ARCH CAPITAL GROUP LTD.
Form 10-Q
November 09, 2009
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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 September 30, 2009

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 o 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

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

Class	**Outstanding at October 31, 2009**
Common Shares, $0.01 par value	59,227,128

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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 September 30, 2009, and the related consolidated statements of income for the three-month and nine-month periods ended September 30, 2009 and September 30, 2008, and the consolidated statement of changes in shareholders equity, comprehensive income and cash flows for the nine-month periods ended September 30, 2009 and September 30, 2008. These interim financial statements are the responsibility of the Company s management.

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

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

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

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

New York, New York

November 9, 2009

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ARCH CAPITAL GROUP LTD. AND SUBSIDIARIES

CONSOLIDATED BALANCE SHEETS

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

	(Unaudited) September 30, 2009	December 31, 2008
Assets		
Investments:		
Fixed maturities available for sale, at market value (amortized cost: 2009, $9,020,404; 2008, $8,314,615)	$ 9,265,961	$ 8,122,221
Short-term investments available for sale, at market value (amortized cost: 2009, $696,114; 2008, $478,088)	706,157	479,586
Investment of funds received under securities lending agreements, at market value (amortized cost: 2009, $621,095; 2008, $750,330)	611,496	730,194
TALF investments, at market value	250,517	
Other investments (cost: 2009, $147,468; 2008, $125,858)	154,526	109,601
Investment funds accounted for using the equity method	376,381	301,027
Total investments	11,365,038	9,742,629
Cash	385,149	251,739
Accrued investment income	77,762	78,052
Investment in joint venture (cost: $100,000)	101,473	98,341
Fixed maturities and short-term investments pledged under securities lending agreements, at market value	609,334	728,065
Premiums receivable	697,806	628,951
Unpaid losses and loss adjustment expenses recoverable	1,709,756	1,729,135
Paid losses and loss adjustment expenses recoverable	58,588	63,294
Prepaid reinsurance premiums	283,290	303,707
Deferred acquisition costs, net	303,826	295,192
Receivable for securities sold	998,431	105,073
Other assets	592,701	592,367
Total Assets	$ 17,183,154	$ 14,616,545
Liabilities		
Reserve for losses and loss adjustment expenses	$ 7,879,586	$ 7,666,957
Unearned premiums	1,627,519	1,526,682
Reinsurance balances payable	159,898	138,509
Senior notes	300,000	300,000
Revolving credit agreement borrowings	100,000	100,000
TALF borrowings, at market value	219,843	
Securities lending payable	625,706	753,528
Payable for securities purchased	1,197,411	123,309
Other liabilities	612,369	574,595
Total Liabilities	12,722,332	11,183,580
Commitments and Contingencies		
Shareholders Equity		
Non-cumulative preferred shares ($0.01 par value, 50,000,000 shares authorized, issued: 13,000,000)	130	130
	595	605

Common shares ($0.01 par value, 200,000,000 shares authorized, issued: 2009, 59,524,309; 2008, 60,511,974)				
Additional paid-in capital		917,204		994,585
Retained earnings		3,321,113		2,693,239
Accumulated other comprehensive income (loss), net of deferred income tax		221,780		(255,594)
Total Shareholders Equity		4,460,822		3,432,965
Total Liabilities and Shareholders Equity	$	17,183,154	$	14,616,545

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 September 30,		(Unaudited) Nine Months Ended September 30,	
	2009	**2008**	**2009**	**2008**
Revenues				
Net premiums written	$ 727,308	$ 692,692	$ 2,244,025	$ 2,190,152
Decrease (increase) in unearned premiums	7,077	40,339	(109,818)	(43,212)
Net premiums earned	734,385	733,031	2,134,207	2,146,940
Net investment income	100,213	117,022	296,580	356,335
Net realized gains (losses)	70,638	(23,001)	53,681	23,765
Other-than-temporary impairment losses	(7,860)	(82,533)	(142,663)	(105,993)
Less investment impairments recognized in other comprehensive income, before taxes	3,217		81,023	
Net impairment losses recognized in earnings	(4,643)	(82,533)	(61,640)	(105,993)
Fee income	826	944	2,568	3,250
Equity in net income (loss) of investment funds accounted for using the equity method	69,119	(1,731)	135,428	(4,461)
Other income	5,687	3,067	14,588	12,071
Total revenues	976,225	746,799	2,575,412	2,431,907
Expenses				
Losses and loss adjustment expenses	444,914	548,886	1,244,314	1,357,928
Acquisition expenses	122,739	133,413	373,011	367,278
Other operating expenses	99,743	95,652	286,153	295,417
Interest expense	6,001	6,241	17,425	17,553
Net foreign exchange (gains) losses	19,755	(68,395)	48,208	(45,106)
Total expenses	693,152	715,797	1,969,111	1,993,070
Income before income taxes	283,073	31,002	606,301	438,837
Income tax expense (benefit)	2,205	(1,849)	20,513	11,360
Net income	280,868	32,851	585,788	427,477
Preferred dividends	6,461	6,461	19,383	19,383
Net income available to common shareholders	$ 274,407	$ 26,390	$ 566,405	$ 408,094
Net income per common share				
Basic	$ 4.56	$ 0.44	$ 9.39	$ 6.50
Diluted	$ 4.39	$ 0.42	$ 9.05	$ 6.23
Weighted average common shares and common share equivalents outstanding				
Basic	60,156,219	60,109,932	60,295,144	62,790,514

