be affected by our ability to raise additional equity or debt financings, by ratings agencies existing or new policies and practices, as well as other factors described herein;
- general economic and market conditions (including inflation, interest rates, foreign currency exchange rates and prevailing credit terms) and conditions specific to the reinsurance and insurance markets in which we operate;
- competition, including increased competition, on the basis of pricing, capacity, coverage terms or other factors;
- developments in the world's financial and capital markets and our access to such markets;
- our ability to successfully integrate, establish and maintain operating procedures (including the implementation of improved computerized systems and programs to replace and support manual systems) to effectively support our underwriting initiatives and to develop accurate actuarial data;
- the loss of key personnel;
- the integration of businesses we have acquired or may acquire into our existing operations;
- accuracy of those estimates and judgments utilized 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, income taxes, contingencies and 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 since relatively limited historical information has been reported to us through June 30, 2009;
- greater than expected loss ratios on business written by us and adverse development on claim and/or claim expense liabilities related to business written by our insurance and reinsurance subsidiaries;
- severity and/or frequency of losses;

Edgar Filing: ARCH CAPITAL GROUP LTD. - Form 10-Q

- claims for natural or man-made catastrophic events in our insurance or reinsurance business could cause large losses and substantial volatility in our results of operations;
- acts of terrorism, political unrest and other hostilities or other unforecasted and unpredictable events;
- losses relating to aviation business and business produced by a certain managing underwriting agency for which we may be liable to the purchaser of our prior reinsurance business or to others in connection with the May 5, 2000 asset sale described in our periodic reports filed with the SEC;
- availability to us of reinsurance to manage our gross and net exposures and the cost of such reinsurance;
- the failure of reinsurers, managing general agents, third party administrators 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;

- our investment performance, including legislative or regulatory developments that may adversely affect the market value of our investments;
- material differences between actual and expected assessments for guaranty funds and mandatory pooling arrangements;
- changes in accounting principles or policies or in our application of such accounting principles or policies;
- changes in the political environment of certain countries in which we operate or underwrite business;
- statutory or regulatory developments, including as to tax policy and matters and insurance 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/or changes in regulations or tax laws applicable to us, our subsidiaries, brokers or customers; and
- the other matters set forth in this Quarterly Report on Form 10-Q, as well as the risk and other factors set forth in ACGL's Annual Report on Form 10-K and other documents on file with the SEC.

In addition, other general factors could affect our results, including developments in the world's financial and capital markets and our access to such markets.

All subsequent written and oral forward-looking statements attributable to us or persons acting on our behalf are expressly qualified in their entirety by these cautionary statements. The foregoing review of important factors should not be construed as exhaustive and should be read in conjunction with other cautionary statements that are included herein or elsewhere. We undertake no obligation to publicly update or revise any forward-looking statement, whether as a result of new information, future events or otherwise.

#### **Other Financial Information**

The consolidated financial statements as of June 30, 2009 and for the six month periods ended June 30, 2009 and 2008 have been reviewed by PricewaterhouseCoopers LLP, an independent registered public accounting firm. Their report (dated August 7, 2009) is included on page 2. The report of PricewaterhouseCoopers LLP states that they did not audit and they do not express an opinion on that unaudited financial information. Accordingly, the degree of reliance on their report on such information should be restricted in light of the limited nature of the review procedures applied. PricewaterhouseCoopers LLP is not subject to the liability provisions of Section 11 of the Securities Act of 1933 for their report on the unaudited financial information because that report is not a report or a part of the registration statement prepared or certified by PricewaterhouseCoopers LLP within the meaning of Sections 7 and 11 of the Securities Act of 1933.



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

Reference is made to the information appearing above under the subheading "Market Sensitive Instruments and Risk Management" under the caption "Management's Discussion and Analysis of Financial Condition and Results of Operations," which information is hereby incorporated by reference.

### **ITEM 4. CONTROLS AND PROCEDURES**

#### **Evaluation of Disclosure Controls and Procedures**

In connection with the filing of this Form 10-Q, our management, including the Chief Executive Officer and Chief Financial Officer, conducted an evaluation of the effectiveness of disclosure controls and procedures pursuant to applicable Exchange Act Rules 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 were effective as of the end of and during the period covered by this report with respect to information being recorded, processed, summarized and reported within time periods specified in the SEC's rules and forms and with respect to timely communication to them and other members of management responsible for preparing periodic reports of all material information required to be disclosed in this report as it relates to ACGL and its consolidated subsidiaries.

