

ARCH CAPITAL GROUP LTD.  
Form 10-Q  
August 08, 2008  
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**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, 2008

Or

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

For the transition period to

Commission file number: **0-26456**

**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.)

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**Wessex House, 45 Reid Street**  
**Hamilton HM 12, Bermuda**  
(Address of principal executive offices)

(Zip Code)

Registrant's telephone number, including area code: **(441) 278-9250**

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

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

Indicate by check mark whether the registrant 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 <input checked="" type="checkbox"/>                                    | Accelerated filer <input type="checkbox"/>         |
| Non-accelerated filer <input type="checkbox"/><br>(Do not check if a smaller reporting coming) | Smaller reporting company <input type="checkbox"/> |

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.

| <u>Class</u>                    | <u>Outstanding at August 1, 2008</u> |
|---------------------------------|--------------------------------------|
| Common Shares, \$0.01 par value | 60,111,444                           |

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**Report of Independent Registered Public Accounting Firm**

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, 2008, and the related consolidated statements of income for each of the three-month and six-month periods ended June 30, 2008 and June 30, 2007, and the consolidated statements of changes in shareholders' equity, comprehensive income and cash flows for the six-month periods ended June 30, 2008 and June 30, 2007. 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.

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, 2007, 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 February 28, 2008, 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, 2007, 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 8, 2008

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## ARCH CAPITAL GROUP LTD. AND SUBSIDIARIES

## CONSOLIDATED BALANCE SHEETS

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

|   | (Unaudited)<br>June 30,<br>2008 | December 31,<br>2007 |
|---|---------------------------------|----------------------|
| <b>Assets</b>   |                                 |                      |
| Investments:  |                                 |                      |
| Fixed maturities available for sale, at fair value (amortized cost: 2008, \$7,787,994; 2007, \$7,037,272)   | \$ 7,746,296                    | \$ 7,137,998         |
| Short-term investments available for sale, at fair value (amortized cost: 2008, \$644,156; 2007, \$700,262) | 645,587                         | 699,036              |
| Short-term investment of funds received under securities lending agreements, at fair value                  | 918,207                         | 1,503,723            |
| Other investments (cost: 2008, \$281,243; 2007, \$323,950)  | 295,638                         | 353,694              |
| Investment funds accounted for using the equity method  | 351,879                         | 235,975              |
| Investment in joint venture   | 100,000                         |                      |
| <b>Total investments</b>  | <b>10,057,607</b>               | <b>9,930,426</b>     |
| Cash  | 246,544                         | 239,915              |
| Accrued investment income   | 76,313                          | 73,862               |
| Fixed maturities and short-term investments pledged under securities lending agreements, at fair value      | 890,822                         | 1,463,045            |
| Premiums receivable   | 859,261                         | 729,628              |
| Unpaid losses and loss adjustment expenses recoverable  | 1,586,201                       | 1,609,619            |
| Paid losses and loss adjustment expenses recoverable  | 113,439                         | 132,289              |
| Prepaid reinsurance premiums  | 364,226                         | 480,462              |
| Deferred income tax assets, net   | 66,944                          | 57,051               |
| Deferred acquisition costs, net   | 319,732                         | 290,059              |
| Receivable for securities sold  | 1,053,379                       | 17,359               |
| Other assets  | 647,034                         | 600,552              |
| <b>Total Assets</b>   | <b>\$ 16,281,502</b>            | <b>\$ 15,624,267</b> |
| <b>Liabilities</b>  |                                 |                      |
| Reserve for losses and loss adjustment expenses   | \$ 7,349,083                    | \$ 7,092,452         |
| Unearned premiums   | 1,735,371                       | 1,765,881            |
| Reinsurance balances payable  | 254,830                         | 301,309              |
| Senior notes  | 300,000                         | 300,000              |
| Revolving credit agreement borrowings   | 100,000                         |                      |
| Securities lending payable  | 918,207                         | 1,503,723            |
| Payable for securities purchased  | 1,064,224                       | 23,155               |
| Other liabilities   | 673,554                         | 601,936              |
| <b>Total Liabilities</b>  | <b>12,395,269</b>               | <b>11,588,456</b>    |
| <b>Commitments and Contingencies</b>  |                                 |                      |
| <b>Shareholders Equity</b>  |                                 |                      |
| Non-cumulative preferred shares (\$0.01 par value, 50,000,000 shares authorized)                            |                                 |                      |
| -Series A (issued: 2008 and 2007, 8,000,000)  | 80                              | 80                   |
| -Series B (issued: 2008 and 2007, 5,000,000)  | 50                              | 50                   |
| Common shares (\$0.01 par value, 200,000,000 shares authorized, issued: 2008, 61,943,100; 2007, 67,318,466) | 619                             | 673                  |
| Additional paid-in capital  | 1,089,636                       | 1,451,667            |

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|   |                      |                      |
|---|----------------------|----------------------|
| Retained earnings   | 2,809,821            | 2,428,117            |
| Accumulated other comprehensive (loss) income, net of deferred income tax | (13,973)             | 155,224              |
| <b>Total Shareholders Equity</b>  | <b>3,886,233</b>     | <b>4,035,811</b>     |
| <b>Total Liabilities and Shareholders Equity</b>                          | <b>\$ 16,281,502</b> | <b>\$ 15,624,267</b> |

See Notes to Consolidated Financial Statements

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## ARCH CAPITAL GROUP LTD. AND SUBSIDIARIES

## CONSOLIDATED STATEMENTS OF INCOME

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

|   | (Unaudited)<br>Three Months Ended<br>June 30, |                   | (Unaudited)<br>Six Months Ended<br>June 30, |                   |
|---|---|-------------------|---|-------------------|
|   | 2008  | 2007              | 2008  | 2007              |
| <b>Revenues</b>   |   |                   |   |                   |
| Net premiums written  | \$ 686,118                                    | \$ 757,895        | \$ 1,497,460                                | \$ 1,629,640      |
| Decrease (increase) in unearned premiums  | 19,557  | (6,483)           | (83,551)                                    | (132,735)         |
| Net premiums earned   | 705,675                                       | 751,412           | 1,413,909                                   | 1,496,905         |
| Net investment income   | 117,120                                       | 113,923           | 239,313                                     | 223,970           |
| Net realized (losses) gains   | (12,669)                                      | (3,757)           | 23,306                                      | (4,738)           |
| Fee income  | 1,238   | 2,091             | 2,306                                       | 4,060             |
| Equity in net income (loss) of investment funds accounted for using the equity method | 19,583  | 3,376             | (2,730)                                     | 6,018             |
| Other income  | 4,968   | 265               | 9,004                                       | 869               |
| <b>Total revenues</b>   | <b>835,915</b>                                | <b>867,310</b>    | <b>1,685,108</b>                            | <b>1,727,084</b>  |
| <b>Expenses</b>   |   |                   |   |                   |
| Losses and loss adjustment expenses   | 404,625                                       | 425,663           | 809,042                                     | 845,724           |
| Acquisition expenses  | 119,226                                       | 117,277           | 233,865                                     | 237,405           |
| Other operating expenses  | 102,578                                       | 100,505           | 199,765                                     | 191,318           |
| Interest expense  | 5,788   | 5,523             | 11,312                                      | 11,046            |
| Net foreign exchange (gains) losses   | (298)   | 6,450             | 23,289                                      | 16,192            |
| <b>Total expenses</b>   | <b>631,919</b>                                | <b>655,418</b>    | <b>1,277,273</b>                            | <b>1,301,685</b>  |
| <b>Income before income taxes</b>   | <b>203,996</b>                                | <b>211,892</b>    | <b>407,835</b>                              | <b>425,399</b>    |
| Income tax expense  | 5,253   | 6,037             | 13,209                                      | 14,532            |
| <b>Net income</b>   | <b>198,743</b>                                | <b>205,855</b>    | <b>394,626</b>                              | <b>410,867</b>    |
| Preferred dividends   | 6,461   | 6,461             | 12,922                                      | 12,922            |
| <b>Net income available to common shareholders</b>                                    | <b>\$ 192,282</b>                             | <b>\$ 199,394</b> | <b>\$ 381,704</b>                           | <b>\$ 397,945</b> |
| <b>Net income per common share</b>  |   |                   |   |                   |
| Basic   | \$ 3.05                                       | \$ 2.75           | \$ 5.95                                     | \$ 5.44           |
| Diluted   | \$ 2.92                                       | \$ 2.65           | \$ 5.71                                     | \$ 5.24           |
| <b>Weighted average common shares and common share equivalents outstanding</b>        |   |                   |   |                   |
| Basic   | 62,995,550                                    | 72,494,823        | 64,145,533                                  | 73,209,439        |
| Diluted   | 65,748,119                                    | 75,254,846        | 66,886,972                                  | 75,947,858        |

See Notes to Consolidated Financial Statements





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## ARCH CAPITAL GROUP LTD. AND SUBSIDIARIES

## CONSOLIDATED STATEMENTS OF CHANGES IN SHAREHOLDERS EQUITY

(U.S. dollars in thousands)

|  | (Unaudited)<br>Six Months Ended<br>June 30, |                     |
|--|---|---------------------|
|  | 2008  | 2007                |
| <b>Non-Cumulative Preferred Shares</b>   |   |                     |
| Balance at beginning and end of period   | \$ 130                                      | \$ 130              |
| <b>Common Shares</b>   |   |                     |
| Balance at beginning of year   | 673   | 743                 |
| Common shares issued, net  | 2   | 6                   |
| Purchases of common shares under share repurchase program  | (56)  | (36)                |
| Balance at end of period   | 619   | 713                 |
| <b>Additional Paid-in Capital</b>  |   |                     |
| Balance at beginning of year   | 1,451,667                                   | 1,944,304           |
| Common shares issued   | 3,511                                       | 405                 |
| Exercise of stock options  | 9,073                                       | 13,373              |
| Common shares retired  | (391,776)                                   | (257,162)           |
| Amortization of share-based compensation   | 17,511                                      | 14,457              |
| Other  | (350)                                       | 918                 |
| Balance at end of period   | 1,089,636                                   | 1,716,295           |
| <b>Retained Earnings</b>   |   |                     |
| Balance at beginning of year   | 2,428,117                                   | 1,593,907           |
| Adjustment to adopt SFAS No. 155, <i>Accounting for Certain Hybrid Financial Instruments an amendment of FASB Statements No. 133 and 140</i> |   | 2,111               |
| Balance at beginning of year, as adjusted  | 2,428,117                                   | 1,596,018           |
| Dividends declared on preferred shares   | (12,922)                                    | (12,922)            |
| Net income   | 394,626                                     | 410,867             |
| Balance at end of period   | 2,809,821                                   | 1,993,963           |
| <b>Accumulated Other Comprehensive Income (Loss)</b>   |   |                     |
| Balance at beginning of year   | 155,224                                     | 51,535              |
| Adjustment to adopt SFAS No. 155, <i>Accounting for Certain Hybrid Financial Instruments an amendment of FASB Statements No. 133 and 140</i> |   | (2,111)             |
| Balance at beginning of year, as adjusted  | 155,224                                     | 49,424              |
| Change in unrealized appreciation (decline) in value of investments, net of deferred income tax  | (169,023)                                   | (67,513)            |
| Foreign currency translation adjustments, net of deferred income tax   | (174)                                       | 11,055              |
| Balance at end of period   | (13,973)                                    | (7,034)             |
| <b>Total Shareholders Equity</b>   | <b>\$ 3,886,233</b>                         | <b>\$ 3,704,067</b> |

See Notes to Consolidated Financial Statements



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**ARCH CAPITAL GROUP LTD. AND SUBSIDIARIES**  
**CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME**  
(U.S. dollars in thousands)

|  | (Unaudited)<br>Six Months Ended<br>June 30, |            |
|--|---|------------|
|  | 2008  | 2007       |
| <b>Comprehensive Income</b>  |   |            |
| Net income   | \$ 394,626                                  | \$ 410,867 |
| Other comprehensive income (loss), net of deferred income tax                                |   |            |
| Unrealized decline in value of investments:  |   |            |
| Unrealized holding losses arising during period  | (127,124)                                   | (72,486)   |
| Reclassification of net realized (gains) losses, net of income taxes, included in net income | (41,899)                                    | 4,973      |
| Foreign currency translation adjustments   | (174)                                       | 11,055     |
| <b>Other comprehensive loss</b>  | (169,197)                                   | (56,458)   |
| <b>Comprehensive Income</b>  | \$ 225,429                                  | \$ 354,409 |

See Notes to Consolidated Financial Statements

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## ARCH CAPITAL GROUP LTD. AND SUBSIDIARIES

## CONSOLIDATED STATEMENTS OF CASH FLOWS

(U.S. dollars in thousands)

|  | 2008              | (Unaudited)<br>Six Months Ended<br>June 30, | 2007             |
|--|-------------------|---|------------------|
| <b>Operating Activities</b>  |                   |   |                  |
| Net income   | \$ 394,626        | \$  | 410,867          |
| Adjustments to reconcile net income to net cash provided by operating activities:                              |                   |   |                  |
| Net realized (gains) losses  | (20,087)          |   | 4,854            |
| Equity in net (income) loss of investment funds accounted for using the equity method and other income         | (6,009)           |   | (6,887)          |
| Share-based compensation   | 17,511            |   | 14,457           |
| Changes in:  |                   |   |                  |
| Reserve for losses and loss adjustment expenses, net of unpaid losses and loss adjustment expenses recoverable | 278,357           |   | 324,793          |
| Unearned premiums, net of prepaid reinsurance premiums   | 85,364            |   | 135,525          |
| Premiums receivable  | (126,518)         |   | (290,437)        |
| Deferred acquisition costs, net  | (29,810)          |   | (18,702)         |
| Reinsurance balances payable   | (47,774)          |   | 79,254           |
| Other liabilities  | 48,281            |   | 1,737            |
| Other items, net   | (3,133)           |   | 21,542           |
| <b>Net Cash Provided By Operating Activities</b>   | <b>590,808</b>    |   | <b>677,003</b>   |
| <b>Investing Activities</b>  |                   |   |                  |
| Purchases of fixed maturity investments  | (7,510,262)       |   | (8,933,304)      |
| Proceeds from sales of fixed maturity investments  | 7,044,479         |   | 8,407,340        |
| Proceeds from redemptions and maturities of fixed maturity investments   | 317,369           |   | 305,847          |
| Purchases of other investments   | (187,652)         |   | (185,357)        |
| Proceeds from sales of other investments   | 89,324            |   | 62,309           |
| Investment in joint venture  | (100,000)         |   |                  |
| Net sales (purchases) of short-term investments  | 60,739            |   | (141,217)        |
| Change in investment of securities lending collateral  | 585,516           |   | (223,583)        |
| Purchases of furniture, equipment and other  | (4,984)           |   | (8,998)          |
| <b>Net Cash Provided By (Used For) Investing Activities</b>  | <b>294,529</b>    |   | <b>(716,963)</b> |
| <b>Financing Activities</b>  |                   |   |                  |
| Purchases of common shares under share repurchase program  | (389,753)         |   | (254,973)        |
| Proceeds from common shares issued, net  | 8,050             |   | 7,427            |
| Revolving credit agreement borrowings  | 100,000           |   |                  |
| Change in securities lending collateral  | (585,516)         |   | 223,583          |
| Excess tax benefits from share-based compensation  | 1,276             |   | 3,965            |
| Preferred dividends paid   | (12,922)          |   | (12,922)         |
| <b>Net Cash Used For Financing Activities</b>  | <b>(878,865)</b>  |   | <b>(32,920)</b>  |
| Effects of exchange rate changes on foreign currency cash  | 157               |   | 1,006            |
| Increase (decrease) in cash  | 6,629             |   | (71,874)         |
| Cash beginning of year   | 239,915           |   | 317,017          |
| <b>Cash end of period</b>  | <b>\$ 246,544</b> | <b>\$</b>                                   | <b>245,143</b>   |

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|                        |    |        |    |        |
|------------------------|----|--------|----|--------|
| Income taxes paid, net | \$ | 5,233  | \$ | 1,881  |
| Interest paid          | \$ | 11,259 | \$ | 11,025 |

See Notes to Consolidated Financial Statements

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**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 normal 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, 2007, 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 2007 consolidated financial statements have been reclassified to conform to the 2008 presentation. Such reclassifications had no effect on the Company s consolidated net income. Tabular dollars and share amounts are in thousands, except per share amounts.