Diluted	62,533,816	62,830,910	62,590,228	65,530,570

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) Nine Months Ended September 30, 2009	2008
Non-Cumulative Preferred Shares		
Balance at beginning and end of period	$ 130	$ 130
Common Shares		
Balance at beginning of year	605	673
Common shares issued, net	6	3
Purchases of common shares under share repurchase program	(16)	(74)
Balance at end of period	595	602
Additional Paid-in Capital		
Balance at beginning of year	994,585	1,451,667
Common shares issued	2,557	3,511
Exercise of stock options	4,138	13,219
Common shares retired	(104,875)	(515,286)
Amortization of share-based compensation	20,843	24,303
Other	(44)	(355)
Balance at end of period	917,204	977,059
Retained Earnings		
Balance at beginning of year	2,693,239	2,428,117
Cumulative effect of change in accounting principle **(1)**	61,469	
Balance at beginning of year, as adjusted	2,754,708	2,428,117
Dividends declared on preferred shares	(19,383)	(19,383)
Net income	585,788	427,477
Balance at end of period	3,321,113	2,836,211
Accumulated Other Comprehensive Income (Loss)		
Balance at beginning of year	(255,594)	155,224
Cumulative effect of change in accounting principle **(1)**	(61,469)	
Balance at beginning of year, as adjusted	(317,063)	155,224
Change in unrealized appreciation (decline) in value of investments, net of deferred income tax	609,446	(440,254)
Portion of other-than-temporary impairment losses recognized in other comprehensive income, net of deferred income tax	(81,023)	
Foreign currency translation adjustments, net of deferred income tax	10,420	(12,262)
Balance at end of period	221,780	(297,292)
Total Shareholders Equity	$ 4,460,822	$ 3,516,710

(1) Adoption of recent 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) Nine Months Ended September 30, 2009	2008
Comprehensive Income (Loss)		
Net income	$ 585,788	$ 427,477
Other comprehensive income (loss), net of deferred income tax		
Unrealized appreciation (decline) in value of investments:		
Unrealized holding gains (losses) arising during period	583,138	(513,176)
Portion of other-than-temporary impairment losses recognized in other comprehensive income, net of deferred income tax	(81,023)	
Reclassification of net realized losses, net of income taxes, included in net income	26,308	72,922
Foreign currency translation adjustments	10,420	(12,262)
Other comprehensive income (loss)	538,843	(452,516)
Comprehensive Income (Loss)	$ 1,124,631	$ (25,039)

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)

	(Unaudited) Nine Months Ended September 30,	
	2009	**2008**
Operating Activities		
Net income	$ 585,788	$ 427,477
Adjustments to reconcile net income to net cash provided by operating activities:		
Net realized gains	(53,161)	(19,631)
Net impairment losses recognized in earnings	61,640	105,993
Equity in net income of investment funds accounted for using the equity method and other income	(145,219)	(7,345)
Share-based compensation	20,843	24,303
Changes in:		
Reserve for losses and loss adjustment expenses, net of unpaid losses and loss adjustment expenses recoverable	168,615	432,217
Unearned premiums, net of prepaid reinsurance premiums	109,109	33,870
Premiums receivable	(54,585)	(10,865)
Deferred acquisition costs, net	(6,064)	(20,581)
Reinsurance balances payable	17,380	(122,091)
Other liabilities	2,142	50,421
Other items, net	102,176	79,229
Net Cash Provided By Operating Activities	808,664	972,997
Investing Activities		
Purchases of fixed maturity investments	(15,798,216)	(11,186,713)
Proceeds from sales of fixed maturity investments	14,723,846	10,506,784
Proceeds from redemptions and maturities of fixed maturity investments	638,638	444,681
Purchases of TALF investments	(250,231)	
Purchases of other investments	(40,879)	(225,688)
Proceeds from sales of other investments	67,879	235,712
Investment in joint venture		(100,000)
Net purchases of short-term investments	(109,500)	(219,985)
Change in investment of securities lending collateral	127,822	553,396
Purchases of furniture, equipment and other assets	(15,586)	(6,756)
Net Cash Provided By (Used For) Investing Activities	(656,227)	1,431
Financing Activities		
Purchases of common shares under share repurchase program	(99,746)	(513,130)
Proceeds from common shares issued, net	772	11,384
Revolving credit agreement borrowings		100,000
TALF borrowings	219,843	
Change in securities lending collateral	(127,822)	(553,396)
Other	(461)	1,778
Preferred dividends paid	(19,383)	(19,383)
Net Cash Used For Financing Activities	(26,797)	(972,747)
Effects of exchange rate changes on foreign currency cash	7,770	(2,499)

