ARCH CAPITAL GROUP LTD.
Form 10-Q
August 05, 2010
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UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

WASHINGTON, D.C. 20549

FORM 10-Q

(Mark One)

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

For the quarterly period ended June 30, 2010

Or

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

Commission file number: 001-26456

ARCH CAPITAL GROUP LTD.

(Exact name of registrant as specified in its charter)

Bermuda

(State or other jurisdiction of incorporation or organization)

Not Applicable

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

Wessex House, 45 Reid Street

Hamilton HM 12, Bermuda

(Address of principal executive offices)

(441) 278-9250

(Registrant s telephone number, including area code)

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

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes x No o

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 x	Accelerated filer o
Non-accelerated filer o	Smaller reporting company o

Indicate by check mark whether the Registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act). Yes o No x

The number of the registrant s common shares (par value, $0.01 per share) outstanding as of July 30, 2010 was 49,676,650.

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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 sheet of Arch Capital Group Ltd. and its subsidiaries (the Company) as of June 30, 2010, and the related consolidated statements of income for the three-month and six-month periods ended June 30, 2010 and June 30, 2009, and the consolidated statements of changes in shareholders equity, comprehensive income and cash flows for each of the six-month periods ended June 30, 2010 and June 30, 2009. 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, 2009, 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 26, 2010, 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, 2009, 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, NY

August 5, 2010

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ARCH CAPITAL GROUP LTD. AND SUBSIDIARIES

CONSOLIDATED BALANCE SHEETS

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

	(Unaudited) June 30, 2010	December 31, 2009
Assets		
Investments:		
Fixed maturities available for sale, at market value (amortized cost: $9,214,640 and $9,227,432)	$ 9,428,456	$ 9,391,926
Short-term investments available for sale, at market value (amortized cost: $558,283 and $570,469)	554,304	571,489
Investment of funds received under securities lending agreements, at market value (amortized cost: $211,456 and $96,590)	209,635	91,160
TALF investments, at market value (amortized cost: $396,499 and $247,192)	407,469	250,265
Other investments (cost: $337,141 and $162,505)	340,598	172,172
Investment funds accounted for using the equity method	408,402	391,869
Total investments	11,348,864	10,868,881
Cash	341,469	334,571
Accrued investment income	72,102	70,673
Investment in joint venture (cost: $100,000)	103,540	102,855
Fixed maturities and short-term investments pledged under securities lending agreements, at market value	214,564	212,820
Securities purchased under agreements to resell using funds received under securities lending agreements		115,839
Premiums receivable	706,503	595,030
Unpaid losses and loss adjustment expenses recoverable	1,673,911	1,659,500
Paid losses and loss adjustment expenses recoverable	47,148	60,770
Prepaid reinsurance premiums	256,952	277,985
Deferred acquisition costs, net	293,982	280,372
Receivable for securities sold	1,084,122	187,171
Other assets	634,242	609,323
Total Assets	$ 16,777,399	$ 15,375,790
Liabilities		
Reserve for losses and loss adjustment expenses	$ 7,940,104	$ 7,873,412
Unearned premiums	1,492,550	1,433,331
Reinsurance balances payable	128,723	156,500
Senior notes	300,000	300,000
Revolving credit agreement borrowings	125,000	100,000
TALF borrowings, at market value (par: $337,937 and $218,740)	336,213	217,565
Securities lending payable	219,796	219,116
Payable for securities purchased	1,192,181	136,381
Other liabilities	644,829	616,136
Total Liabilities	12,379,396	11,052,441
Commitments and Contingencies		
Shareholders Equity		
Non-cumulative preferred shares - Series A and B	325,000	325,000

Common shares ($0.01 par, shares issued: 52,864,928 and 54,761,678)		529		548
Additional paid-in capital		83,828		253,466
Retained earnings		4,053,332		3,605,809
Accumulated other comprehensive income, net of deferred income tax		173,231		138,526
Common shares held in treasury, at cost (shares: 3,234,358 and 0)		(237,917)		
Total Shareholders Equity		4,398,003		4,323,349
Total Liabilities and Shareholders Equity	$	16,777,399	$	15,375,790