**2. Share Transactions**

*Share Repurchase Program*

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 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 13.4 million common shares for an aggregate purchase price of \$926.8 million. During the 2008 second quarter and six months ended June 30, 2008, ACGL repurchased approximately 2.9 million and 5.6 million common shares, respectively, for an aggregate purchase price of \$199.9 million and \$389.8 million, respectively. As a result of share

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repurchase transactions, book value per common share was reduced by \$2.09 per share at June 30, 2008. 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. Weighted average shares outstanding for the 2007 second quarter and six months ended June 30, 2007 were reduced by 1.8 million and 1.0 million shares, respectively.

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 its shareholders agreement with ACGL for all repurchases of common shares by ACGL under the repurchase program in open market transactions and certain privately negotiated transactions.

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**ARCH CAPITAL GROUP LTD. AND SUBSIDIARIES**

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

*Non-Cumulative Preferred Shares*

During 2006, ACGL completed two public offerings of non-cumulative preferred shares ( 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 ) 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. At June 30, 2008, the Company had declared an aggregate of \$3.3 million of dividends to be paid to holders of the Preferred Shares.

*Share-Based Compensation*

As required by the provisions of Financial Accounting Standards Board ( FASB ) Statement No. 123 (revised 2004), Share-Based Payment ( SFAS No. 123(R) ), the Company recorded after-tax share-based compensation expense related to stock options in the 2008 second quarter of \$2.8 million, or \$0.04 per diluted share, compared to \$2.8 million, or \$0.04 per diluted share, in the 2007 second quarter, and \$3.9 million, or \$0.06 per diluted share, for the six months ended June 30, 2008, compared to \$4.4 million, or \$0.06 per diluted share, for the six months ended June 30, 2007.

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 were approximately \$19.07 and \$69.30 per share, respectively. Such value will be amortized over the respective substantive vesting period.



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**ARCH CAPITAL GROUP LTD. AND SUBSIDIARIES**

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

**3. 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, 2008 and 2007, interest expense on the Senior Notes was approximately \$11.0 million. The fair value of the Senior Notes at June 30, 2008 and December 31, 2007 was \$304.1 million and \$325.4 million, respectively.

*Letter of Credit and Revolving Credit Facilities*

As of June 30, 2008, 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 ). The \$300 million unsecured revolving loan is also available for the issuance of unsecured letters of credit up to \$100 million for Arch Reinsurance Company ( Arch Re U.S. ). 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 shareholders' equity 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, 2008. The Credit Agreement expires on August 30, 2011.

In May 2008, the Company borrowed \$100.0 million under the Credit Agreement at a variable interest rate based on 1 month, 3 month or 6 month LIBOR rates plus 27.5 basis points. The proceeds from such borrowings, which are repayable on August 30, 2011, were contributed to Arch Reinsurance Ltd. ( Arch Re Bermuda ) and used to fund an investment in a joint venture. See Note 6, Investment Information Investment in Joint Venture. The Company incurred interest expense in connection with the borrowing of \$0.3 million during the 2008 second quarter.

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

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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 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

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**ARCH CAPITAL GROUP LTD. AND SUBSIDIARIES**

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

of certain covenants, which the Company was in compliance with at June 30, 2008. At such date, the Company had approximately \$565.0 million in outstanding letters of credit under the LOC Facilities, which were secured by investments totaling \$582.2 million at fair value. It is anticipated that the LOC Facilities will be renewed (or replaced) on expiry, but such renewal (or replacement) will be subject to the availability of credit from banks which the Company utilizes. In addition to letters of credit, the Company has and may establish insurance trust accounts in the U.S. and Canada to secure its reinsurance amounts payable as required.

**4. 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 nine product lines: casualty; construction and national accounts; executive assurance; healthcare; professional liability; programs; property, marine and aviation; surety; and other (consisting of collateral protection, excess workers compensation and employers' liability business and travel and accident 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 treaties. 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 fee income, net of related expenses, other income (loss), other expenses incurred by the Company, interest expense, net realized gains or losses, equity in net income (loss) of investment funds accounted for using the equity method, net foreign exchange gains or losses and income taxes. In addition, corporate and other results include dividends on the Company's non-cumulative preferred shares.



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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:

|   | Insurance  | Three Months Ended<br>June 30, 2008<br>Reinsurance | Total             |
|---|------------|--|-------------------|
| 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  | (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   |            |  | (12,669)          |
| Equity in net income (loss) 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 policy-related fee income.



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## ARCH CAPITAL GROUP LTD. AND SUBSIDIARIES

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)

|   | Insurance  | Three Months Ended<br>June 30, 2007<br>Reinsurance | Total             |
|---|------------|--|-------------------|
| Gross premiums written (1)  | \$ 684,725 | \$ 427,348   | \$ 1,102,210      |
| Net premiums written (1)  | 451,828    | 306,067  | 757,895           |
| Net premiums earned (1)   | \$ 432,560 | \$ 318,852   | \$ 751,412        |
| Fee income  | 1,276      | 815  | 2,091             |
| Losses and loss adjustment expenses   | (272,658)  | (153,005)  | (425,663)         |
| Acquisition expenses  | (47,532)   | (69,745)   | (117,277)         |
| Other operating expenses  | (70,269)   | (19,999)   | (90,268)          |
| Underwriting income   | \$ 43,377  | \$ 76,918  | 120,295           |
| Net investment income   |            |  | 113,923           |
| Net realized losses   |            |  | (3,757)           |
| Equity in net income (loss) of investment funds accounted for using the equity method |            |  | 3,376             |
| Other income  |            |  | 265               |
| Other expenses  |            |  | (10,237)          |
| Interest expense  |            |  | (5,523)           |
| Net foreign exchange losses   |            |  | (6,450)           |
| Income before income taxes  |            |  | 211,892           |
| Income tax expense  |            |  | (6,037)           |
| <b>Net income</b>   |            |  | <b>205,855</b>    |
| Preferred dividends   |            |  | (6,461)           |
| <b>Net income available to common shareholders</b>                                    |            |  | <b>\$ 199,394</b> |
| <b>Underwriting Ratios</b>  |            |  |                   |
| Loss ratio  | 63.0%      | 48.0%  | 56.6%             |
| Acquisition expense ratio (2)   | 10.8%      | 21.9%  | 15.5%             |
| Other operating expense ratio   | 16.2%      | 6.3%   | 12.0%             |
| Combined ratio  | 90.0%      | 76.2%  | 84.1%             |

(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 \$0.3 million and \$9.6 million, respectively, of gross and net premiums written and \$0.3 million and \$10.8 million, respectively, of net premiums earned assumed through intersegment transactions.

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

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## ARCH CAPITAL GROUP LTD. AND SUBSIDIARIES

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)

|   | Insurance    | Six Months Ended<br>June 30, 2008 |           | Total          |
|---|--------------|-----------------------------------|-----------|----------------|
|   |              | Reinsurance                       |           |                |
| 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  | (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  |              |                                   |           | 23,306         |
| 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>\$</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 policy-related fee income.





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## ARCH CAPITAL GROUP LTD. AND SUBSIDIARIES

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)

|   | Insurance    | Six Months Ended<br>June 30, 2007<br>Reinsurance | Total             |
|---|--------------|--|-------------------|
| Gross premiums written (1)  | \$ 1,345,935 | \$ 986,002                                       | 2,312,824         |
| Net premiums written (1)  | 880,172      | 749,468  | 1,629,640         |
| Net premiums earned (1)   | \$ 846,407   | \$ 650,498                                       | \$ 1,496,905      |
| Fee income  | 2,701        | 1,359  | 4,060             |
| Losses and loss adjustment expenses   | (531,980)    | (313,744)  | (845,724)         |
| Acquisition expenses  | (94,227)     | (143,178)  | (237,405)         |
| Other operating expenses  | (139,163)    | (33,780)   | (172,943)         |
| Underwriting income   | \$ 83,738    | \$ 161,155                                       | 244,893           |
| Net investment income   |              |  | 223,970           |
| Net realized losses   |              |  | (4,738)           |
| Equity in net income (loss) of investment funds accounted for using the equity method |              |  | 6,018             |
| Other income  |              |  | 869               |
| Other expenses  |              |  | (18,375)          |
| Interest expense  |              |  | (11,046)          |
| Net foreign exchange losses   |              |  | (16,192)          |
| Income before income taxes  |              |  | 425,399           |
| Income tax expense  |              |  | (14,532)          |
| <b>Net income</b>   |              |  | <b>410,867</b>    |
| Preferred dividends   |              |  | (12,922)          |
| <b>Net income available to common shareholders</b>                                    |              |  | <b>\$ 397,945</b> |
| <b>Underwriting Ratios</b>  |              |  |                   |
| Loss ratio  | 62.9%        | 48.2%  | 56.5%             |
| Acquisition expense ratio (2)   | 10.9%        | 22.0%  | 15.8%             |
| Other operating expense ratio   | 16.4%        | 5.2%   | 11.6%             |
| Combined ratio  | 90.2%        | 75.4%  | 83.9%             |

(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 \$0.8 million and \$18.3 million, respectively, of gross and net premiums written and \$0.8 million and \$21.4 million, respectively, of net premiums earned assumed through intersegment transactions.

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



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## ARCH CAPITAL GROUP LTD. AND SUBSIDIARIES

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)

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

|  | 2008       |               | Three Months Ended<br>June 30, |               | 2007   |               |
|--|------------|---------------|--------------------------------|---------------|--------|---------------|
|  | Amount     | % of<br>Total | Amount                         | % of<br>Total | Amount | % of<br>Total |
| <b>INSURANCE SEGMENT</b>                                 |            |               |                                |               |        |               |
| <b>Net premiums written (1)</b>                          |            |               |                                |               |        |               |
| Property, marine and aviation                            | \$ 90,569  | 21.5          | \$ 104,705                     | 23.2          |        |               |
| Programs   | 73,202     | 17.3          | 59,154                         | 13.1          |        |               |
| Construction and national accounts                       | 65,752     | 15.6          | 55,514                         | 12.3          |        |               |
| Professional liability                                   | 63,583     | 15.1          | 64,584                         | 14.3          |        |               |
| Executive assurance                                      | 43,740     | 10.4          | 47,904                         | 10.6          |        |               |
| Casualty   | 30,266     | 7.2           | 57,240                         | 12.6          |        |               |
| Healthcare   | 11,027     | 2.6           | 12,383                         | 2.7           |        |               |
| Surety   | 10,206     | 2.4           | 12,968                         | 2.9           |        |               |
| Other (2)  | 33,156     | 7.9           | 37,376                         | 8.3           |        |               |
| Total  | \$ 421,501 | 100.0         | \$ 451,828                     | 100.0         |        |               |
| <b>Net premiums earned (1)</b>                           |            |               |                                |               |        |               |
| Property, marine and aviation                            | \$ 84,472  | 20.3          | \$ 92,387                      | 21.4          |        |               |
| Programs   | 62,085     | 14.9          | 57,036                         | 13.2          |        |               |
| Construction and national accounts                       | 58,166     | 14.0          | 50,965                         | 11.8          |        |               |
| Professional liability                                   | 66,200     | 15.9          | 65,804                         | 15.2          |        |               |
| Executive assurance                                      | 44,496     | 10.7          | 47,408                         | 11.0          |        |               |
| Casualty   | 37,650     | 9.0           | 52,570                         | 12.1          |        |               |
| Healthcare   | 13,137     | 3.1           | 17,107                         | 3.9           |        |               |
| Surety   | 12,057     | 2.9           | 16,597                         | 3.8           |        |               |
| Other (2)  | 38,322     | 9.2           | 32,686                         | 7.6           |        |               |
| Total  | \$ 416,585 | 100.0         | \$ 432,560                     | 100.0         |        |               |
| <b>Net premiums written by client location (1)</b>       |            |               |                                |               |        |               |
| United States  | \$ 330,154 | 78.3          | \$ 361,733                     | 80.1          |        |               |
| Europe   | 56,657     | 13.5          | 60,968                         | 13.5          |        |               |
| Other  | 34,690     | 8.2           | 29,127                         | 6.4           |        |               |
| Total  | \$ 421,501 | 100.0         | \$ 451,828                     | 100.0         |        |               |
| <b>Net premiums written by underwriting location (1)</b> |            |               |                                |               |        |               |

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|               |    |         |       |    |         |       |
|---------------|----|---------|-------|----|---------|-------|
| United States | \$ | 318,227 | 75.5  | \$ | 341,456 | 75.6  |
| Europe        |    | 79,854  | 18.9  |    | 83,730  | 18.5  |
| Other         |    | 23,420  | 5.6   |    | 26,642  | 5.9   |
| Total         | \$ | 421,501 | 100.0 | \$ | 451,828 | 100.0 |

- 
- (1) Insurance segment results include premiums written and earned assumed through intersegment transactions of \$0.1 million for the 2008 second quarter and \$0.3 million for the 2007 second quarter. Insurance segment results exclude premiums written and earned ceded through intersegment transactions of \$8.0 million and \$8.5 million, respectively, for the 2008 second quarter and \$9.6 million and \$10.8 million, respectively, for the 2007 second quarter.
- (2) Includes excess workers compensation and employers liability business and travel and accident business.