We continue to enhance our operating procedures and internal controls to effectively support our business and our regulatory and reporting requirements. Our management does not expect that our disclosure controls or our internal controls will prevent all errors and all fraud. A control system, no matter how well conceived and operated, can provide only reasonable, not absolute, assurance that the objectives of the control system are met. Further, the design of a control system must reflect the fact that there are resource constraints, and the benefits of controls must be considered relative to their costs. As a result of the inherent limitations in all control systems, no evaluation of controls can provide absolute assurance that all control issues and instances of fraud, if any, within the company have been detected. These inherent limitations include the realities that judgments in decision-making can be faulty, and that breakdowns can occur because of simple error or mistake. Additionally, controls can be circumvented by the individual acts of some persons or by collusion of two or more people. The design of any system of controls also is based in part upon certain assumptions about the likelihood of future events, and there can be no assurance that any design will succeed in achieving its stated goals under all potential future conditions; over time, controls may become inadequate because of changes in conditions, or the degree of compliance with the policies or procedures may deteriorate. As a result of the inherent limitations in a cost-effective control system, misstatement due to error or fraud may occur and not be detected. Accordingly, our disclosure controls and procedures are designed to provide reasonable, not absolute, assurance that the disclosure controls and procedures are met.

#### **Changes in Internal Controls Over Financial Reporting**

There have been no changes in internal control over financial reporting that occurred during the fiscal quarter ended June 30, 2009 that have materially affected, or are reasonably likely to materially affect, internal control over financial reporting.

**PART II. OTHER INFORMATION**





*Item 1. Legal Proceedings*



## Edgar Filing: ARCH CAPITAL GROUP LTD. - Form 10-Q

We, in common with the insurance industry in general, are subject to litigation and arbitration in the normal course of our business. As of June 30, 2009, we were not a party to any material litigation or arbitration other than as a part of the ordinary course of business in relation to claims and reinsurance recoverable matters, none of which is expected by management to have a significant adverse effect on our results of operations and financial condition and liquidity.

### *Item 2. Unregistered Sales of Equity Securities and Use of Proceeds*



## Edgar Filing: ARCH CAPITAL GROUP LTD. - Form 10-Q

The following table summarizes ACGL's purchases of its common shares for the 2009 second quarter:

(U.S. dollars in thousands, except share data)

Period	Issuer Purchases of Equity Securities			Total Number of Shares Purchased as Part of Publicly Announced Plans or Programs (2)	Approximate Dollar Value of Shares that May Yet be Purchased Under the Plan or Programs (2)
	Total Number of Shares Purchased (1)	Average Price Paid per Share			
4/1/2009-4/30/2009	2,554	\$ 54.98		\$ 448,252	448,252
5/1/2009-5/31/2009	39,305	\$ 58.80		\$ 448,252	448,252
6/1/2009-6/30/2009	524	\$ 59.37		\$ 448,252	448,252
Total	42,383	\$ 58.58		\$ 448,252	448,252

(1) ACGL repurchases shares, from time to time, from employees in order to facilitate the payment of withholding taxes on restricted shares granted and the exercise of stock appreciation rights. We purchased these shares at their fair market value, as determined by reference to the closing price of our common shares on the day the restricted shares vested or the stock appreciation rights were exercised.

(2) ACGL's board of directors authorized ACGL to invest up to \$1.5 billion in ACGL's common shares through a share repurchase program. Such amount consisted of a \$1.0 billion authorization in February 2007 and a \$500.0 million authorization in May 2008. Repurchases under the program may be effected from time to time in open market or privately negotiated transactions through February 2010. Since the inception of the share repurchase program, ACGL has repurchased approximately 15.3 million common shares for an aggregate purchase price of \$1.05 billion. The timing and amount of the repurchase transactions under this program will depend on a variety of factors, including market conditions and corporate and regulatory considerations. In connection with the repurchase program, the Warburg Pincus funds waived their rights relating to share repurchases under the shareholders agreement for all repurchases of common shares by ACGL under the repurchase program in open market transactions and certain privately negotiated transactions.