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) Three Months Ended June 30,		(Unaudited) Six Months Ended June 30,	
	2010	2009	2010	2009
Revenues				
Net premiums written	$ 624,258	$ 693,854	$ 1,392,012	$ 1,516,717
Change in unearned premiums	(1,247)	5,404	(99,084)	(116,895)
Net premiums earned	623,011	699,258	1,292,928	1,399,822
Net investment income	90,537	100,485	183,509	196,367
Net realized gains (losses)	62,114	(11,793)	109,896	(16,957)
Other-than-temporary impairment losses	(4,718)	(20,657)	(7,054)	(113,646)
Less investment impairments recognized in other comprehensive income, before taxes	308	(206)	1,038	56,649
Net impairment losses recognized in earnings	(4,410)	(20,863)	(6,016)	(56,997)
Fee income	883	817	1,677	1,742
Equity in net income (loss) of investment funds accounted for using the equity method	(348)	75,890	28,702	66,309
Other income	4,528	4,950	10,506	8,901
Total revenues	776,315	848,744	1,621,202	1,599,187
Expenses				
Losses and loss adjustment expenses	363,145	398,858	791,196	799,400
Acquisition expenses	107,475	123,814	225,099	250,272
Other operating expenses	101,533	99,294	208,339	186,410
Interest expense	7,916	5,712	15,176	11,424
Net foreign exchange (gains) losses	(48,625)	53,658	(87,226)	28,453
Total expenses	531,444	681,336	1,152,584	1,275,959
Income before income taxes	244,871	167,408	468,618	323,228
Income tax expense	1,420	8,818	8,173	18,308
Net Income	243,451	158,590	460,445	304,920
Preferred dividends	6,461	6,461	12,922	12,922
Net income available to common shareholders	$ 236,990	$ 152,129	$ 447,523	$ 291,998
Net income per common share				
Basic	$ 4.65	$ 2.52	$ 8.60	$ 4.84
Diluted	$ 4.45	$ 2.43	$ 8.23	$ 4.67
Weighted average common shares and common share equivalents outstanding				
Basic	50,987,540	60,417,391	52,007,616	60,365,758
Diluted	53,265,303	62,626,317	54,386,690	62,589,856

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ARCH CAPITAL GROUP LTD. AND SUBSIDIARIES

CONSOLIDATED STATEMENTS OF CHANGES IN SHAREHOLDERS EQUITY

(U.S. dollars in thousands)

	(Unaudited) Six Months Ended June 30, 2010	2009
Non-Cumulative Preferred Shares		
Balance at beginning and end of period	$ 325,000	$ 325,000
Common Shares		
Balance at beginning of year	548	605
Common shares issued, net	11	5
Purchases of common shares under share repurchase program	(30)	(0)
Balance at end of period	529	610
Additional Paid-in Capital		
Balance at beginning of year	253,466	669,715
Common shares issued	3,289	2,557
Exercise of stock options	24,664	1,233
Common shares retired	(217,562)	(6,243)
Amortization of share-based compensation	19,376	14,267
Other	595	(84)
Balance at end of period	83,828	681,445
Retained Earnings		
Balance at beginning of year	3,605,809	2,693,239
Cumulative effect of change in accounting principle (1)		61,469
Balance at beginning of year, as adjusted	3,605,809	2,754,708
Dividends declared on preferred shares	(12,922)	(12,922)
Net income	460,445	304,920
Balance at end of period	4,053,332	3,046,706
Accumulated Other Comprehensive Income (Loss)		
Balance at beginning of year	138,526	(255,594)
Cumulative effect of change in accounting principle (1)		(61,469)
Balance at beginning of year, as adjusted	138,526	(317,063)
Change in unrealized appreciation in value of investments, net of deferred income tax	43,716	360,865
Portion of other-than-temporary impairment losses recognized in other comprehensive income, net of deferred income tax	(1,038)	(77,806)
Foreign currency translation adjustments, net of deferred income tax	(7,973)	10,211
Balance at end of period	173,231	(23,793)
Common Shares Held in Treasury, at Cost		
Balance at beginning of year		
Shares repurchased for treasury	(237,917)	
Balance at end of period	(237,917)	
Total Shareholders Equity	$ 4,398,003	$ 4,029,968

(1) Adoption of accounting guidance regarding the recognition and presentation of other-than-temporary impairments.