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## ARCH CAPITAL GROUP LTD. AND SUBSIDIARIES

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)

|  | 2008       |               | Six Months Ended<br>June 30, |               | 2007   |               |
|--|------------|---------------|------------------------------|---------------|--------|---------------|
|  | Amount     | % of<br>Total | Amount                       | % of<br>Total | Amount | % of<br>Total |
| <b>INSURANCE SEGMENT</b>                                 |            |               |                              |               |        |               |
| <b>Net premiums written (1)</b>                          |            |               |                              |               |        |               |
| Property, marine and aviation                            | \$ 188,731 | 22.9          | \$ 189,568                   | 21.5          |        |               |
| Programs   | 127,785    | 15.5          | 117,477                      | 13.3          |        |               |
| Construction and national accounts                       | 126,963    | 15.4          | 115,997                      | 13.2          |        |               |
| Professional liability                                   | 117,664    | 14.3          | 122,939                      | 14.0          |        |               |
| Executive assurance                                      | 85,909     | 10.4          | 91,995                       | 10.4          |        |               |
| Casualty   | 57,884     | 7.0           | 100,331                      | 11.4          |        |               |
| Healthcare   | 22,024     | 2.7           | 33,913                       | 3.9           |        |               |
| Surety   | 21,073     | 2.6           | 31,715                       | 3.6           |        |               |
| Other (2)  | 76,232     | 9.2           | 76,237                       | 8.7           |        |               |
| Total  | \$ 824,265 | 100.0         | \$ 880,172                   | 100.0         |        |               |
| <b>Net premiums earned (1)</b>                           |            |               |                              |               |        |               |
| Property, marine and aviation                            | \$ 169,464 | 20.3          | \$ 174,191                   | 20.6          |        |               |
| Programs   | 119,072    | 14.2          | 113,245                      | 13.4          |        |               |
| Construction and national accounts                       | 115,281    | 13.8          | 98,940                       | 11.7          |        |               |
| Professional liability                                   | 135,010    | 16.2          | 133,688                      | 15.8          |        |               |
| Executive assurance                                      | 88,904     | 10.6          | 92,786                       | 10.9          |        |               |
| Casualty   | 79,422     | 9.5           | 104,112                      | 12.3          |        |               |
| Healthcare   | 26,582     | 3.2           | 36,951                       | 4.4           |        |               |
| Surety   | 25,556     | 3.1           | 35,726                       | 4.2           |        |               |
| Other (2)  | 76,394     | 9.1           | 56,768                       | 6.7           |        |               |
| Total  | \$ 835,685 | 100.0         | \$ 846,407                   | 100.0         |        |               |
| <b>Net premiums written by client location (1)</b>       |            |               |                              |               |        |               |
| United States  | \$ 609,409 | 73.9          | \$ 681,738                   | 77.5          |        |               |
| Europe   | 142,957    | 17.4          | 135,903                      | 15.4          |        |               |
| Other  | 71,899     | 8.7           | 62,531                       | 7.1           |        |               |
| Total  | \$ 824,265 | 100.0         | \$ 880,172                   | 100.0         |        |               |
| <b>Net premiums written by underwriting location (1)</b> |            |               |                              |               |        |               |
| United States  | \$ 605,436 | 73.4          | \$ 673,014                   | 76.5          |        |               |
| Europe   | 181,865    | 22.1          | 165,746                      | 18.8          |        |               |
| Other  | 36,964     | 4.5           | 41,412                       | 4.7           |        |               |
| Total  | \$ 824,265 | 100.0         | \$ 880,172                   | 100.0         |        |               |

- (1) Insurance segment results include premiums written and earned assumed through intersegment transactions of \$0.1 million and \$0.2 million, respectively, for the 2008 period and \$0.8 million for the 2007 period. Insurance segment results exclude premiums written and earned ceded through intersegment transactions of \$15.0 million and \$17.2 million, respectively, for the 2008 period and \$18.3 million and \$21.4 million, respectively, for the 2007 period.
- (2) Includes excess workers compensation and employers liability business and travel and accident business.

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## 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 and underwriting location:

|  | 2008       |            | Three Months Ended<br>June 30, |            | 2007   |            |
|--|------------|------------|--------------------------------|------------|--------|------------|
|  | Amount     | % of Total | Amount                         | % of Total | Amount | % of Total |
| <b>REINSURANCE SEGMENT</b>                         |            |            |                                |            |        |            |
| <b>Net premiums written (1)</b>                    |            |            |                                |            |        |            |
| Casualty (2)                                       | \$ 86,974  | 32.9       | \$ 110,108                     | 36.0       |        |            |
| Property excluding property catastrophe (3)        | 85,748     | 32.4       | 69,351                         | 22.7       |        |            |
| Property catastrophe                               | 52,797     | 19.9       | 77,514                         | 25.3       |        |            |
| Other specialty                                    | 20,693     | 7.8        | 27,971                         | 9.1        |        |            |
| Marine and aviation                                | 17,975     | 6.8        | 19,812                         | 6.5        |        |            |
| Other  | 430        | 0.2        | 1,311                          | 0.4        |        |            |
| Total  | \$ 264,617 | 100.0      | \$ 306,067                     | 100.0      |        |            |
| <b>Net premiums earned (1)</b>                     |            |            |                                |            |        |            |
| Casualty (2)                                       | \$ 106,199 | 36.8       | \$ 131,114                     | 41.1       |        |            |
| Property excluding property catastrophe (3)        | 67,445     | 23.3       | 64,734                         | 20.3       |        |            |
| Property catastrophe                               | 51,496     | 17.8       | 38,152                         | 12.0       |        |            |
| Other specialty                                    | 36,058     | 12.5       | 52,582                         | 16.5       |        |            |
| Marine and aviation                                | 26,946     | 9.3        | 30,021                         | 9.4        |        |            |
| Other  | 946        | 0.3        | 2,249                          | 0.7        |        |            |
| Total  | \$ 289,090 | 100.0      | \$ 318,852                     | 100.0      |        |            |
| <b>Net premiums written (1)</b>                    |            |            |                                |            |        |            |
| Pro rata   | \$ 168,025 | 63.5       | \$ 184,972                     | 60.4       |        |            |
| Excess of loss                                     | 96,592     | 36.5       | 121,095                        | 39.6       |        |            |
| Total  | \$ 264,617 | 100.0      | \$ 306,067                     | 100.0      |        |            |
| <b>Net premiums earned (1)</b>                     |            |            |                                |            |        |            |
| Pro rata   | \$ 195,070 | 67.5       | \$ 228,815                     | 71.8       |        |            |
| Excess of loss                                     | 94,020     | 32.5       | 90,037                         | 28.2       |        |            |
| Total  | \$ 289,090 | 100.0      | \$ 318,852                     | 100.0      |        |            |
| <b>Net premiums written by client location (1)</b> |            |            |                                |            |        |            |
| United States                                      | \$ 153,106 | 57.9       | \$ 206,456                     | 67.5       |        |            |
| Europe   | 58,372     | 22.1       | 37,710                         | 12.3       |        |            |
| Bermuda  | 40,784     | 15.4       | 47,851                         | 15.6       |        |            |



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|  |    |         |       |    |         |       |
|--|----|---------|-------|----|---------|-------|
| Other  |    | 12,355  | 4.6   |    | 14,050  | 4.6   |
| Total  | \$ | 264,617 | 100.0 | \$ | 306,067 | 100.0 |
| <b>Net premiums written by underwriting location (1)</b> |    |         |       |    |         |       |
| Bermuda  | \$ | 160,228 | 60.6  | \$ | 205,138 | 67.0  |
| United States  |    | 92,629  | 35.0  |    | 99,515  | 32.5  |
| Other  |    | 11,760  | 4.4   |    | 1,414   | 0.5   |
| Total  | \$ | 264,617 | 100.0 | \$ | 306,067 | 100.0 |

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- (1) Reinsurance segment results include premiums written and earned assumed through intersegment transactions of \$8.0 million and \$8.5 million, respectively, for the 2008 second quarter and \$9.6 million and \$10.8 million, respectively, for the 2007 second quarter. Reinsurance segment results exclude premiums written and earned ceded through intersegment transactions of \$0.1 million for the 2008 second quarter and \$0.3 million for the 2007 second quarter.
- (2) Includes professional liability, executive assurance and healthcare business.
- (3) Includes facultative business.

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## ARCH CAPITAL GROUP LTD. AND SUBSIDIARIES

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)

|  | 2008       |            | Six Months Ended<br>June 30, |            | 2007   |            |
|--|------------|------------|------------------------------|------------|--------|------------|
|  | Amount     | % of Total | Amount                       | % of Total | Amount | % of Total |
| <b>REINSURANCE SEGMENT</b>                               |            |            |                              |            |        |            |
| <b>Net premiums written (1)</b>                          |            |            |                              |            |        |            |
| Casualty (2)   | \$ 192,961 | 28.7       | \$ 254,582                   | 34.0       |        |            |
| Property excluding property catastrophe (3)              | 181,670    | 27.0       | 164,297                      | 21.9       |        |            |
| Property catastrophe                                     | 159,021    | 23.6       | 158,173                      | 21.1       |        |            |
| Other specialty  | 96,373     | 14.3       | 101,967                      | 13.6       |        |            |
| Marine and aviation                                      | 40,139     | 6.0        | 63,527                       | 8.5        |        |            |
| Other  | 3,031      | 0.4        | 6,922                        | 0.9        |        |            |
| Total  | \$ 673,195 | 100.0      | \$ 749,468                   | 100.0      |        |            |
| <b>Net premiums earned (1)</b>                           |            |            |                              |            |        |            |
| Casualty (2)   | \$ 213,847 | 37.0       | \$ 271,556                   | 41.7       |        |            |
| Property excluding property catastrophe (3)              | 130,786    | 22.6       | 137,776                      | 21.2       |        |            |
| Property catastrophe                                     | 101,777    | 17.6       | 72,842                       | 11.2       |        |            |
| Other specialty  | 74,542     | 12.9       | 104,624                      | 16.1       |        |            |
| Marine and aviation                                      | 54,377     | 9.4        | 56,643                       | 8.7        |        |            |
| Other  | 2,895      | 0.5        | 7,057                        | 1.1        |        |            |
| Total  | \$ 578,224 | 100.0      | \$ 650,498                   | 100.0      |        |            |
| <b>Net premiums written (1)</b>                          |            |            |                              |            |        |            |
| Pro rata   | \$ 383,444 | 57.0       | \$ 448,787                   | 59.9       |        |            |
| Excess of loss   | 289,751    | 43.0       | 300,681                      | 40.1       |        |            |
| Total  | \$ 673,195 | 100.0      | \$ 749,468                   | 100.0      |        |            |
| <b>Net premiums earned (1)</b>                           |            |            |                              |            |        |            |
| Pro rata   | \$ 387,146 | 67.0       | \$ 471,254                   | 72.4       |        |            |
| Excess of loss   | 191,078    | 33.0       | 179,244                      | 27.6       |        |            |
| Total  | \$ 578,224 | 100.0      | \$ 650,498                   | 100.0      |        |            |
| <b>Net premiums written by client location (1)</b>       |            |            |                              |            |        |            |
| United States  | \$ 370,285 | 55.0       | \$ 460,447                   | 61.4       |        |            |
| Europe   | 202,292    | 30.1       | 162,048                      | 21.6       |        |            |
| Bermuda  | 74,844     | 11.1       | 98,692                       | 13.2       |        |            |
| Other  | 25,774     | 3.8        | 28,281                       | 3.8        |        |            |
| Total  | \$ 673,195 | 100.0      | \$ 749,468                   | 100.0      |        |            |
| <b>Net premiums written by underwriting location (1)</b> |            |            |                              |            |        |            |
| Bermuda  | \$ 380,897 | 56.6       | \$ 457,166                   | 61.0       |        |            |
| United States  | 247,109    | 36.7       | 279,877                      | 37.3       |        |            |
| Other  | 45,189     | 6.7        | 12,425                       | 1.7        |        |            |

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|       |    |         |       |    |         |       |
|-------|----|---------|-------|----|---------|-------|
| Total | \$ | 673,195 | 100.0 | \$ | 749,468 | 100.0 |
|-------|----|---------|-------|----|---------|-------|

- 
- (1) Reinsurance segment results include premiums written and earned assumed through intersegment transactions of \$15.0 million and \$17.2 million, respectively, for the 2008 period and \$18.3 million and \$21.4 million, respectively, for the 2007 period. Reinsurance segment results exclude premiums written and earned ceded through intersegment transactions of \$0.1 million and \$0.2 million, respectively, for the 2008 period and \$0.8 million for the 2007 period.
  - (2) Includes professional liability, executive assurance and healthcare business.
  - (3) Includes facultative business.

**Table of Contents****ARCH CAPITAL GROUP LTD. AND SUBSIDIARIES****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)****5. Reinsurance**

In the normal course of business, the Company's insurance subsidiaries cede a substantial portion of their premium through pro rata, excess of loss and facultative reinsurance agreements. 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:

|  | Three Months Ended<br>June 30, |            | Six Months Ended<br>June 30, |              |
|--|--------------------------------|------------|------------------------------|--------------|
|  | 2008                           | 2007       | 2008                         | 2007         |
| <b>Premiums Written</b>                    |                                |            |                              |              |
| Direct                                     | \$ 579,006                     | \$ 673,960 | \$ 1,198,492                 | \$ 1,323,840 |
| Assumed                                    | 307,920                        | 428,250    | 741,586                      | 988,984      |
| Ceded                                      | (200,808)                      | (344,315)  | (442,618)                    | (683,184)    |
| Net  | \$ 686,118                     | \$ 757,895 | \$ 1,497,460                 | \$ 1,629,640 |
| <b>Premiums Earned</b>                     |                                |            |                              |              |
| Direct                                     | \$ 615,216                     | \$ 655,173 | \$ 1,246,030                 | \$ 1,292,181 |
| Assumed                                    | 354,712                        | 407,543    | 720,076                      | 823,675      |
| Ceded                                      | (264,253)                      | (311,304)  | (552,197)                    | (618,951)    |
| Net  | \$ 705,675                     | \$ 751,412 | \$ 1,413,909                 | \$ 1,496,905 |
| <b>Losses and Loss Adjustment Expenses</b> |                                |            |                              |              |
| Direct                                     | \$ 355,680                     | \$ 378,249 | \$ 776,651                   | \$ 737,725   |
| Assumed                                    | 186,099                        | 183,150    | 327,348                      | 378,421      |
| Ceded                                      | (137,154)                      | (135,736)  | (294,957)                    | (270,422)    |
| Net  | \$ 404,625                     | \$ 425,663 | \$ 809,042                   | \$ 845,724   |

The Company monitors the financial condition of its reinsurers and attempts to place coverages only with substantial, financially sound carriers. At June 30, 2008 and December 31, 2007, approximately 86.2% and 88.5%, respectively, of the Company's reinsurance recoverables on paid and unpaid losses (not including prepaid reinsurance premiums) of \$1.70 billion and \$1.74 billion, respectively, were due from carriers which had an A.M. Best rating of A- or better. At June 30, 2008 and December 31, 2007, the largest reinsurance recoverables from any one carrier were

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less than 5.8% and 5.2%, respectively, 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., a Bermuda reinsurance company, pursuant to which Flatiron Re Ltd. 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 Re Ltd. from 45% to 70% of all covered business bound by Arch Re Bermuda from (and including) June 28, 2006 until (and including) August 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.

Table of Contents**ARCH CAPITAL GROUP LTD. AND SUBSIDIARIES****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)**

Flatiron Re Ltd. 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 Re Ltd. will make, or will have the ability to make, the required contributions into the Trust.

Arch Re Bermuda pays to Flatiron Re Ltd. 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 2008 second quarter, \$7.0 million of premiums written, \$45.9 million of premiums earned and \$15.7 million of losses and loss adjustment expenses were ceded to Flatiron Re Ltd. by Arch Re Bermuda, compared to \$115.9 million of premiums written, \$72.5 million of premiums earned and \$28.0 million of losses and loss adjustment expenses for the 2007 second quarter. For the six months ended June 30, 2008, \$25.4 million of premiums written, \$104.7 million of premiums earned and \$27.5 million of losses and loss adjustment expenses were ceded to Flatiron Re Ltd. by Arch Re Bermuda, compared to \$224.8 million of premiums written, \$138.5 million of premiums earned and \$53.4 million of losses and loss adjustment expenses for 2007 period. At June 30, 2008, \$65.6 million of premiums ceded to Flatiron Re Ltd. were unearned. Reinsurance recoverables from Flatiron Re Ltd., which is not rated by A.M. Best, were \$180.1 million at June 30, 2008, compared to \$152.6 million at December 31, 2007. As noted above, Flatiron Re Ltd. is required to contribute funds into a trust for the benefit of Arch Re Bermuda. The recoverable from Flatiron Re Ltd. was fully collateralized through such trust at June 30, 2008 and December 31, 2007.