*Item 4. Submission of Matters to a Vote of Security Holders*





## Edgar Filing: ARCH CAPITAL GROUP LTD. - Form 10-Q

- (a) The annual meeting of shareholders (the Annual Meeting ) of ACGL was held on May 6, 2009.
- (b) Proxies for the Annual Meeting were solicited pursuant to Regulation 14 under the Securities Exchange Act of 1934. There was no solicitation in opposition to management s nominees as listed in ACGL s proxy statement, dated March 31, 2009 (the Proxy Statement ).
- (c) The shareholders of ACGL (1) elected Class II Directors to hold office until the 2012 annual meeting of shareholders or until their successors are elected and qualified, (2) elected certain individuals as Designated Company Directors of certain of ACGL s non-U.S. subsidiaries and (3) appointed PricewaterhouseCoopers LLP as independent registered public accounting firm for the fiscal year ending December 31, 2009. Set forth below are the voting results for these proposals:

### Election of Class II Directors of ACGL

	FOR	WITHHOLD
Constantine Iordanou		
Total:	52,306,192	257,447
James J. Meenaghan		
Total:	52,308,484	255,155
John M. Pasquesi		
Total:	52,293,433	270,206

### Election of Designated Directors of Non-U.S. Subsidiaries

	FOR	WITHHOLD
William Beveridge		
Total:	51,980,985	582,654
Dennis Brand		
Total:	51,982,092	581,547
Knud Christensen		
Total:	51,982,451	581,188
Graham B. Collis		
Total:	51,364,582	1,199,057
William J. Cooney		
Total:	52,315,131	248,508
Elizabeth Fullerton-Rome		
Total:	51,982,427	581,212
Rutger H.W. Funnekotter		
Total:	52,316,672	246,967

Edgar Filing: ARCH CAPITAL GROUP LTD. - Form 10-Q

Marc Grandisson		
Total:	51,982,133	581,506

Michael A. Greene		
Total:	52,316,715	246,924

Edgar Filing: ARCH CAPITAL GROUP LTD. - Form 10-Q

John C.R. Hele		
Total:	51,095,995	1,467,644
David Hipkin		
Total:	51,982,350	581,289
W. Preston Hutchings		
Total:	51,983,318	580,321
Constantine Iordanou		
Total:	51,983,087	580,552
Wolbert H. Kamphuijs		
Total:	52,316,527	247,112
Michael H. Kier		
Total:	52,316,962	246,677
Mark D. Lyons		
Total:	51,983,417	580,222
Michael Murphy		
Total:	51,981,947	581,692
Martin J. Nilsen		
Total:	51,982,304	581,335
Nicolas Papadopoulo		
Total:	51,979,501	584,138
Michael Quinn		
Total:	52,316,582	247,057
Maamoun Rajeh		
Total:	51,981,102	582,537
Paul S. Robotham		
Total:	51,096,150	1,467,489
Søren Scheuer		
Total:	51,980,636	583,003
Budhi Singh		
Total:	51,980,156	583,483
Helmut Sohler		
Total:	51,981,169	582,470
Robert T. Van Gieson		
Total:	51,982,310	581,329
Angus Watson		
Total:	51,981,114	582,525
James Weatherstone		
Total:	51,981,901	581,738

**Ratification of Selection of PricewaterhouseCoopers LLP as Independent Registered Public Accounting Firm**

	FOR	AGAINST	ABSTAIN
Total:	52,278,525	278,463	6,651

*Item 5. Other Information*



## Edgar Filing: ARCH CAPITAL GROUP LTD. - Form 10-Q

In accordance with Section 10a(i)(2) of the Securities Exchange Act of 1934, as amended, we are responsible for disclosing non-audit services to be provided by our independent auditor, PricewaterhouseCoopers LLP, which are approved by the Audit Committee of our board of directors. During the 2009 second quarter, the Audit Committee approved engagements of PricewaterhouseCoopers LLP for permitted non-audit services, substantially all of which consisted of tax services, tax consulting and tax compliance.