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) Six Months Ended June 30, 2010	2009
Comprehensive Income		
Net income	$ 460,445	$ 304,920
Other comprehensive income, net of deferred income tax		
Unrealized appreciation in value of investments:		
Unrealized holding gains arising during period	113,934	282,405
Portion of other-than-temporary impairment losses recognized in other comprehensive income, net of deferred income tax	(1,038)	(77,806)
Reclassification of net realized (gains) losses, net of income taxes, included in net income	(70,218)	78,460
Foreign currency translation adjustments	(7,973)	10,211
Other comprehensive income	34,705	293,270
Comprehensive Income	**$** 495,150	**$** 598,190

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ARCH CAPITAL GROUP LTD. AND SUBSIDIARIES

CONSOLIDATED STATEMENTS OF CASH FLOWS

(U.S. dollars in thousands)

	(Unaudited) Six Months Ended June 30, 2010	2009
Operating Activities		
Net income	$ 460,445	$ 304,920
Adjustments to reconcile net income to net cash provided by operating activities:		
Net realized (gains) losses	(111,889)	17,451
Net impairment losses recognized in earnings	6,016	56,997
Equity in net (income) loss of investment funds accounted for using the equity method and other income	(18,380)	(70,234)
Share-based compensation	19,376	14,267
Changes in:		
Reserve for losses and loss adjustment expenses, net of unpaid losses and loss adjustment expenses recoverable	162,604	88,914
Unearned premiums, net of prepaid reinsurance premiums	96,881	116,092
Premiums receivable	(136,851)	(95,693)
Deferred acquisition costs, net	(17,617)	(10,420)
Reinsurance balances payable	(17,402)	17,465
Other liabilities	(15,771)	7,991
Other items, net	(37,275)	70,795
Net Cash Provided By Operating Activities	390,137	518,545
Investing Activities		
Purchases of:		
Fixed maturity investments	(9,483,319)	(9,373,252)
Other investments	(357,460)	(32,351)
Proceeds from the sales of:		
Fixed maturity investments	9,111,774	8,657,765
Other investments	213,814	19,794
Proceeds from redemptions and maturities of fixed maturity investments	456,937	377,034
Net purchases of short-term investments	(6,682)	(61,105)
Change in investment of securities lending collateral	(680)	179,514
Purchases of furniture, equipment and other assets	(7,860)	(11,519)
Net Cash Used For Investing Activities	(73,476)	(244,120)
Financing Activities		
Purchases of common shares under share repurchase program	(450,326)	(1,552)
Proceeds from common shares issued, net	14,370	(1,380)
Proceeds from borrowings	264,526	
Repayments of borrowings	(120,339)	
Change in securities lending collateral	680	(179,514)
Other	7,357	(549)
Preferred dividends paid	(12,922)	(12,922)
Net Cash Used For Financing Activities	(296,654)	(195,917)
Effects of exchange rate changes on foreign currency cash	(13,109)	6,446

Increase in cash	6,898	84,954
Cash beginning of year	334,571	251,739
Cash end of period	$ 341,469	$ 336,693

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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 normally recurring accruals) necessary for a fair statement of results on an interim basis. The results of any interim period are not necessarily indicative of the results for a full year or any future periods.

Certain information and footnote disclosures normally included in financial statements prepared in accordance with GAAP have been condensed or omitted; however, management believes that the disclosures are adequate to make the information presented not misleading. This report should be read in conjunction with the Company s Annual Report on Form 10-K for the year ended December 31, 2009, including the Company s audited consolidated financial statements and related notes.

The Company has reclassified the presentation of certain prior year information to conform to the current presentation. Such reclassifications had no effect on the Company s net income, shareholders equity or cash flows. Tabular amounts are in U.S. Dollars in thousands, except share amounts, unless otherwise noted.