**6. Investment Information**

The following table summarizes the Company's invested assets:

|  | <b>June 30,<br/>2008</b> | <b>December 31,<br/>2007</b> |
|--|--------------------------|------------------------------|
| Fixed maturities available for sale, at fair value   | \$ 7,746,296             | \$ 7,137,998                 |
| Fixed maturities pledged under securities lending agreements, at fair value (1)              | 890,822                  | 1,462,826                    |
| <b>Total fixed maturities</b>  | <b>8,637,118</b>         | <b>8,600,824</b>             |
| Short-term investments available for sale, at fair value                                     | 645,587                  | 699,036                      |
| <b>Short-term investments pledged under securities lending agreements, at fair value (1)</b> |                          | <b>219</b>                   |

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|  |                   |                  |
|--|-------------------|------------------|
| Other investments  | 295,638           | 353,694          |
| Investment funds accounted for using the equity method                         | 351,879           | 235,975          |
| Investment in joint venture  | 100,000           |                  |
| <b>Total investments (1)</b>   | <b>10,030,222</b> | <b>9,889,748</b> |
| Securities transactions entered into but not settled at the balance sheet date | (10,845)          | (5,796)          |
| Total investments, net of securities transactions                              | \$ 10,019,377     | \$ 9,883,952     |

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- (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, 2008 and December 31, 2007 of \$918.2 million and \$1.5 billion, respectively, which is reflected as short-term investment of funds received under securities lending agreements, at fair value and included the \$890.8 million and \$1.46 billion, respectively, of fixed maturities and short-term investments pledged under securities lending agreements, at fair value.

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## 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 details the Company's fixed maturities and fixed maturities pledged under securities lending agreements:

|   | Estimated<br>Fair Value | Gross<br>Unrealized<br>Gains | Gross<br>Unrealized<br>Losses | Amortized<br>Cost |
|---|-------------------------|------------------------------|-------------------------------|-------------------|
| <b>June 30, 2008:</b>                   |                         |                              |                               |                   |
| Corporate bonds                         | \$ 2,318,198            | \$ 42,801                    | \$ (70,098)                   | \$ 2,345,495      |
| Mortgage backed securities              | 1,532,524               | 13,235                       | (48,999)                      | 1,568,288         |
| Commercial mortgage backed securities   | 1,277,512               | 9,761                        | (5,481)                       | 1,273,232         |
| Asset backed securities                 | 1,100,914               | 8,190                        | (7,505)                       | 1,100,229         |
| Municipal bonds                         | 1,066,325               | 5,905                        | (7,825)                       | 1,068,245         |
| U.S. government and government agencies | 937,496                 | 10,839                       | (7,055)                       | 933,712           |
| Non-U.S. government securities          | 404,149                 | 23,205                       | (10,097)                      | 391,041           |
| Total                                   | \$ 8,637,118            | \$ 113,936                   | \$ (157,060)                  | \$ 8,680,242      |
| <b>December 31, 2007:</b>               |                         |                              |                               |                   |
| Corporate bonds                         | \$ 2,452,527            | \$ 40,296                    | \$ (10,994)                   | \$ 2,423,225      |
| Mortgage backed securities              | 1,234,596               | 14,211                       | (4,087)                       | 1,224,472         |
| Commercial mortgage backed securities   | 1,315,680               | 17,339                       | (558)                         | 1,298,899         |
| Asset backed securities                 | 1,008,030               | 9,508                        | (4,030)                       | 1,002,552         |
| Municipal bonds                         | 990,325                 | 13,213                       | (195)                         | 977,307           |
| U.S. government and government agencies | 1,165,423               | 21,598                       | (447)                         | 1,144,272         |
| Non-U.S. government securities          | 434,243                 | 28,032                       | (3,056)                       | 409,267           |
| Total                                   | \$ 8,600,824            | \$ 144,197                   | \$ (23,367)                   | \$ 8,479,994      |

In February 2006, the FASB issued SFAS No. 155, *Accounting for Certain Hybrid Financial Instruments* an amendment of FASB Statements No. 133 and 140 ( SFAS No. 155 ). Upon adopting SFAS No. 155 on January 1, 2007, the Company applied the fair value option to certain hybrid securities which are included in the Company's fixed maturities and records changes in market value of such securities as realized gains or losses. The fair market values of such securities at June 30, 2008 were approximately \$61.9 million and the Company recorded a realized gain of \$0.1 million on such securities for the six months ended June 30, 2008.

As of June 30, 2008, the Company held insurance enhanced municipal bonds, net of prerefunded bonds that are escrowed in U.S. government obligations, in the amount of approximately \$387.5 million, which represented approximately 3.9% of the Company's 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



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credit quality of the Company's insured municipal bond portfolio was an average underlying rating of Aa3 by Moody's and AA- by Standard & Poor's. Guarantors of the Company's \$387.5 million of insurance enhanced municipal bonds, net of prerefunded bonds that are escrowed in U.S. government obligations, include MBIA Insurance Corporation (\$148.0 million), Financial Security Assurance Inc. (\$86.4 million), Ambac Financial Group, Inc. (\$76.7 million), Financial Guaranty Insurance Company (\$53.3 million) and the Texas Permanent School Fund (\$23.1 million). The Company does not have a significant exposure to insurance enhanced asset-backed or mortgage-backed securities. The Company does not have any significant investments in companies which guarantee securities at June 30, 2008.

Table of Contents**ARCH CAPITAL GROUP LTD. AND SUBSIDIARIES****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)**

The Company's investment portfolio, which includes fixed maturity securities, short-term investments and other investments, had a AA+ average credit quality rating at June 30, 2008 and December 31, 2007. The credit quality distribution of the Company's fixed maturities and fixed maturities pledged under securities lending agreements are shown below:

| Rating (1)   | June 30, 2008        |            | December 31, 2007    |            |
|--------------|----------------------|------------|----------------------|------------|
|              | Estimated Fair Value | % of Total | Estimated Fair Value | % of Total |
| AAA          | \$ 6,110,053         | 70.7       | \$ 6,600,258         | 76.7       |
| AA           | 1,287,086            | 14.9       | 882,262              | 10.3       |
| A            | 772,697              | 9.0        | 677,047              | 7.9        |
| BBB          | 227,699              | 2.6        | 243,610              | 2.8        |
| BB           | 48,083               | 0.6        | 25,390               | 0.3        |
| B            | 123,650              | 1.4        | 128,459              | 1.5        |
| Lower than B | 9,738                | 0.1        | 11,321               | 0.1        |
| Not rated    | 58,112               | 0.7        | 32,477               | 0.4        |
| Total        | \$ 8,637,118         | 100.0      | \$ 8,600,824         | 100.0      |

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

***Securities Lending Agreements***

The Company participates in 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, at fair value. The Company maintains 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, which to date has only been 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 Short-term investment of funds received under securities lending agreements, at fair value. At June 30, 2008, the fair value and amortized cost of fixed maturities and short-term investments pledged under securities lending agreements were \$890.8 million and \$892.2 million, respectively, while collateral received totaled \$918.2 million at fair value and amortized cost. At December 31, 2007, the fair value and amortized cost of fixed maturities and short-term investments pledged under securities lending agreements were \$1.46 billion and \$1.44 billion, respectively, while collateral received totaled \$1.5 billion at fair value and amortized cost.

*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 fair values of those derivatives are based on quoted market prices. At June 30, 2008, the notional value of the net short position for equity futures was nil, compared to a net long position for equity futures of \$91.2 million at December 31, 2007. At June 30, 2008 and December 31, 2007, the notional value of the net long position for Treasury note futures was nil and \$61.7 million, respectively. For the 2008 second quarter and six months ended June 30, 2008, the Company recorded net realized losses of \$11.0 million and \$16.8 million, respectively, related to changes in the fair value of all futures contracts, compared to net realized gains of \$4.8 million and \$3.9 million, respectively, for the 2007 second quarter and six months ended June 30, 2007.

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## ARCH CAPITAL GROUP LTD. AND SUBSIDIARIES

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)

*Other Investments*

The following table details the Company's other investments:

|                                     | June 30, 2008           |            | December 31, 2007       |            |
|-------------------------------------|-------------------------|------------|-------------------------|------------|
|                                     | Estimated<br>Fair Value | Cost       | Estimated<br>Fair Value | Cost       |
| Mutual funds                        | \$ 228,466              | \$ 222,393 | \$ 286,147              | \$ 266,515 |
| Privately held securities and other | 67,172                  | 58,850     | 67,547                  | 57,435     |
| Total                               | \$ 295,638              | \$ 281,243 | \$ 353,694              | \$ 323,950 |

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 the Company's investment in Aeolus LP (see Note 9). The Company's investment commitments relating to its other investments and investment funds accounted for using the equity method totaled approximately \$53.3 million at June 30, 2008.

*Investment Funds Accounted for Using the Equity Method*

The Company's investment portfolio includes certain funds that invest in fixed maturity securities which, due to their ownership structure, are accounted for by the Company using 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). 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. 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.

Investment funds accounted for using the equity method totaled \$351.9 million at June 30, 2008, compared to \$294.4 million at March 31, 2008 and \$236.0 million at December 31, 2007. For the 2008 second quarter, the Company recorded \$19.6 million of equity in net income of investment funds accounted for using the equity method, compared to \$3.4 million of equity in net income for the 2007 second quarter. For the six months ended June 30, 2008, the Company recorded \$2.7 million of equity in net loss of investment funds accounted for using the equity method, compared to \$6.0 million of equity in net income for the 2007 period.

*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, each of Arch Re Bermuda and GIC owns 50% of Gulf Re, which has commenced underwriting activities. 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 total capital of the joint venture consists of \$200.0 million, plus an additional \$200.0 million 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 using the equity method and records its equity in the operating results of Gulf Re on a quarter lag basis.

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## 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 assets on deposit are available to settle insurance and reinsurance liabilities to third parties. The Company also has investments in segregated portfolios primarily to provide collateral or guarantees for letters of credit to third parties. The following table details the value of restricted assets:

|   | June 30,<br>2008 | December 31,<br>2007 |
|---|------------------|----------------------|
| Assets used for collateral or guarantees      | \$ 665,656       | \$ 736,938           |
| Deposits with U.S. regulatory authorities     | 245,088          | 251,586              |
| Trust funds                                   | 136,901          | 133,238              |
| Deposits with non-U.S. regulatory authorities | 51,799           | 46,789               |
| Total restricted assets                       | \$ 1,099,444     | \$ 1,168,551         |

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, 2008 and December 31, 2007, such amounts approximated \$3.85 billion and \$3.8 billion, respectively.

*Net Investment Income*

The components of net investment income were as follows:

|                         | Three Months Ended<br>June 30, |            | Six Months Ended<br>June 30, |            |
|-------------------------|--------------------------------|------------|------------------------------|------------|
|                         | 2008                           | 2007       | 2008                         | 2007       |
| Fixed maturities        | \$ 110,883                     | \$ 102,472 | \$ 218,133                   | \$ 200,571 |
| Short-term investments  | 5,486                          | 8,829      | 12,601                       | 18,563     |
| Other (1)               | 4,393                          | 6,103      | 15,214                       | 12,122     |
| Gross investment income | 120,762                        | 117,404    | 245,948                      | 231,256    |

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|                       |    |         |    |         |    |         |    |         |
|-----------------------|----|---------|----|---------|----|---------|----|---------|
| Investment expenses   |    | (3,642) |    | (3,481) |    | (6,635) |    | (7,286) |
| Net investment income | \$ | 117,120 | \$ | 113,923 | \$ | 239,313 | \$ | 223,970 |

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

*Net Realized Gains (Losses)*

The components of net realized gains (losses) were as follows:

|                             | Three Months Ended<br>June 30, |          |      | Six Months Ended<br>June 30, |    |          |    |          |
|-----------------------------|--------------------------------|----------|------|------------------------------|----|----------|----|----------|
|                             | 2008                           |          | 2007 | 2008                         |    | 2007     |    |          |
| Fixed maturities            | \$                             | (4,143)  | \$   | (8,983)                      | \$ | 48,678   | \$ | (10,127) |
| Other investments           |                                | (2,103)  |      | 1,000                        |    | (5,281)  |    | 2,139    |
| Other                       |                                | (6,423)  |      | 4,226                        |    | (20,091) |    | 3,250    |
| Net realized (losses) gains | \$                             | (12,669) | \$   | (3,757)                      | \$ | 23,306   | \$ | (4,738)  |

Currently, the Company's portfolio is actively managed on a total return basis within certain guidelines. The effect of financial market movements will influence the recognition of net realized gains and losses as the portfolio is adjusted and rebalanced.

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**ARCH CAPITAL GROUP LTD. AND SUBSIDIARIES**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)**

For the 2008 second quarter and six months ended June 30, 2008, net realized gains or losses on the Company's fixed maturities included provisions for declines in the market value of investments held in the Company's available for sale portfolio which were considered to be other-than-temporary of \$10.7 million and \$23.4 million, respectively, based on reviews performed in each period. For the 2007 second quarter and six months ended June 30, 2007, net realized losses on the Company's fixed maturities included provisions for declines in the market value of investments held in the Company's available for sale portfolio which were considered to be other-than-temporary of \$0.5 million and \$7.7 million, respectively, based on reviews performed in each period. For the 2008 and 2007 periods, the balance of net realized gains or losses on the Company's fixed maturities resulted from the sale of securities following the Company's decisions to reduce credit exposure, changes in duration targets and sales related to rebalancing the portfolio.

Certain of the Company's investments, primarily those included in other investments and investment funds accounted for using the equity method on the Company's 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 the Company's potential losses from such investments would be magnified.

***Fair Value***

Effective January 1, 2008, the Company adopted and implemented SFAS No. 159, *The Fair Value Option for Financial Assets and Financial Liabilities Including an Amendment of FASB Statement No. 115 (SFAS No. 159)*, which provides a fair value option to measure many financial instruments and certain other assets and liabilities at fair value on an instrument-by-instrument basis. The Company did not apply the fair value option on any financial assets or financial liabilities during 2008.

In addition, effective January 1, 2008, the Company adopted and implemented SFAS No. 157, *Fair Value Measurements (SFAS No. 157)*, which 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:



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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

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**ARCH CAPITAL GROUP LTD. AND SUBSIDIARIES  
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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 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) initial and ongoing evaluation of methodologies used by outside parties to calculate fair value; (iii) comparing the fair value estimates to its knowledge of the current market; and (iv) back-testing, which includes randomly selecting purchased or sold securities and comparing the executed prices to the fair value estimates from the pricing service. 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 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.

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, 2008, the Company determined that Level 1 securities would include 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 would include 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 investments in mutual funds.

In certain cases where there is limited activity or less transparency around inputs to the valuation, securities are classified within Level 3 of the valuation hierarchy. Securities classified within Level 3 include certain private equity investments and a small number of corporate premium-tax bonds held at amortized cost by the Company's U.S. insurance operations. Private equity investments are valued initially based upon transaction price and then adjusted upwards or downwards from the transaction price to reflect expected exit values.

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Further, on a quarterly basis, the Company evaluates whether the fair value of any of its investments are other-than-temporarily impaired. The Company's process for identifying declines in the fair value of investments that are other-than-temporary involves consideration of several factors. These factors include (i) the time period in which there has been a significant decline in value, (ii) an analysis of the liquidity, business prospects and overall financial condition of the issuer, (iii) the significance of the decline and (iv) the Company's intent and ability to hold the investment for a sufficient period of time for the value to recover. Where the Company's analysis of the above factors results in the conclusion that declines in fair values are

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

other-than-temporary, the cost basis of the securities is written down to fair value and the write-down is reflected as a realized loss.