Increase (decrease) in cash		133,410		(818)
Cash beginning of year		251,739		239,915
Cash end of period	$	385,149	$	239,097

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

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

To facilitate period-to-period comparisons, certain amounts in the 2008 consolidated financial statements have been reclassified to conform to the 2009 presentation. Such reclassifications had no effect on the Company s consolidated net income. Additionally, the Company adopted recent accounting guidance regarding the recognition and presentation of other-than-temporary impairments, effective for its interim period ending March 31, 2009. See Note 8, Investment Information Other-Than-Temporary Impairments for further details.

2. Recent Accounting Pronouncements

In September 2009, the FASB issued an Accounting Standards Update (ASU) regarding the estimation of the fair value of investments in certain entities that calculate net asset value per share (or its equivalent). This ASU provides additional guidance on estimating the fair value of certain alternative investments and its provisions create a practical expedient to measure the fair value of an alternative investment on the basis of the net asset value per share of the investment. The ASU also requires additional disclosures about the attributes of alternative investments. The ASU is effective for interim and annual reporting periods ending after December 15, 2009 and, accordingly, the Company will adopt it on January 1, 2010. The Company is currently evaluating the impact that this ASU may have on its financial condition and results of operations.

In August 2009, the FASB issued an ASU to amend the guidance regarding the fair value measurement of liabilities. This ASU provides clarification that in circumstances in which a quoted price in an active market for an identical liability is not available, a reporting entity is required to measure fair value using other valuation techniques, including a technique that uses: (a) the quoted price of the identical liability when traded as an asset; and (b) quoted prices for similar liabilities or similar liabilities when traded as assets. The amendments in this ASU also clarify that when estimating the fair value of a liability, a reporting entity is not required to include a separate input or adjustment to other inputs relating to the existence of a restriction that prevents the transfer of the liability. Lastly, this ASU clarifies that both a quoted price in an active market for the identical liability at the measurement date and the quoted price for the identical liability when traded as an asset in an active market when no adjustments to the quoted price of the asset are required are Level 1 fair value measurements. This

ARCH CAPITAL GROUP LTD. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)

ASU was effective for the Company in the interim period ending September 30, 2009, and the adoption did not have a material impact on the Company s consolidated financial position or results of operations.

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

In June 2009, the FASB issued amendments to the guidance regarding the consolidation of variable interest entities (VIEs), which affect all entities currently within the scope of the December 2003 revised version of the guidance, as well as qualifying special-purpose entities that are currently excluded from the scope of the guidance. The amendments require an analysis to determine whether a variable interest gives a company a controlling financial interest in a VIE. In addition, they require an ongoing reassessment of all VIEs and eliminate the quantitative approach previously required for determining whether a company is the primary beneficiary. The amendments are effective for fiscal years beginning after November 15, 2009. Accordingly, the Company will adopt them on January 1, 2010. The Company is currently evaluating the impact that these amendments may have on its financial condition and results of operations.

In June 2009, the FASB issued an amendment to the guidance regarding accounting for transfers of financial assets. This amendment removes the concept of a qualifying special-purpose entity from the guidance regarding the accounting for transfers and servicing of financial assets and extinguishment of liabilities, and removes the exception from applying to the consolidation of VIEs. This amendment also clarifies the requirements for isolation and limitations on portions of financial assets that are eligible for sale accounting and enhances disclosures about transfers of financial assets and a transferor s continuing involvement with transferred financial assets. This amendment is effective prospectively to transfers of financial assets occurring in fiscal years beginning after November 15, 2009. Accordingly, the Company will adopt this amendment on January 1, 2010. The Company is currently evaluating the impact that this amendment may have on its financial condition and results of operations.