2. Recent Accounting Pronouncements

In March 2010, the Financial Accounting Standards Board (FASB) issued an Accounting Standards Update (ASU) that clarifies the type of embedded credit derivative that is exempt from embedded derivative bifurcation requirements. Only one form of embedded credit derivative qualifies for the exemption one that is related only to the subordination of one financial instrument to another. As a result, entities that have contracts containing an embedded credit derivative feature in a form other than such subordination may need to separately account for the embedded credit derivative feature. This ASU is effective at the beginning of the first fiscal quarter beginning after June 15, 2010. The Company does not expect the adoption of this ASU to have a material effect on the Company s consolidated financial position or results of operations.

In January 2010, the FASB issued an ASU to improve disclosure requirements related to fair value measurements. The ASU requires more robust disclosures about (i) different classes of assets and liabilities measured at fair value, (ii) the valuation techniques and inputs to fair value measurements for both Levels 2 and 3, (iii) the activity within Level 3 fair value measurements (*i.e*., in the reconciliation for fair value measurements using significant unobservable inputs activity should be presented on a gross basis), and (iv) the transfers between Levels 1, 2 and 3, (*i.e*., include the reasons for significant transfers in and out of Levels 1 and 2).The ASU is effective for interim and annual reporting periods beginning after December 15, 2009, except for the disclosures about purchases, sales, issuances, and settlements in the roll forward activity in Level 3 fair value measurements, which will become effective for fiscal years beginning after December 15, 2010. Accordingly, the Company adopted the appropriate disclosure provisions of the ASU on January 1, 2010.

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ARCH CAPITAL GROUP LTD. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)

3. Share Transactions

Share Repurchases

The board of directors of ACGL has authorized the investment of up to $2.5 billion in ACGL s common shares through a share repurchase program, consisting of a $1.0 billion authorization in February 2007, a $500 million authorization in May 2008, and a $1.0 billion authorization in November 2009. Repurchases under the program may be effected from time to time in open market or privately negotiated transactions through December 2011. Since the inception of the share repurchase program, ACGL has repurchased 28.1 million common shares for an aggregate purchase price of $1.96 billion. During the 2010 second quarter, ACGL repurchased 3.6 million common shares for an aggregate purchase price of $269.1 million, compared to nil during the 2009 second quarter. During the six months ended June 30, 2010, ACGL repurchased 6.2 million common shares for an aggregate purchase price of $450.3 million, compared to a de minimis number of shares for an aggregate purchase price of $1.6 million during the 2009 period.

At June 30, 2010, approximately $541.1 million of share repurchases were available under the program. The timing and amount of the repurchase transactions under this program will depend on a variety of factors, including market conditions and corporate and regulatory considerations.

Treasury Shares

In May 2010, ACGL s shareholders approved amendments to the bye-laws to permit ACGL to hold its own acquired shares as treasury shares in lieu of cancellation, at the discretion of ACGL s board of directors. From May 5 to June 30, 2010, all repurchases of ACGL s common shares in connection with the share repurchase plan noted above and other share-based transactions were held in the treasury under the cost method, and the cost of the common shares acquired is included in Common shares held in treasury, at cost. Prior to May 5, 2010, such acquisitions were reflected as a reduction in additional paid-in capital. At June 30, 2010, the Company held 3.2 million shares for an aggregate cost of $237.9 million in treasury, at cost.

Non-Cumulative Preferred Shares

ACGL s outstanding non-cumulative preferred shares consist of $200.0 million principal amount of 8.0% series A non-cumulative preferred shares (Series A Preferred Shares) and $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). 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. During the six month periods ended June 30, 2010 and 2009, the Company paid $12.9 million to holders of the Preferred Shares. At June 30, 2010, the Company had declared an aggregate of $3.3 million of dividends to be paid to holders of the Preferred Shares.