The following table presents the Company's invested assets, categorized by the level within the SFAS No. 157 hierarchy in which the fair value measurements fall, at June 30, 2008:

|                            | June 30,<br>2008 | Fair Value Measurement Using:   |   |  |
|----------------------------|------------------|---|---|--|
|                            |                  | Quoted Prices<br>in Active<br>Markets for<br>Identical<br>Assets<br>(Level 1) | Significant<br>Other<br>Observable<br>Inputs<br>(Level 2) | Significant<br>Unobservable<br>Inputs<br>(Level 3) |
| Fixed maturities (1)       | \$ 8,637,118     | \$ 95,021   | \$ 8,535,618  | \$ 6,479   |
| Short-term investments (1) | 645,587          | 598,452   | 47,135  |  |
| Other investments (2)      | 227,196          |   | 217,554   | 9,642  |
| Total                      | \$ 9,509,901     | \$ 693,473  | \$ 8,800,307  | \$ 16,121  |

(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 of \$918.2 million which is reflected as short-term investment of funds received under securities lending agreements, at fair value and included the \$890.8 million of fixed maturities and short-term investments pledged under securities lending agreements, at fair value.

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

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 for the 2008 second quarter and six months ended June 30, 2008:

|   | Fair Value Measurements Using: |                      |           |
|---|--------------------------------|----------------------|-----------|
|   | Fixed<br>Maturities            | Other<br>Investments | Total     |
| <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     |

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|   |    |       |    |         |    |         |
|---|----|-------|----|---------|----|---------|
| 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, 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 gains on other investments were recorded in net realized gains.

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**ARCH CAPITAL GROUP LTD. AND SUBSIDIARIES**  
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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.

**7. Earnings Per Common Share**

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

|   | Three Months Ended<br>June 30, |            | Six Months Ended<br>June 30, |            |
|---|--------------------------------|------------|------------------------------|------------|
|   | 2008                           | 2007       | 2008                         | 2007       |
| <b>Basic earnings per common share:</b>   |                                |            |                              |            |
| Net income  | \$ 198,743                     | \$ 205,855 | \$ 394,626                   | \$ 410,867 |
| Preferred dividends   | (6,461)                        | (6,461)    | (12,922)                     | (12,922)   |
| Net income available to common shareholders                                     | 192,282                        | 199,394    | 381,704                      | 397,945    |
| Divided by:   |                                |            |                              |            |
| Weighted average common shares outstanding                                      | 62,996                         | 72,495     | 64,146                       | 73,209     |
| Basic earnings per common share   | \$ 3.05                        | \$ 2.75    | \$ 5.95                      | \$ 5.44    |
| <b>Diluted earnings per common share:</b>                                       |                                |            |                              |            |
| Net income  | \$ 198,743                     | \$ 205,855 | \$ 394,626                   | \$ 410,867 |
| Preferred dividends   | (6,461)                        | (6,461)    | (12,922)                     | (12,922)   |
| Net income available to common shareholders                                     | 192,282                        | 199,394    | 381,704                      | 397,945    |
| Divided by:   |                                |            |                              |            |
| Weighted average common shares outstanding                                      | 62,996                         | 72,495     | 64,146                       | 73,209     |
| Effect of dilutive securities:  |                                |            |                              |            |
| Nonvested restricted shares   | 248                            | 143        | 239                          | 158        |
| Stock options (1)   | 2,504                          | 2,617      | 2,502                        | 2,581      |
| Weighted average common shares and common share equivalents outstanding diluted | 65,748                         | 75,255     | 66,887                       | 75,948     |
| Diluted earnings per common share   | \$ 2.92                        | \$ 2.65    | \$ 5.71                      | \$ 5.24    |

(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 2008 second quarter and six months ended June 30, 2008, the number of stock options excluded were 0.5 million and 0.4 million, respectively. For the 2007 second quarter and six months ended June 30, 2007, the number of stock options excluded were 0.2 million and 0.1 million, respectively.

**8. 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.

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**ARCH CAPITAL GROUP LTD. AND SUBSIDIARIES**  
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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, Canada, Switzerland, Germany and Denmark.

The Company's income tax provision resulted in an effective tax rate on income before income taxes of 2.6% and 3.2%, respectively, for the 2008 second quarter and six months ended June 30, 2008, compared to 2.8% and 3.4%, respectively, for the 2007 second quarter and six months ended June 30, 2007. 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 2008 second quarter and six months ended June 30, 2008, the Company withheld and paid approximately \$4.3 million and \$7.2 million, respectively, of federal excise taxes, compared to \$2.7 million and \$6.6 million, respectively, for the 2007 second quarter and six months ended June 30, 2007.

**9. Transactions with Related Parties**

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 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 12.1% of the Company's outstanding voting shares as of June 30, 2008. In addition, one of the founders of Aeolus is Peter Appel, former President and CEO and a former director of the Company.

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



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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 Folksamerica Reinsurance Company and Folksamerica Holding Company (collectively, Folksamerica ). Folksamerica Reinsurance Company assumed Arch Re U.S. s

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**ARCH CAPITAL GROUP LTD. AND SUBSIDIARIES**  
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liabilities under the reinsurance agreements transferred in the asset sale and Arch Re U.S. transferred to Folksamerica Reinsurance Company assets estimated in an aggregate amount equal in book value to the book value of the liabilities assumed. The Folksamerica 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. Folksamerica 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 Folksamerica 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 reinsured. 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. Folksamerica has agreed to indemnify the Company for any losses arising out of the reinsurance agreements transferred to Folksamerica Reinsurance Company in the asset sale. However, in the event that Folksamerica 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. Folksamerica's A.M. Best rating was A- (Excellent) at June 30, 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 Folksamerica 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 Folksamerica 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 Folksamerica about the Company and the business transferred to Folksamerica 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 Folksamerica, including all liabilities not arising under reinsurance agreements transferred to Folksamerica 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 Folksamerica has not asserted that any amount is currently due under any of the indemnities provided by the Company under the asset purchase agreement, Folksamerica 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.

## **11. Commitments and Contingencies**

### ***Variable Interest Entities***

On December 29, 2005, Arch Re Bermuda entered into a quota share reinsurance treaty with Flatiron Re Ltd., a newly-formed Bermuda reinsurance company, pursuant to which Flatiron Re Ltd. 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). As a result of the terms of the Treaty, the Company determined that Flatiron Re Ltd. is a variable interest entity. However, Arch Re Bermuda is not the primary beneficiary of Flatiron Re Ltd. and, as such, the Company is not required to consolidate the assets, liabilities and results of operations of Flatiron Re Ltd. per FIN 46R. On December 31, 2007, the Treaty expired by its terms. See Note 5, Reinsurance for information on the Treaty with Flatiron Re Ltd.

## **12. 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, 2008, 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

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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.

**13. Recent Accounting Pronouncements**

In December 2007, the FASB issued Statement No. 141(R), *Business Combinations* (SFAS No. 141R). SFAS No. 141R replaces SFAS No. 141 and provides greater consistency in the accounting and financial reporting of business combinations. SFAS No. 141R requires the acquiring entity in a business combination to recognize all assets acquired and liabilities assumed in the transaction, establishes the acquisition date fair value as the measurement objective for all assets acquired and liabilities assumed, establishes principles and requirements for how an acquirer recognizes and measures any non-controlling interest in the acquiree and the goodwill acquired, and requires the acquirer to disclose the nature and financial effect of the business combination. Among other changes, SFAS No. 141R also requires that negative goodwill be recognized in earnings as a gain attributable to the acquisition, that acquisition-related costs are to be recognized separately from the acquisition and expensed as incurred and that any deferred tax benefits resulted in a business combination are recognized in income from continuing operations in the period of the combination. SFAS No. 141R is effective for business combinations for which the acquisition date is on or after the beginning of the first annual reporting period beginning on or after December 15, 2008. The Company will assess the impact that SFAS No. 141R may have on its financial position and results of operations.

In December 2007, the FASB issued Statement No. 160, *Noncontrolling Interests in Consolidated Financial Statements*—An amendment of ARB No. 51 (SFAS No. 160). SFAS No. 160 amends ARB No. 51 to establish accounting and reporting standards for the noncontrolling interest in a subsidiary and for the deconsolidation of a subsidiary. It clarifies that a noncontrolling interest in a subsidiary, which is sometimes referred to as minority interest, is an ownership interest in the consolidated entity that should be reported as equity in the consolidated financial statements. Among other requirements, this statement requires consolidated net income to be reported at amounts that include the amounts attributable to both the parent and the noncontrolling interest. It also requires disclosure, on the face of the consolidated income statement, of the amounts of consolidated net income attributable to the parent and to the noncontrolling interest. This Statement is effective for fiscal years, and interim periods within those fiscal years, beginning on or after December 15, 2008. Earlier adoption is prohibited. The Company is currently assessing the effect SFAS No. 160 may have on its consolidated results of operations and financial position.

In March 2008, the FASB issued SFAS No. 161, *Disclosures about Derivative Instruments and Hedging Activities* (SFAS No. 161). SFAS No. 161 is intended to improve financial reporting about derivative instruments and hedging activities by requiring enhanced disclosures to enable investors to better understand their effects on an entity's financial position, financial performance, and cash flows. The new standard also improves transparency about the location and amounts of derivative instruments in an entity's financial statements; how derivative instruments and related hedged items are accounted for under Statement 133; and how derivative instruments and related hedged items affect its financial position, financial performance, and cash flows. SFAS No. 161 is effective for financial statements issued for fiscal years and interim periods beginning after November 15, 2008, with early application encouraged. The Company is reviewing the impact that adopting SFAS No. 161 will have on its financial statements.

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

The following discussion and analysis contains forward-looking statements which involve inherent risks and uncertainties. All statements other than statements of historical fact are forward-looking statements. These statements are based on our current assessment of risks and uncertainties. Actual 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 in this report, including the section entitled "Cautionary Note Regarding Forward Looking Statements," and in our periodic reports filed with the Securities and Exchange Commission (SEC). For additional information regarding our business and operations, please also refer to our Annual Report on Form 10-K for the year ended December 31, 2007, including our audited consolidated financial statements and related notes and the sections entitled "Risk Factors" and "Management's Discussion and Analysis of Financial Condition and Results of Operations."

**GENERAL**

**Overview**

Arch Capital Group Ltd. (ACGL and, together with its subsidiaries, we or us) is a Bermuda public limited liability company with approximately \$4.3 billion in capital at June 30, 2008 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

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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

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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. This trend has continued in 2008.

**Current Outlook**

We increased our writings in property and certain marine lines of business in 2006 and 2007 in order to take advantage of improved market conditions and these lines represented a larger proportion of our overall book of business in 2006 and 2007 than in prior periods. We expect that our writings in these lines of business will continue to represent a significant proportion of our overall book of business in future periods and may represent a larger proportion of our overall book of business in future periods, which could increase the volatility in our results of operations. Although we saw price erosion in many of our lines in 2006 and 2007, current pricing remains at acceptable levels in many areas. We believe that we are still able to write insurance and reinsurance business at what we believe to be acceptable rates. We have maintained underwriting discipline during 2008 and, as a result, premiums written by our insurance and reinsurance operations were lower than in 2007. Such trend may continue as market conditions remain challenging.

In December 2005, we entered into a quota-share reinsurance treaty with Flatiron Re Ltd., a dedicated reinsurance vehicle, which allowed us to increase our participation in property and marine lines without significantly increasing our probable maximum loss. On December 31, 2007, the treaty expired by its terms. For its January 1, 2008 renewals, our Bermuda-based reinsurer adjusted its book of business in light of the expiration of the treaty with Flatiron Re Ltd. The treaty with Flatiron Re Ltd. provides for commission income (in excess of the reimbursement of direct acquisition expenses) which includes a profit commission based on the reported underwriting results on a cumulative basis. We record the profit commission portion of income from Flatiron Re Ltd. based on underwriting experience recorded each quarter. The profit commission arrangement with Flatiron Re Ltd. may increase the volatility of our reported results of operations on both a quarterly and annual basis. At June 30, 2008, \$65.6 million of premiums ceded to Flatiron Re Ltd. were unearned. The attendant premiums earned, losses incurred and acquisition expenses will primarily be reflected in our results during the balance of 2008.

We believe that the most attractive area from a pricing point of view remains catastrophe-related property business. 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. In July 2008, the probable maximum pre-tax loss for a catastrophic event in any geographic zone arising from a 1-in-250 year event was approximately \$815 million, compared to \$765 million in February 2008. 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. 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, 2007.

Table of Contents**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, 2007, updated where applicable in the notes accompanying our consolidated financial statements.

**RESULTS OF OPERATIONS****Three Months Ended June 30, 2008 and 2007**

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

|   | <b>Three Months Ended<br/>June 30,</b> |             |
|---|--|-------------|
|   | <b>2008</b>                            | <b>2007</b> |
| Net income available to common shareholders                                     | \$ 192,282                             | \$ 199,394  |
| Diluted net income per common share   | \$ 2.92                                | \$ 2.65     |
| Diluted weighted average common shares and common share equivalents outstanding | 65,748                                 | 75,255      |

Net income available to common shareholders was \$192.3 million for the 2008 second quarter, compared to \$199.4 million for the 2007 second quarter. The decrease in net income was primarily due to a decrease in underwriting income from our insurance and reinsurance operations, as discussed in Segment Information below. Our net income available to common shareholders for the 2008 second quarter represented a 21.2% annualized return on average common equity, compared to 23.3% for the 2007 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 65.7 million in the 2008 second quarter, compared to 75.3 million in the 2007 second quarter. The lower level of weighted average shares outstanding in the 2008 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 2008 second quarter were reduced by 11.9 million shares, compared to 1.8 million shares for the 2007 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 4, Segment Information, of the notes accompanying our consolidated financial statements. Management measures segment performance based on underwriting income or loss.

Table of Contents*Insurance Segment*

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

|                                     | Three Months Ended<br>June 30, |            |
|-------------------------------------|--------------------------------|------------|
|                                     | 2008                           | 2007       |
| Gross premiums written              | \$ 621,663                     | \$ 684,725 |
| Net premiums written                | 421,501                        | 451,828    |
| Net premiums earned                 | \$ 416,585                     | \$ 432,560 |
| Fee income                          | 880                            | 1,276      |
| Losses and loss adjustment expenses | (262,633)                      | (272,658)  |
| Acquisition expenses                | (55,400)                       | (47,532)   |
| Other operating expenses            | (71,566)                       | (70,269)   |
| Underwriting income                 | \$ 27,866                      | \$ 43,377  |
| <b>Underwriting Ratios</b>          |                                |            |
| Loss ratio                          | 63.0%                          | 63.0%      |
| Acquisition expense ratio (1)       | 13.1%                          | 10.8%      |
| Other operating expense ratio       | 17.2%                          | 16.2%      |
| Combined ratio                      | 93.3%                          | 90.0%      |

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

The insurance segment's underwriting income was \$27.9 million for the 2008 second quarter, compared to \$43.4 million for the 2007 second quarter. The combined ratio for the insurance segment was 93.3% for the 2008 second quarter, compared to 90.0% for the 2007 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 2008 second quarter were 9.2% lower than in the 2007 second quarter, while net premiums written were 6.7% lower as the insurance segment maintained underwriting discipline in response to the current rate environment. The decrease in net premiums written in the 2008 second quarter was partially driven by a lower level of U.S. specialty casualty business, primarily due to the decline in U.S. residential construction project activity. For information regarding net premiums written produced by major line of business and geographic location, refer to note 4, Segment Information, of the notes accompanying our consolidated financial statements.

*Net Premiums Earned.* Net premiums earned by the insurance segment in the 2008 second quarter were 3.7% lower than in the 2007 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 insurance segment's loss ratio was 63.0% in the 2008 and 2007 second quarters. The 2008 second quarter loss ratio reflected a 5.6 point reduction related to estimated net favorable development in prior year loss reserves, compared to 0.8

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points of estimated net adverse development in prior year loss reserves in the 2007 second quarter. The estimated net favorable development in the 2008 second quarter was primarily in medium-tail and longer-tail lines and resulted from better than expected claims emergence. The insurance segment's loss ratio in the 2008 second quarter also reflected an increase in expected loss ratios across a number of lines of business primarily due to rate changes and changes in the mix of business. In addition, the 2008 second quarter included a higher level of large, specific risk loss activity than the 2007 second quarter.