### *Item 6. Exhibits*





## Edgar Filing: ARCH CAPITAL GROUP LTD. - Form 10-Q

Exhibit No.	Description
10.1	Second Amendment, dated as of June 26, 2009, to the Second Amended and Restated Credit Agreement, dated as of August 30, 2006, as amended on October 1, 2007, by and among Arch Capital Group Ltd., Arch Capital Group (U.S.) Inc., Arch Reinsurance Ltd., Arch Reinsurance Company, Arch Insurance Company, Arch Specialty Insurance Company, Arch Excess & Surplus Insurance Company, Arch Indemnity Insurance Company (formerly Western Diversified Casualty Insurance Company) and Arch Insurance Company (Europe) Limited, with Barclays Bank Plc, The Bank of New York, Calyon, New York Branch, Citibank, N.A., ING Bank N.V., London Branch, Lloyds TSB Bank plc, and Wachovia Bank, N.A., as documentation agents, Bank of America, N.A., as syndication agent, JPMorgan Chase Bank, N.A., as administrative agent, and the lenders named therein*
10.2	Amendment, dated as of June 26, 2009, to the Letter of Credit and Reimbursement Agreement, dated as of December 12, 2007, by and among Arch Reinsurance Ltd., as obligor, Lloyds TSB Bank plc, as agent, Lloyds TSB Bank plc, ING Bank N.V., London Branch and Barclays Bank plc, as original lenders, and Lloyds TSB Bank plc, as mandated lead arranger*
15	Accountants Awareness Letter (regarding unaudited interim financial information)
31.1	Certification of Chief Executive Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002
31.2	Certification of Chief Financial Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002
32.1	Certification of Chief Executive Officer pursuant to Section 906 of the Sarbanes-Oxley Act of 2002
32.2	Certification of Chief Financial Officer pursuant to Section 906 of the Sarbanes-Oxley Act of 2002

---

\* Filed as an exhibit to our Report on Form 8-K, as filed with the SEC on June 29, 2009, and incorporated by reference.

*SIGNATURES*

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

**ARCH CAPITAL GROUP LTD.  
(REGISTRANT)**

Date: August 7, 2009

/s/ Constantine Iordanou  
Constantine Iordanou  
President and Chief Executive Officer  
(Principal Executive Officer) and Director

Date: August 7, 2009

/s/ John C.R. Hele  
John C.R. Hele  
Executive Vice President, Chief Financial  
Officer and Treasurer (Principal Financial and Accounting Officer)

**EXHIBIT INDEX**



## Edgar Filing: ARCH CAPITAL GROUP LTD. - Form 10-Q

Exhibit No.	Description
10.1	Second Amendment, dated as of June 26, 2009, to the Second Amended and Restated Credit Agreement, dated as of August 30, 2006, as amended on October 1, 2007, by and among Arch Capital Group Ltd., Arch Capital Group (U.S.) Inc., Arch Reinsurance Ltd., Arch Reinsurance Company, Arch Insurance Company, Arch Specialty Insurance Company, Arch Excess & Surplus Insurance Company, Arch Indemnity Insurance Company (formerly Western Diversified Casualty Insurance Company) and Arch Insurance Company (Europe) Limited, with Barclays Bank Plc, The Bank of New York, Calyon, New York Branch, Citibank, N.A., ING Bank N.V., London Branch, Lloyds TSB Bank plc, and Wachovia Bank, N.A., as documentation agents, Bank of America, N.A., as syndication agent, JPMorgan Chase Bank, N.A., as administrative agent, and the lenders named therein*
10.2	Amendment, dated as of June 26, 2009, to the Letter of Credit and Reimbursement Agreement, dated as of December 12, 2007, by and among Arch Reinsurance Ltd., as obligor, Lloyds TSB Bank plc, as agent, Lloyds TSB Bank plc, ING Bank N.V., London Branch and Barclays Bank plc, as original lenders, and Lloyds TSB Bank plc, as mandated lead arranger*
15	Accountants Awareness Letter (regarding unaudited interim financial information)
31.1	Certification of Chief Executive Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002
31.2	Certification of Chief Financial Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002
32.1	Certification of Chief Executive Officer pursuant to Section 906 of the Sarbanes-Oxley Act of 2002
32.2	Certification of Chief Financial Officer pursuant to Section 906 of the Sarbanes-Oxley Act of 2002

---

\* Filed as an exhibit to our Report on Form 8-K, as filed with the SEC on June 29, 2009, and incorporated by reference.