Share-Based Compensation

During the 2010 second quarter, the Company made a stock grant of 288,319 stock appreciation rights and stock options and 298,655 restricted shares and units to certain employees. The stock appreciation rights and stock options were valued at the grant date using the Black-Scholes option pricing model. The weighted average grant-date fair value of the stock appreciation rights and options and restricted shares and units granted during the 2010 second quarter were approximately $22.97 and $75.03 per share, respectively. During the 2009 second quarter, the Company made a stock grant of 367,825 stock appreciation rights and stock options and 361,075 restricted shares and units to certain employees. The weighted average grant-date fair value of the stock

ARCH CAPITAL GROUP LTD. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)

appreciation rights and options and restricted shares and units granted during the 2009 second quarter were approximately $17.64 and $57.63 per share, respectively. Such values are being amortized over the respective substantive vesting period. For awards granted to retirement-eligible employees where no service is required for the employee to retain the award, the grant date fair value is immediately recognized as compensation expense at the grant date because the employee is able to retain the award without continuing to provide service. For employees near retirement eligibility, attribution of compensation cost is over the period from the grant date to the retirement eligibility date.

4. Debt and Financing Arrangements

Senior Notes

On May 4, 2004, ACGL completed a public offering of $300 million principal amount of 7.35% senior notes (Senior Notes) due May 1, 2034 and received net proceeds of $296.4 million. ACGL used $200 million of the net proceeds to repay all amounts outstanding under a revolving credit agreement. The Senior Notes are ACGL s senior unsecured obligations and rank equally with all of its existing and future senior unsecured indebtedness. Interest payments on the Senior Notes are due on May 1st and November 1st of each year. ACGL may redeem the Senior Notes at any time and from time to time, in whole or in part, at a make-whole redemption price. For the six month periods ended June 30, 2010 and 2009, interest expense on the Senior Notes was $11.0 million. The market value of the Senior Notes at June 30, 2010 and December 31, 2009 was $312.4 million and $298.6 million, respectively.

Letter of Credit and Revolving Credit Facilities

As of June 30, 2010, the Company had a $300 million unsecured revolving loan and letter of credit facility and a $1.0 billion secured letter of credit facility (the Credit Agreement). Under the terms of the agreement, Arch Reinsurance Company (Arch Re U.S.) is limited to issuing $100 million of unsecured letters of credit as part of the $300 million unsecured revolving loan. Borrowings of revolving loans may be made by ACGL and Arch Re U.S. at a variable rate based on LIBOR or an alternative base rate at the option of the Company. Secured letters of credit are available for issuance on behalf of the Company s insurance and reinsurance subsidiaries. The Credit Agreement and related documents are structured such that each party that requests a letter of credit or borrowing does so only for itself and for only its own obligations. Issuance of letters of credit and borrowings under the Credit Agreement are subject to the Company s compliance with certain covenants and conditions, including absence of a material adverse change. These covenants require, among other things, that the Company maintain a debt to total capital ratio of not greater than 0.35 to 1 and shareholders equity in excess of $1.95 billion plus 25% of future aggregate net income for each quarterly period (not including any future net losses) beginning after June 30, 2006 and 25% of future aggregate proceeds from the issuance of common or preferred equity and that the Company s principal insurance and reinsurance subsidiaries maintain at least a B++ rating from A.M. Best. In addition, certain of the Company s subsidiaries which are party to the Credit Agreement are required to maintain minimum shareholders equity levels. The Company was in compliance with all covenants contained in the Credit Agreement at June 30, 2010. The Credit Agreement expires on August 30, 2011.

Including the secured letter of credit portion of the Credit Agreement, the Company has access to letter of credit facilities for up to a total of $1.45 billion. Arch Reinsurance Ltd. (Arch Re Bermuda) also has access to other letter of credit facilities, some of which are available on a limited basis and for limited purposes (together with the secured portion of the Credit Agreement and these letter of credit facilities, the LOC Facilities). The principal purpose of the LOC Facilities is to issue, as required, evergreen standby letters of credit in favor of primary insurance or reinsurance counterparties with which the Company has entered into reinsurance arrangements to ensure that such counterparties are permitted to take credit for reinsurance obtained from the

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ARCH CAPITAL GROUP LTD. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)

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 of certain covenants, which the Company was in compliance with at June 30, 2010. At such date, the Company had $721.2 million in outstanding letters of credit under the LOC Facilities, which were secured by investments with a market value of $840.1 million. At June 30, 2010, the Company had $125.0 million of borrowings outstanding under the Credit Agreement at a Company-selected variable interest rate that is based on 1 month, 3 month or 6 month reset option terms and their corresponding term LIBOR rates plus 27.5 basis points.