In the 2008 first quarter, the insurance segment renewed its reinsurance program which provides coverage for certain property-catastrophe related losses occurring during 2008 equal to a maximum of 70% of the first

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\$275 million in excess of a \$75 million retention per occurrence. The insurance segment had in effect during 2007 a reinsurance program which provided coverage equal to a maximum of 88% of the first \$325 million in excess of a \$75 million retention per occurrence for certain property catastrophe-related losses occurring during 2007.

*Underwriting Expenses.* The insurance segment's underwriting expense ratio was 30.3% in the 2008 second quarter, compared to 27.0% in the 2007 second quarter. The acquisition expense ratio was 13.1% for the 2008 second quarter, compared to 10.8% for the 2007 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. The higher acquisition expense ratio in the 2008 second quarter primarily resulted from changes in the form of reinsurance ceded and the mix of business. In addition, the acquisition expense ratio for the 2008 second quarter included 0.9 points related to favorable prior year loss development, compared to 0.1 points in the 2007 second quarter. The insurance segment's other operating expense ratio was 17.2% for the 2008 second quarter, compared to 16.2% in the 2007 second quarter. Operating expenses in the 2008 second quarter included \$1.6 million of costs related to the relocation of certain of the insurance segment's U.S. operations. Such actions were undertaken as part of an expense management plan, which includes office relocation, personnel and other expense saving initiatives, the implementation of which began in response to market conditions.

*Reinsurance Segment*

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

|                                     | <b>Three Months Ended</b> |             |
|-------------------------------------|---------------------------|-------------|
|                                     | <b>June 30,</b>           |             |
|                                     | <b>2008</b>               | <b>2007</b> |
| Gross premiums written              | \$ 273,318                | \$ 427,348  |
| Net premiums written                | 264,617                   | 306,067     |
| Net premiums earned                 | \$ 289,090                | \$ 318,852  |
| Fee income                          | 358                       | 815         |
| Losses and loss adjustment expenses | (141,992)                 | (153,005)   |
| Acquisition expenses                | (63,826)                  | (69,745)    |
| Other operating expenses            | (20,091)                  | (19,999)    |
| Underwriting income                 | \$ 63,539                 | \$ 76,918   |
| <b>Underwriting Ratios</b>          |                           |             |
| Loss ratio                          | 49.1%                     | 48.0%       |
| Acquisition expense ratio           | 22.1%                     | 21.9%       |
| Other operating expense ratio       | 6.9%                      | 6.3%        |
| Combined ratio                      | 78.1%                     | 76.2%       |

The reinsurance segment's underwriting income was \$63.5 million for the 2008 second quarter, compared to \$76.9 million for the 2007 second quarter. The combined ratio for the reinsurance segment was 78.1% for the 2008 second quarter, compared to 76.2% for the 2007 second quarter. The components of the reinsurance segment's underwriting income are discussed below.

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*Premiums Written.* Gross premiums written by the reinsurance segment in the 2008 second quarter were 36.0% lower than in the 2007 second quarter, with reductions in all treaty lines of business. Commencing in 2006, the reinsurance segment's Bermuda-based reinsurer, Arch Reinsurance Ltd. ( Arch Re Bermuda ), ceded certain lines of property and marine premiums written under a quota share reinsurance treaty (the Treaty ) to Flatiron Re Ltd. Under the Treaty, Flatiron Re Ltd. assumed a 45% quota share of certain lines of property and marine business underwritten by Arch Re Bermuda for the 2006 and 2007 underwriting years (the percentage

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ceded was increased from 45% to 70% of covered business bound from June 28, 2006 until August 15, 2006 provided such business did not incept beyond September 30, 2006). On December 31, 2007, the Treaty expired by its terms. For its January 1, 2008 renewals, Arch Re Bermuda adjusted its book of business in light of the expiration of the Treaty. In addition, gross and net premiums written for the 2007 second quarter included \$64.0 million and \$35.2 million, respectively, of property catastrophe business on a contract written with a two-year term while the 2008 second quarter did not include any comparable contracts. Other reductions in the reinsurance segment's book of business resulted from continued competition which led to non-renewals or lower shares written.

Ceded premiums written by the reinsurance segment were 3.2% of gross premiums written for the 2008 second quarter, compared to 28.4% for the 2007 second quarter. In the 2008 second quarter, Arch Re Bermuda ceded \$7.0 million, or 2.6% of gross premiums written, of certain lines of property and marine premiums written under the Treaty to Flatiron Re Ltd., compared to \$115.9 million, or 27.1%, in the 2007 second quarter, with the lower level due to the expiration of the Treaty. On an earned basis, Arch Re Bermuda ceded \$45.9 million to Flatiron Re Ltd. in the 2008 second quarter, compared to \$72.5 million in the 2007 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 2.3 points in the 2008 second quarter, compared to 3.1 points in the 2007 second quarter. At June 30, 2008, \$65.6 million of premiums ceded to Flatiron Re Ltd. were unearned. The attendant premiums earned, losses incurred and acquisition expenses will primarily be reflected in the reinsurance segment's results during the balance of 2008.

Net premiums written by the reinsurance segment in the 2008 second quarter were 13.5% lower than in the 2007 second quarter. For information regarding net premiums written produced by major line of business and geographic location, refer to note 4, Segment Information, of the notes accompanying our consolidated financial statements.

*Net Premiums Earned.* Net premiums earned by the reinsurance segment in the 2008 second quarter were 9.3% lower than in the 2007 second quarter. The decrease in net premiums earned in the 2008 second quarter primarily resulted from 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 49.1% in the 2008 second quarter, compared to 48.0% for the 2007 second quarter. The 2008 second quarter loss ratio reflected approximately 5.8 points of catastrophic activity, while the 2007 second quarter loss ratio reflected approximately 3.8 points of catastrophic activity. The loss ratio for the 2008 second quarter also reflected a 13.5 point reduction related to estimated net favorable development in prior year loss reserves, compared to a 12.1 point reduction in the 2007 second quarter. The estimated net favorable development in the 2008 second quarter was primarily in short-tail lines and resulted from better than anticipated claims emergence. The reinsurance segment's loss ratio in the 2008 second quarter also reflected an increase in expected loss ratios across a number of lines of business primarily due to rate changes and changes in the mix of business.

For its January 1 renewals, Arch Re Bermuda adjusted its book of business in light of the expiration of the Treaty with Flatiron Re Ltd. While our reinsurance operations may purchase industry loss warranty contracts and other reinsurance which is intended to limit their exposure, the expiration of the Treaty increases the level of risk retained by 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 29.0% in the 2008 second quarter, compared to 28.2% in the 2007 second quarter. The acquisition expense ratio for the 2008 second quarter was 22.1%, compared to 21.9% for the 2007 second quarter. The acquisition expense ratio for the 2008 second quarter included 1.2 points related to favorable prior year loss development, compared to 0.8 points in the 2007 second quarter. In addition, the acquisition expense ratio is influenced by, among other



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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 6.9% for the 2008 second quarter, compared to 6.3% for the 2007 second quarter. The higher ratio in the 2008 second quarter primarily resulted from a lower level of net premiums earned.

***Net Investment Income***

Net investment income for the 2008 second quarter was \$117.1 million, compared to \$113.9 million for the 2007 second quarter. The increase in net investment income in the 2008 second quarter primarily resulted from a higher level of average invested assets. The pre-tax investment income yield was 4.80% for the 2008 second quarter, compared to 4.94% for the 2007 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***

Following is a summary of net realized gains (losses):

|                   | <b>Three Months Ended<br/>June 30,</b> |             |
|-------------------|--|-------------|
|                   | <b>2008</b>                            | <b>2007</b> |
| Fixed maturities  | \$ (4,143)                             | \$ (8,983)  |
| Other investments | (2,103)                                | 1,000       |
| Other             | (6,423)                                | 4,226       |
| Total             | \$ (12,669)                            | \$ (3,757)  |

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 2008 second quarter was (0.09%), compared to 0.27% for the 2007 second quarter.

For the 2008 second quarter, net realized losses on our fixed maturities of \$4.1 million included a provision for declines in the market value of investments held in our available for sale portfolio which were considered to be other-than-temporary of \$10.7 million based on a review performed. For the 2007 second quarter, net realized losses on our fixed maturities of \$9.0 million included a provision for declines in the market value of investments held in our available for sale portfolio which were considered to be other-than-temporary of \$0.5 million based on a review performed. For the 2008 and 2007 second quarters, the balance of net realized gains or losses on our fixed maturities resulted from the sale of securities following our decisions to reduce credit exposure, changes in duration targets and sales related to rebalancing the portfolio.



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

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). We recorded \$19.6 million of equity in net income of investment funds accounted for using the equity method in the 2008 second quarter, compared to \$3.4 million of equity in net income for the 2007 second quarter. Investment funds accounted for using the equity method totaled \$351.9

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million at June 30, 2008, compared to \$294.4 million at March 31, 2008 and \$236.0 million at December 31, 2007.

*Other Expenses*

Other expenses, which are included in our other operating expenses and part of corporate and other (non-underwriting), were \$10.9 million for the 2008 second quarter, compared to \$10.2 million for the 2007 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 gains for the 2008 second quarter of \$0.3 million consisted of net unrealized gains of \$1.1 million and net realized losses of \$0.8 million, compared to net foreign exchange losses for the 2007 second quarter of \$6.5 million, which consisted of net unrealized losses of \$5.9 million and net realized losses of \$0.6 million. 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, as part of the Change in unrealized appreciation (decline) in value of investments, net of deferred income tax in accumulated other comprehensive income, and not in the statement of income.

*Income Taxes*

The effective tax rate on income before income taxes was 2.6% for the 2008 second quarter, compared to 2.8% for the 2007 second quarter. Our effective tax rates may fluctuate from period to period based on the relative mix of income reported by jurisdiction primarily due to the varying tax rates in each jurisdiction. Our quarterly tax provision is adjusted to reflect changes in our expected annual effective tax rates, if any.

A significant portion of our catastrophe-exposed property business is written by a Bermuda-based subsidiary. As a result, generally, our effective tax rate is likely to be favorably affected in periods that have a low level of catastrophic losses incurred and adversely impacted in periods with significant catastrophic claims activity. In addition, our Bermuda-based reinsurer incurs federal excise taxes for premiums assumed on U.S. risks. Such expenses are included in our acquisition expenses.

**Six Months Ended June 30, 2008 and 2007**

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

|   | Six Months Ended<br>June 30, |            |
|---|------------------------------|------------|
|   | 2008                         | 2007       |
| Net income available to common shareholders                                     | \$ 381,704                   | \$ 397,945 |
| Diluted net income per common share   | \$ 5.71                      | \$ 5.24    |
| Diluted weighted average common shares and common share equivalents outstanding | 66,887                       | 75,948     |

Net income available to common shareholders was \$381.7 million for the 2008 period, compared to \$397.9 million for the 2007 period. The decrease in net income was primarily due to a decrease in underwriting income

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from our insurance and reinsurance operations, as discussed in Segment Information below. Our net income available to common shareholders for the 2008 period represented a 21.0% annualized return on average common equity, compared to 24.0% for the 2007 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.

Diluted weighted average common shares and common share equivalents outstanding, used in the calculation of net income per common share, were 66.9 million in the 2008 period, compared to 75.9 million in the 2007 period. The lower level of weighted average shares outstanding in the 2008 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 2008 period were reduced by 10.6 million shares, compared to 1.0 million shares for the 2007 period.

**Segment Information***Insurance Segment*

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

|                                     | Six Months Ended<br>June 30, |              |
|-------------------------------------|------------------------------|--------------|
|                                     | 2008                         | 2007         |
| Gross premiums written              | \$ 1,248,011                 | \$ 1,345,935 |
| Net premiums written                | 824,265                      | 880,172      |
| Net premiums earned                 | \$ 835,685                   | \$ 846,407   |
| Fee income                          | 1,762                        | 2,701        |
| Losses and loss adjustment expenses | (549,936)                    | (531,980)    |
| Acquisition expenses                | (107,289)                    | (94,227)     |
| Other operating expenses            | (145,203)                    | (139,163)    |
| Underwriting income                 | \$ 35,019                    | \$ 83,738    |
| <b>Underwriting Ratios</b>          |                              |              |
| Loss ratio                          | 65.8%                        | 62.9%        |
| Acquisition expense ratio (1)       | 12.6%                        | 10.9%        |
| Other operating expense ratio       | 17.4%                        | 16.4%        |
| Combined ratio                      | 95.8%                        | 90.2%        |

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

The insurance segment's underwriting income was \$35.0 million for the 2008 period, compared to \$83.7 million for the 2007 period. The combined ratio for the insurance segment was 95.8% for the 2008 period, compared to 90.2% for the 2007 period. The components of the insurance segment's underwriting income are discussed below.

*Premiums Written.* Gross premiums written by the insurance segment in the 2008 period were 7.3% lower than in the 2007 period, while net premiums written were 6.4% lower as the insurance segment maintained underwriting discipline in response to the current rate environment. The decrease in net premiums written in the 2008 period was partially driven by a lower level of U.S. specialty casualty business, primarily due to the decline in U.S. residential construction project activity. Other contributors to the decrease in the 2008 period were a reduction in healthcare business in response to competition and the current rate environment and an increase in the use of reinsurance on surety business. For information regarding net premiums written produced by major line of business and geographic location, refer to note 4, Segment Information, of the notes accompanying our consolidated financial statements.

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*Net Premiums Earned.* Net premiums earned by the insurance segment in the 2008 period were 1.3% lower than in the 2007 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 insurance segment's loss ratio was 65.8% for the 2008 period, compared to 62.9% for the 2007 period. The 2008 period loss ratio reflected approximately 3.3 points of catastrophic activity, while the 2007 period did not include significant catastrophic activity. The 2008 period loss ratio also reflected a 3.5 point reduction related to estimated net favorable development in prior year loss reserves, compared to 0.3 points of estimated net adverse development in prior year loss reserves in the 2007 period. The estimated net favorable development in the 2008 period was primarily in medium-tail and longer-tail lines and resulted from better than expected claims emergence. The insurance segment's loss ratio in the 2008 period also reflected an increase in expected loss ratios across a number of lines of business primarily due to rate changes and changes in the mix of business.

*Underwriting Expenses.* The underwriting expense ratio for the insurance segment was 30.0% in the 2008 period, compared to 27.3% in the 2007 period. The acquisition expense ratio was 12.6% for the 2008 period, compared to 10.9% for the 2007 period. The acquisition expense ratio is influenced by, among other things, (1) the amount of ceding commissions received from unaffiliated reinsurers and (2) the amount of business written on a surplus lines (non-admitted) basis. The acquisition expense ratio in the 2008 period reflects changes in the form of reinsurance ceded and the mix of business. In addition, the acquisition expense ratio for the 2008 period included 0.5 points related to favorable prior year loss development, compared to 0.5 points in the 2007 period. The insurance segment's other operating expense ratio was 17.4% for the 2008 period, compared to 16.4% for the 2007 period. Operating expenses in the 2008 period included \$1.6 million of costs related to the relocation of certain of the insurance segment's U.S. operations. Such actions were undertaken as part of an expense management plan, which includes office relocation, personnel and other expense saving initiatives, the implementation of which began in response to market conditions.