TALF Program

The Company participates in the Federal Reserve Bank of New York s (FRBNY) Term Asset-Backed Securities Loan Facility (TALF). TALF provides secured financing for asset-backed securities backed by certain types of consumer and small business loans and for legacy commercial mortgage-backed securities. TALF financing is non-recourse to the Company, except in certain limited instances, and is collateralized by the purchased securities and provides financing for the purchase price of the securities, less a haircut that varies based on the type of collateral. The Company can deliver the collateralized securities to a special purpose vehicle created by the FRBNY in full defeasance of the borrowings.

The Company elected to carry the securities and related borrowings at fair value under the fair value option afforded by accounting guidance regarding the fair value option for financial assets and financial liabilities. As of June 30, 2010, the Company had $407.5 million of securities under TALF which are reflected as TALF investments, at market value and $336.2 million of secured financing from the FRBNY which is reflected as TALF borrowings, at market value. As of December 31, 2009, the Company had $250.3 million of securities under TALF which are reflected as TALF investments, at market value and $217.6 million of secured financing from the FRBNY which is reflected as TALF borrowings, at market value. The original maturity dates for the TALF borrowings vary between 2 to 5 years with floating or fixed coupons depending on the related TALF investments.

Interest Paid

During the six months ended June 30, 2010, the Company made interest payments of $15.2 million related to its debt and financing arrangements, compared to $11.5 million for the six months ended June 30, 2009.

ARCH CAPITAL GROUP LTD. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)

5. Segment Information

The Company classifies its businesses into two underwriting segments insurance and reinsurance and corporate and other (non-underwriting). The Company s insurance and reinsurance operating segments each have segment managers who are responsible for the overall profitability of their respective segments and who are directly accountable to the Company s chief operating decision makers, the Chairman, 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 accounting guidance regarding 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. Specialty product lines include: casualty; construction; executive assurance; healthcare; national accounts casualty; professional liability; programs; property, energy, marine and aviation; surety; travel and accident; and other (consisting of excess workers compensation, employers liability, collateral protection and alternative markets business).

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

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

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ARCH CAPITAL GROUP LTD. AND SUBSIDIARIES

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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, summary information regarding net premiums written and earned by major line of business and net premiums written by location:

	Three Months Ended June 30, 2010		
	Insurance	Reinsurance	Total
Gross premiums written (1)	$ 616,353	$ 203,695	$ 817,100
Net premiums written (1)	422,837	201,421	624,258
Net premiums earned (1)	$ 405,473	$ 217,538	$ 623,011
Fee income	874	9	883
Losses and loss adjustment expenses	(275,294)	(87,851)	(363,145)
Acquisition expenses, net	(65,359)	(42,116)	(107,475)
Other operating expenses	(71,727)	(19,303)	(91,030)
Underwriting income (loss)	$ (6,033)	$ 68,277	62,244
Net investment income			90,537
Net realized gains			62,114
Net impairment losses recognized in earnings			(4,410)
Equity in net income of investment funds accounted for using the equity method			(348)
Other income			4,528
Other expenses			(10,503)
Interest expense			(7,916)
Net foreign exchange gains			48,625
Income before income taxes			244,871
Income tax expense			(1,420)
Net income			243,451
Preferred dividends			(6,461)
Net income available to common shareholders			$ 236,990
Underwriting Ratios			
Loss ratio	67.9%	40.4%	58.3%
Acquisition expense ratio (2)	15.9%	19.4%	17.1%
Other operating expense ratio	17.7%	8.9%	14.6%
Combined ratio	101.5%	68.7%	90.0%

(1) Certain amounts included in the gross premiums written of each segment are related to intersegment transactions. Accordingly, the sum of gross premiums written for each segment does not agree to the total gross premiums written as shown in the table above due to the elimination of intersegment transactions in the total. The insurance segment and reinsurance segment results include nil and $2.9 million, respectively, of gross and net premiums written and $0.3 million and $3.2 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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	Three Months Ended June 30, 2009