*Reinsurance Segment*

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

|                                     | <b>Six Months Ended<br/>June 30,</b> |             |
|-------------------------------------|--------------------------------------|-------------|
|                                     | <b>2008</b>                          | <b>2007</b> |
| Gross premiums written              | \$ 707,145                           | \$ 986,002  |
| Net premiums written                | 673,195                              | 749,468     |
| Net premiums earned                 | \$ 578,224                           | \$ 650,498  |
| Fee income                          | 544                                  | 1,359       |
| Losses and loss adjustment expenses | (259,106)                            | (313,744)   |
| Acquisition expenses                | (126,576)                            | (143,178)   |
| Other operating expenses            | (38,329)                             | (33,780)    |
| Underwriting income                 | \$ 154,757                           | \$ 161,155  |
| <b>Underwriting Ratios</b>          |                                      |             |
| Loss ratio                          | 44.8%                                | 48.2%       |
| Acquisition expense ratio           | 21.9%                                | 22.0%       |
| Other operating expense ratio       | 6.6%                                 | 5.2%        |
| Combined ratio                      | 73.3%                                | 75.4%       |

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The reinsurance segment's underwriting income was \$154.8 million for the 2008 period, compared to \$161.2 million for the 2007 period. The combined ratio for the reinsurance segment was 73.3% for the 2008

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period, compared to 75.4% for the 2007 period. The components of the reinsurance segment's underwriting income are discussed below.

*Premiums Written.* Gross premiums written by the reinsurance segment in the 2008 period were 28.3% lower than in the 2007 period, with reductions in all treaty lines of business. For its January 1, 2008 renewals, Arch Re Bermuda adjusted its book of business in light of the expiration of the Treaty with Flatiron Re Ltd. In addition, gross and net premiums written for the 2007 period included \$64.0 million and \$35.2 million, respectively, of property catastrophe business on a contract written with a two-year term while the 2008 period did not include any comparable contracts. Other reductions in the reinsurance segment's book of business resulted from continued competition which led to non-renewals or lower shares written.

Ceded premiums written by the reinsurance segment were 4.8% of gross premiums written for the 2008 period, compared to 24.0% for the 2007 period. In the 2008 period, Arch Re Bermuda ceded \$25.4 million, or 3.6% of gross premiums written, of certain lines of property and marine premiums written under the Treaty to Flatiron Re Ltd., compared to \$224.8 million, or 22.8%, in the 2007 period, with the lower level due to the expiration of the Treaty. On an earned basis, Arch Re Bermuda ceded \$104.7 million to Flatiron Re Ltd. in the 2008 period, compared to \$138.5 million in the 2007 period. Commission income from the Treaty (in excess of the reimbursement of direct acquisition expenses) reduced the reinsurance segment's acquisition expense ratio by 2.8 points in the 2008 period, compared to 2.9 points in the 2007 period.

Net premiums written by the reinsurance segment in the 2008 period were 10.2% lower than in the 2007 period. For information regarding net premiums written produced by major line of business and geographic location, refer to note 4, Segment Information, of the notes accompanying our consolidated financial statements.

*Net Premiums Earned.* Net premiums earned by the reinsurance segment in the 2008 period were 11.1% lower than in the 2007 period. The decrease in net premiums earned in the 2008 period primarily resulted from 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 44.8% in the 2008 period, compared to 48.2% for the 2007 period. The loss ratio for the 2008 period reflected a 15.6 point reduction related to estimated net favorable development in prior year loss reserves, compared to a 13.1 point reduction in the 2007 period. The estimated net favorable development in the 2008 period was primarily in short-tail lines and resulted from better than anticipated loss emergence. The 2008 period loss ratio also reflected approximately 3.9 points of catastrophic activity, while the 2007 period loss ratio reflected approximately 4.3 points of catastrophic activity. The reinsurance segment's loss ratio in the 2008 period also reflected an increase in expected loss ratios across a number of lines of business and changes in the mix of business.

*Underwriting Expenses.* The underwriting expense ratio for the reinsurance segment was 28.5% in the 2008 period, compared to 27.2% in the 2007 period. The acquisition expense ratio for the 2008 period was 21.9%, compared to 22.0% for the 2007 period. The acquisition expense ratio 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 6.6% for the 2008 period, compared to 5.2% for the 2007 period. The higher ratio in the 2008 period resulted from expenses related to the reinsurance segment's property facultative reinsurance operation, which commenced operations during the 2007 second quarter, and a lower level of net premiums earned.

*Net Investment Income*



Net investment income for the 2008 period was \$239.3 million, compared to \$224.0 million for the 2007 period. The increase in net investment income in the 2008 period primarily resulted from a higher level of

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average invested assets. The pre-tax investment income yield was 4.84% for the 2008 period, compared to 4.90% for the 2007 period. The pre-tax investment income yields were calculated based on amortized cost.

***Net Realized Gains or Losses***

Following is a summary of net realized gains (losses):

|                   | <b>Six Months Ended<br/>June 30,</b> |             |
|-------------------|--------------------------------------|-------------|
|                   | <b>2008</b>                          | <b>2007</b> |
| Fixed maturities  | \$ 48,678                            | \$ (10,127) |
| Other investments | (5,281)                              | 2,139       |
| Other             | (20,091)                             | 3,250       |
| Total             | \$ 23,306                            | \$ (4,738)  |

Total return on our portfolio under management, as reported to us by our investment advisors, for the 2008 period was 0.86%, compared to 1.74% for the 2007 period. For the 2008 period, net realized gains on our fixed maturities of \$48.7 million included a provision for declines in the market value of investments held in our available for sale portfolio which were considered to be other-than-temporary of \$23.4 million based on reviews performed during the period. For the 2007 period, net realized losses on our fixed maturities of \$10.1 million included a provision for declines in the market value of investments held in our available for sale portfolio which were considered to be other-than-temporary of \$7.7 million based on reviews performed during the period. For the 2008 and 2007 periods, the balance of net realized gains or losses on our fixed maturities resulted from the sale of securities following our decisions to reduce credit exposure, changes in duration targets and sales related to rebalancing the portfolio.

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

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). We recorded \$2.7 million of equity in net loss of investment funds accounted for using the equity method in the 2008 period, compared to equity in net income of \$6.0 million in the 2007 period.

***Other Expenses***

Other expenses, which are included in our other operating expenses and part of corporate and other (non-underwriting), were \$16.2 million for the 2008 period, compared to \$18.4 million for the 2007 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 2008 period of \$23.3 million consisted of net unrealized losses of \$21.2 million and net realized losses of \$2.1 million, compared to net foreign exchange losses for the 2007 period of \$16.2 million, which consisted of net unrealized losses of \$23.1 million and net realized gains of \$6.9 million.

Table of Contents*Income Taxes*

The effective tax rate on income before income taxes was 3.2% for the 2008 period, compared to 3.4% for the 2007 period. Our effective tax rates may fluctuate from period to period based on the relative mix of income reported by jurisdiction primarily due to the varying tax rates in each jurisdiction. Our quarterly tax provision is adjusted to reflect changes in our expected annual effective tax rates, if any.

A significant portion of our catastrophe-exposed property business is written by a Bermuda-based subsidiary. As a result, on a relative basis, our effective tax rate is likely to be favorably affected in periods that have a low level of catastrophic losses incurred and adversely impacted in periods with significant catastrophic claims activity. In addition, our Bermuda-based reinsurer incurs federal excise taxes for premiums assumed on U.S. risks. Such expenses are included in our acquisition expenses.

**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 creates 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.

On a consolidated basis, our aggregate investable assets totaled \$10.27 billion at June 30, 2008, compared to \$10.12 billion at December 31, 2007, as detailed in the table below. The increase in investable assets in the 2008 period resulted primarily from cash flows from operations during the period, partially offset by share repurchase activity.

|   | <b>June 30,<br/>2008</b> | <b>December 31,<br/>2007</b> |
|---|--------------------------|------------------------------|
| Fixed maturities available for sale, at fair value                                    | \$ 7,746,296             | \$ 7,137,998                 |
| Fixed maturities pledged under securities lending agreements, at fair value (1)       | 890,822                  | 1,462,826                    |
| <b>Total fixed maturities</b>   | <b>8,637,118</b>         | <b>8,600,824</b>             |
| Short-term investments available for sale, at fair value                              | 645,587                  | 699,036                      |
| Short-term investments pledged under securities lending agreements, at fair value (1) |                          | 219                          |
| Cash  | 246,544                  | 239,915                      |
| Other investments   | 295,638                  | 353,694                      |
| Investment funds accounted for using the equity method                                | 351,879                  | 235,975                      |
| Investment in joint venture   | 100,000                  |                              |

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|  |    |            |    |            |
|--|----|------------|----|------------|
| Total cash and investments (1)   |    | 10,276,766 |    | 10,129,663 |
| Securities transactions entered into but not settled at the balance sheet date |    | (10,845)   |    | (5,796)    |
| Total investable assets  | \$ | 10,265,921 | \$ | 10,123,867 |

(1) In our securities lending transactions, we receive 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, we have excluded the collateral received at June 30, 2008 and December 31, 2007 of \$918.2 million and \$1.5 billion, respectively, which is reflected as short-term investment of funds received under securities lending agreements, at fair value and included the \$890.8 million and \$1.46 billion, respectively, of fixed maturities and short-term investments pledged under securities lending agreements, at fair value.

At June 30, 2008, 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 3.36 years,

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and an average yield to maturity (imbedded book yield), before investment expenses, of 4.96%. At December 31, 2007, our fixed income portfolio had a AA+ average Standard & Poor's quality rating, an average effective duration of 3.29 years, and an average yield to maturity (imbedded book yield), before investment expenses, of 5.03%.

In recent months, delinquencies and losses with respect to residential mortgage loans generally have increased and may continue to increase, particularly in the subprime sector. In addition, in recent months residential property values in many states have declined or remained stable, after extended periods during which those values appreciated. A continued decline or an extended flattening in those values may result in additional increases in delinquencies and losses on residential mortgage loans generally, especially with respect to second homes and investment properties, and with respect to any residential mortgage loans where the aggregate loan amounts (including any subordinate loans) are close to or greater than the related property values. These developments may have a significant adverse effect on the prices of loans and securities, including those in our investment portfolio. The situation continues to have wide ranging consequences, including downward pressure on economic growth and the potential for increased insurance and reinsurance exposures, which could have an adverse impact on our results of operations, financial condition, business and operations.

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.

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. At June 30, 2008, approximately \$4.75 billion, or 46.3%, of our total investments and cash was internally managed, compared to \$4.61 billion, or 45.5%, at December 31, 2007. 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 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, to replicate investment positions or to manage market exposures and duration risk that would be allowed under our investment guidelines if implemented in other ways. See Note 6, Investment Information Investment-Related Derivatives, of the notes accompanying our consolidated financial Statements for additional disclosures concerning derivatives.

Other investments totaled \$295.6 million at June 30, 2008, compared to \$353.7 million at December 31, 2007. Investment funds accounted for using the equity method totaled \$351.9 million at June 30, 2008, compared to \$236.0 million at December 31, 2007. Our investment commitments related to other investments and investment funds accounted for using the equity method totaled approximately \$53.3 million at June 30, 2008. See Note 6, 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.

In May 2008, Arch Re Bermuda 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, each of Arch Re Bermuda



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and GIC owns 50% of Gulf Re. The initial total capital of the joint venture consists of \$200.0 million, plus an additional \$200.0 million to be funded equally by us and GIC depending on the joint venture's business needs.

Effective January 1, 2008, we adopted and implemented SFAS No. 157, Fair Value Measurements (SFAS No. 157), which 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. See Note 6, Investment Information Fair Value of the notes accompanying our consolidated financial statements for further details.

***Reinsurance Recoverables***

We monitor the financial condition of our reinsurers and attempt to place coverages only with substantial, financially sound carriers. At June 30, 2008, approximately 86.2% of reinsurance recoverables on paid and unpaid losses (not including prepaid reinsurance premiums) of \$1.7 billion were due from carriers which had an A.M. Best rating of A- or better and the largest reinsurance recoverable from any one carrier was less than 5.8% of our total shareholders' equity. At December 31, 2007, approximately 88.5% of our reinsurance recoverables on paid and unpaid losses (not including prepaid reinsurance premiums) of \$1.74 billion were due from carriers which had an A.M. Best rating of A- or better, and the largest reinsurance recoverable from any one carrier was less than 5.2%, respectively, of our total shareholders' equity.

Reinsurance recoverables from Flatiron Re Ltd., which is not rated by A.M. Best, were \$180.1 million at June 30, 2008, compared to \$152.6 million at December 31, 2007. Flatiron Re Ltd. is required to contribute funds into a trust for the benefit of Arch Re Bermuda. The recoverable from Flatiron Re Ltd. was fully collateralized through such trust at June 30, 2008 and December 31, 2007. See Note 5, Reinsurance, of the notes accompanying our consolidated financial Statements for further details on the quota share reinsurance treaty with Flatiron Re Ltd.

***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.



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At June 30, 2008 and December 31, 2007, our Loss Reserves, net of unpaid losses and loss adjustment expenses recoverable, by type and by operating segment were as follows:

|                          | June 30,<br>2008 | December 31,<br>2007 |
|--------------------------|------------------|----------------------|
| <b>Insurance:</b>        |                  |                      |
| Case reserves.           | \$ 941,056       | \$ 811,054           |
| IBNR reserves            | 2,176,842        | 2,100,696            |
| Total net reserves       | \$ 3,117,898     | \$ 2,911,750         |
| <b>Reinsurance:</b>      |                  |                      |
| Case reserves.           | \$ 632,345       | \$ 623,419           |
| Additional case reserves | 91,541           | 80,438               |
| IBNR reserves            | 1,921,098        | 1,867,226            |
| Total net reserves       | \$ 2,644,984     | \$ 2,571,083         |
| <b>Total:</b>            |                  |                      |
| Case reserves.           | \$ 1,573,401     | \$ 1,434,473         |
| Additional case reserves | 91,541           | 80,438               |
| IBNR reserves            | 4,097,940        | 3,967,922            |
| Total net reserves       | \$ 5,762,882     | \$ 5,482,833         |

At June 30, 2008 and December 31, 2007, 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,<br>2008 | December 31,<br>2007 |
|------------------------------------|------------------|----------------------|
| Casualty                           | \$ 660,250       | \$ 647,842           |
| Construction and national accounts | 478,713          | 431,309              |
| Professional liability             | 459,980          | 412,527              |
| Executive assurance                | 455,901          | 431,068              |
| Property, marine and aviation.     | 402,720          | 345,177              |
| Programs                           | 379,932          | 370,852              |
| Healthcare                         | 152,226          | 153,018              |
| Surety                             | 83,873           | 87,232               |
| Other                              | 44,303           | 32,725               |
| Total net reserves                 | \$ 3,117,898     | \$ 2,911,750         |

At June 30, 2008 and December 31, 2007, 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,<br>2008 | December 31,<br>2007 |
|----------|------------------|----------------------|
| Casualty | \$ 1,764,469     | \$ 1,715,712         |

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|   |              |              |
|---|--------------|--------------|
| Property excluding property catastrophe | 300,885      | 295,728      |
| Other specialty.                        | 240,421      | 212,088      |
| Marine and aviation                     | 164,195      | 167,290      |
| Property catastrophe                    | 111,856      | 111,084      |
| Other                                   | 63,158       | 69,181       |
| Total net reserves                      | \$ 2,644,984 | \$ 2,571,083 |

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**Shareholders Equity**

Our shareholders equity was \$3.89 billion at June 30, 2008, compared to \$4.04 billion at December 31, 2007. The decrease in the 2008 period of \$149.6 million was primarily attributable to share repurchase activity and an after-tax decrease in the fair value of our investment portfolio, partially offset by net income in the period.

**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.

On a consolidated basis, our aggregate cash and invested assets totaled \$10.27 billion at June 30, 2008, compared to \$10.12 billion at December 31, 2007. 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, 2008, compared to \$36.3 million at December 31, 2007. For the six months ended June 30, 2008, ACGL received dividends of \$381.0 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 a 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 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 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, 2007, as determined under Bermuda law, Arch Re Bermuda had statutory capital of \$2.0 billion and statutory capital and surplus of \$3.73 billion. Such amounts include ownership interests in U.S. insurance and reinsurance subsidiaries. Accordingly, Arch Re Bermuda can pay approximately \$933 million to ACGL during 2008 without providing an affidavit to the Bermuda Monetary Authority, as discussed above. Our U.S. insurance and reinsurance subsidiaries can pay approximately \$113.9 million in dividends or distributions to Arch-U.S., our U.S. holding company, which is owned by Arch Re Bermuda, during 2008 without prior regulatory approval. Such dividends or distributions may be subject to applicable withholding or other taxes. Arch-Europe can pay approximately £8.4 million, or \$16.7 million, in dividends to ACGL during 2008 without prior notice to and approval by the Financial Services Authority. In addition, the ability of our insurance and reinsurance subsidiaries to pay dividends 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.



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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, 2008 and December 31, 2007, such amounts approximated \$1.1 billion and \$1.17 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, 2008 and December 31, 2007, such amounts approximated \$3.85 billion and \$3.8 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 cash provided by operating activities was \$590.8 million for the six months ended June 30, 2008, compared to \$677.0 million for the 2007 period. The lower level of operating cash flows in the 2008 period primarily resulted from an increase in paid losses, as our insurance and reinsurance loss reserves have continued to mature, along with a lower level of premiums written and collected. 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.

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-



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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 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 through June 30, 2008, ACGL has repurchased approximately 13.4 million common shares for an aggregate purchase price of \$926.8 million. During the six months ended June 30, 2008, ACGL repurchased approximately 5.6 million common shares under the share repurchase program for an aggregate purchase price of \$389.8 million. As a result of the share repurchase transactions to date, book value per common share was reduced by \$2.09 per share at June 30, 2008, compared to \$1.45 at December 31, 2007.

In July 2008, we purchased approximately 1.8 million common shares for an aggregate purchase price of \$122.2 million. 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.

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. 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 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. Any 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



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result, and, in any case, such securities may have rights, preferences and privileges that are senior to those of our outstanding securities.

In June 2006, ACGL and Arch-U.S. 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.

In August 2006, we entered into a five-year agreement for a \$300 million unsecured revolving loan and letter of credit facility and a \$1.0 billion secured letter of credit facility. The \$300 million unsecured loan and letter of credit facility is also available for the issuance of unsecured letters of credit up to \$100 million for our U.S.-based reinsurance operation. Including the secured letter of credit portion of the Credit Agreement and another letter of credit facility (together, the LOC Facilities), we have access to letter of credit facilities for up to a total of \$1.45 billion. At June 30, 2008 and December 31, 2007, we had approximately \$565.0 million and \$612.4 million, respectively, in outstanding letters of credit under the LOC Facilities, which were secured by investments at fair value totaling \$582.2 million and \$652.8 million, respectively. In May 2008, we borrowed \$100.0 million under the Credit Agreement at a variable interest rate based on 1 month, 3 month or 6 month LIBOR rates plus 27.5 basis points. The proceeds from such borrowings, which are repayable in August 2011, were contributed to Arch Re Bermuda and used to fund the investment in Gulf Re noted above.

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 months ended June 30, 2008 and 2007, we paid \$12.9 million to holders of the preferred shares and, at June 30, 2008, had declared an aggregate of \$3.3 million of dividends to be paid to holders of the preferred shares.

At June 30, 2008, ACGL's capital of \$4.29 billion consisted of \$300.0 million of senior notes, representing 7.0% of the total, \$100.0 million of revolving credit agreement borrowings, representing 2.3% of the total, \$325.0 million of preferred shares, representing 7.6% of the total, and common shareholders' equity of \$3.56 billion, representing the balance. At December 31, 2007, ACGL's capital of \$4.34 billion consisted of \$300.0 million of senior notes, representing 6.9% of the total, \$325.0 million of preferred shares, representing 7.5% of the total, and common shareholders' equity of \$3.71 billion, representing the balance. The decrease in capital



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during 2008 was primarily attributable to share repurchase activity and an after-tax decrease in the fair value of our investment portfolio, partially offset by net income and borrowings during the period.

**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, 2007.

**Book Value Per Common Share and Share Repurchases**

The following table presents the calculation of book value per common share and the impact of transactions under the share repurchase program on book value per common share:

|   | <b>June 30,<br/>2008</b> | <b>December 31,<br/>2007</b> |
|---|--------------------------|------------------------------|
| Calculation of book value per common share:                         |                          |                              |
| Total shareholders' equity  | \$ 3,886,233             | \$ 4,035,811                 |
| Less preferred shareholders' equity                                 | (325,000)                | (325,000)                    |
| Common shareholders' equity   | \$ 3,561,233             | \$ 3,710,811                 |
| Common shares outstanding (1)                                       | 61,943                   | 67,318                       |
| Book value per common share   | \$ 57.49                 | \$ 55.12                     |
| Effect of share repurchases to date:                                |                          |                              |
| Aggregate purchase price of shares repurchased                      | \$ 926,819               | \$ 537,066                   |
| Shares repurchased  | 13,391                   | 7,769                        |
| Average price per share repurchased                                 | \$ 69.21                 | \$ 69.13                     |
| Estimated dilutive impact on ending book value per common share (2) | \$ (2.09)                | \$ (1.45)                    |

(1) Excludes the effects of 5.6 million and 5.5 million stock options and 0.4 million and 0.1 million restricted stock units outstanding at June 30, 2008 and December 31, 2007, respectively.

(2) As the average price per share repurchased during the periods exceeded the book value per common share at June 30, 2008 and December 31, 2007, the repurchase of shares during the periods reduced book value per common share at both dates.

**Market Sensitive Instruments and Risk Management**

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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, 2008. (See section captioned "Management's Discussion and Analysis of Financial Condition and Results of Operations - Market Sensitive Instruments and Risk Management" included in our 2007 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, 2008, material changes in market risk exposures that affect the quantitative and qualitative disclosures presented as of December 31, 2007 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 and

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investment funds accounted for using the equity method 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, 2008 and December 31, 2007. 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 and, 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 Investments.

| (U.S. dollars in millions)    | Interest Rate Shift in Basis Points |            |            |            |            |
|-------------------------------|-------------------------------------|------------|------------|------------|------------|
|                               | -100                                | -50        | 0          | 50         | 100        |
| <b>June 30, 2008:</b>         |                                     |            |            |            |            |
| Total market value            | \$ 10,080.6                         | \$ 9,911.9 | \$ 9,745.4 | \$ 9,584.3 | \$ 9,425.7 |
| Market value change from base | 3.44%                               | 1.71%      |            | (1.65%)    | (3.28%)    |
| Change in unrealized value    | \$ 335.2                            | \$ 166.5   |            | \$ (161.1) | \$ (319.7) |
| <b>December 31, 2007:</b>     |                                     |            |            |            |            |
| Total market value            | \$ 10,048.9                         | \$ 9,885.3 | \$ 9,725.0 | \$ 9,565.4 | \$ 9,409.6 |
| Market value change from base | 3.33%                               | 1.65%      |            | (1.64%)    | (3.24%)    |
| Change in unrealized value    | \$ 323.9                            | \$ 160.3   |            | \$ (159.6) | \$ (315.4) |

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, 2008, our portfolio's VaR was estimated to be 5.28%, compared to an estimated 3.73% at December 31, 2007.

*Equities and Privately Held Securities.* Our investment portfolio includes an allocation to other investments which include investments in certain stock index funds, other preferred stocks and privately held securities. See Note 6, Investment Information Other Investments, of the notes accompanying our consolidated financial Statements for additional disclosures concerning our other investments. At June 30, 2008 and December 31, 2007, the fair value of our investments in equities and privately held securities totaled \$184.8 million and \$164.8 million, respectively. These securities are exposed to price risk, which is the potential loss arising from decreases in the market value of equities. An immediate hypothetical 10% depreciation in the value of each equity position would reduce the fair value of such investments by approximately \$18.5 million and \$16.5 million at June 30, 2008 and December 31, 2007, respectively, and would have decreased book value per common share by approximately \$0.30 and \$0.24, respectively.

*Investment-Related Derivatives.* We invest in certain derivative instruments to replicate investment positions and to manage market exposures and duration risk. At June 30, 2008, the notional value of the net short position for equity futures was nil, compared to a net long position for equity futures of \$91.2 million at December 31, 2007. At June 30, 2008 and December 31, 2007, the notional value of the net long position for Treasury note futures was nil and \$61.7 million, respectively. A 10% depreciation of the underlying exposure to these derivative instruments at June 30, 2008 and December 31, 2007 would have resulted in a reduction in net income of nil and \$15.3 million, respectively, and would have decreased book value per common share by nil and \$0.23, respectively.



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***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, 2008 and December 31, 2007, net of unrealized appreciation on our securities denominated in currencies other than the U.S. Dollar, would have resulted in unrealized gains of approximately \$10.9 million and \$12.9 million, respectively, and would have increased book value per common share by approximately \$0.18 and \$0.19, respectively. A 10% appreciation of the U.S. Dollar against other currencies under our outstanding contracts at June 30, 2008 and December 31, 2007, net of unrealized depreciation on our securities denominated in currencies other than the U.S. Dollar, would have resulted in unrealized losses of approximately \$10.9 million and \$12.9 million, respectively, and would have decreased book value per common share by approximately \$0.18 and \$0.19, 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;
  
- 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;

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- 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;
- 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;



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- 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, 2008;
  
- 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;
  
- 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;

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- our investment performance;
- 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.

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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 interim financial information included in this Quarterly Report on Form 10-Q as of and for the three and six months ended June 30, 2008 has not been audited by PricewaterhouseCoopers LLP. In reviewing such information, PricewaterhouseCoopers LLP has applied limited procedures in accordance with professional standards for reviews of interim financial information. However, their separate report included in this Quarterly Report on Form 10-Q for the 2008 second quarter states that they did not audit and they do not express an opinion on that interim financial information. Accordingly, you should restrict your reliance on their reports on such information. PricewaterhouseCoopers LLP is not subject to the liability provisions of Section 11 of the Securities Act of 1933 for their reports on the interim financial information because such reports do not constitute reports or parts of the registration statements 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;

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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, 2008 that have materially affected, or are reasonably likely to materially affect, internal control over financial reporting.

**PART II. OTHER INFORMATION***Item 1. Legal Proceedings*

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, 2008, 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*

The following table summarizes ACGL's purchases of its common shares for the 2008 second quarter:

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

| Period             | Issuer Purchases of Equity Securities |                              |  |   |
|--------------------|---------------------------------------|------------------------------|--|---|
|                    | Total Number of Shares Purchased (1)  | Average Price Paid per Share | 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) |
| 4/1/2008-4/30/2008 | 601,986                               | \$ 70.51                     | 599,674  | \$ 731,046  |
| 5/1/2008-5/31/2008 | 1,367,007                             | \$ 70.64                     | 1,347,100  | \$ 637,337  |
| 6/1/2008-6/30/2008 | 925,761                               | \$ 70.63                     | 925,085  | \$ 573,181  |
| Total              | 2,894,754                             | \$ 70.63                     | 2,871,859  | \$ 573,181  |

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(1) Includes 22,895 shares repurchased from employees in order to facilitate the payment of withholding taxes on restricted shares granted. 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.

(2) ACGL's Board of Directors have authorized ACGL to invest 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. 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.

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

(a) The annual meeting of shareholders (the Annual Meeting) of ACGL was held on May 9, 2008.

(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 April 1, 2008 (the Proxy Statement).

(c) The shareholders of ACGL (1) elected Class I Directors to hold office until the 2011 annual meeting of shareholders or until their successors are elected or 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, 2008. Set forth below are the voting results for these proposals:

**Election of Class I Directors of ACGL**

|                 | FOR        | WITHHOLD |
|-----------------|------------|----------|
| Paul B. Ingrey  |            |          |
| Total:          | 56,131,779 | 296,793  |
| Kewsong Lee     |            |          |
| Total:          | 55,904,391 | 524,181  |
| Robert F. Works |            |          |
| Total:          | 56,134,387 | 294,185  |

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

|                      | FOR        | WITHHOLD  |
|----------------------|------------|-----------|
| Graham B. Collis     |            |           |
| Total:               | 54,627,275 | 1,801,297 |
| Marc Grandisson      |            |           |
| Total:               | 56,371,916 | 56,656    |
| W. Preston Hutchings |            |           |
| Total:               | 56,376,581 | 51,991    |
| Constantine Iordanou |            |           |
| Total:               | 56,376,430 | 52,142    |

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|                     |            |        |
|---------------------|------------|--------|
| Ralph E. Jones III  |            |        |
| Total:              | 56,374,439 | 54,133 |
| Thomas G. Kaiser    |            |        |
| Total:              | 56,375,466 | 53,106 |
| Mark D. Lyons       |            |        |
| Total:              | 56,375,751 | 52,821 |
| Martin J. Nilsen    |            |        |
| Total:              | 56,376,276 | 52,296 |
| Nicolas Papadopoulo |            |        |
| Total:              | 56,376,536 | 52,036 |
| Michael Quinn       |            |        |
| Total:              | 56,374,855 | 53,717 |



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|                      |            |           |
|----------------------|------------|-----------|
| Maamoun Rajeh        |            |           |
| Total:               | 56,376,585 | 51,987    |
| Paul S. Robotham     |            |           |
| Total:               | 54,797,751 | 1,630,821 |
| Robert T. Van Gieson |            |           |
| Total:               | 56,375,301 | 53,271    |
| John D. Vollaro      |            |           |
| Total:               | 54,796,491 | 1,632,081 |
| James Weatherstone   |            |           |
| Total:               | 56,377,676 | 50,896    |

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

|        | FOR        | AGAINST | ABSTAIN |
|--------|------------|---------|---------|
| Total: | 56,367,458 | 48,401  | 12,713  |

**Item 5. Other Information**

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 2008 second quarter, the Audit Committee approved engagements of PricewaterhouseCoopers LLP for the following permitted non-audit services: tax services, tax consulting and tax compliance.

**Item 6. Exhibits**

| Exhibit No. | Description   |
|-------------|---|
| 10.1        | Agreement, dated May 14, 2008, among Arch Capital Group Ltd., Arch Insurance Group Inc. and Ralph E. Jones III  |
| 10.2        | Amendment to Employment Agreement, dated May 21, 2008, between Arch Capital Group Ltd. and W. Preston Hutchings |
| 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              |



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*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 8, 2008

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

Date: August 8, 2008

/s/ John D. Vollaro  
John D. Vollaro  
Executive Vice President, Chief Financial  
Officer and Treasurer (Principal Financial and  
Accounting Officer)

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**EXHIBIT INDEX**

| <b>Exhibit No.</b> | <b>Description</b>  |
|--------------------|---|
| 10.1               | Agreement, dated May 14, 2008, among Arch Capital Group Ltd., Arch Insurance Group Inc. and Ralph E. Jones III  |
| 10.2               | Amendment to Employment Agreement, dated May 21, 2008, between Arch Capital Group Ltd. and W. Preston Hutchings |
| 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              |
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