In May 2009, the FASB issued guidance regarding subsequent events, which establishes general standards for accounting for and disclosure of events that occur after the balance sheet date but before the financial statements are issued or are available to be issued. The guidance requires the disclosure of the date through which an entity has evaluated subsequent events and the basis for that date, whether that date represents the date the financial statements were issued or were available to be issued. This guidance was effective with interim and annual financial periods ending after June 15, 2009, and the adoption did not impact the Company s consolidated financial position or results of operations. See Note 16, Subsequent Events.

In April 2009, the FASB issued guidance regarding the recognition and presentation of other-than-temporary impairments, which requires entities to separate an other-than-temporary impairment of a debt security into two components when there are credit related losses associated with the impaired debt security for which the Company asserts that it does not have the intent to sell the security, and it is more likely than not that it will not be required to sell the security before recovery of its cost basis. The amount of the other-than-temporary impairment related to a

credit loss is recognized in earnings, and the amount of the other-than-temporary impairment related to other factors (e.g., interest rates, market conditions, etc.) is recorded as a component of other comprehensive income (loss). This guidance was effective for periods ending after June 15, 2009, with early adoption permitted for periods ending after March 15, 2009. The Company elected to adopt this guidance effective for its interim period ending March 31, 2009. See Note 8, Investment Information Other-Than-Temporary Impairments.

ARCH CAPITAL GROUP LTD. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)

In April 2009, the FASB issued guidance regarding the determination of fair value when the volume and level of activity for the asset or liability have significantly decreased and the identification of transactions that are not orderly. This guidance also amended guidance regarding fair value measurements to expand certain disclosure requirements. This guidance was effective for periods ending after June 15, 2009, with early adoption permitted for periods ending after March 15, 2009. The Company elected to adopt this guidance effective for its interim period ending March 31, 2009, and its adoption did not have a material impact on the Company s consolidated financial condition or results of operations. See Note 8, Investment Information Fair Value.

In April 2009, the FASB issued guidance regarding the interim disclosures about fair value of financial instruments, which requires disclosures about fair value of financial instruments in interim and annual financial statements. This guidance was effective for periods ending after June 15, 2009, with early adoption permitted for periods ending after March 15, 2009. The Company elected to adopt this guidance effective for its interim period ending March 31, 2009, and has included the required disclosures in its notes to consolidated financial statements where applicable.

3. Share Transactions

Share Repurchases

The board of directors of ACGL has authorized the investment of up to $1.5 billion in ACGL s common shares through a share repurchase program. Repurchases under the program may be effected from time to time in open market or privately negotiated transactions through February 2010. During the third quarter, ACGL repurchased 1.5 million common shares for an aggregate purchase price of $98.2 million and for the nine months ended September 30, 2009, repurchased 1.6 million common shares for an aggregate purchase price of $99.7 million of common shares through the share repurchase program, respectively. Since the inception of the share repurchase program through September 30, 2009, ACGL has repurchased 16.8 million common shares for an aggregate purchase price of $1.15 billion. As a result of the share repurchase transactions to date, weighted average shares outstanding for the 2009 third quarter and nine months ended September 30, 2009 were reduced by 15.7 million and 15.4 million shares, respectively. Weighted average shares outstanding for the 2008 third quarter and nine months ended September 30, 2008 were reduced by 14.9 million and 12.1 million shares, respectively.

At September 30, 2009, $350.1 million of repurchases were available under the share repurchase program. The timing and amount of the repurchase transactions under this program will depend on a variety of factors, including market conditions and corporate and regulatory considerations. In connection with the share repurchase program, the Warburg Pincus funds waived their rights relating to share repurchases under its shareholders agreement with ACGL for all repurchases of common shares by ACGL under the share repurchase program in open market transactions and certain privately negotiated transactions.

Non-Cumulative Preferred Shares

During 2006, ACGL completed two public offerings of non-cumulative preferred shares. On February 1, 2006, $200.0 million principal amount of 8.0% series A non-cumulative preferred shares (Series A Preferred Shares) were issued with net proceeds of $193.5 million and, on May 24, 2006, $125.0 million principal amount of 7.875% series B non-cumulative preferred shares (Series B Preferred Shares and together with the Series A Preferred Shares, the Preferred Shares) were issued with net proceeds of $120.9 million. The net proceeds of the offerings were used to support the underwriting activities of ACGL s insurance and reinsurance subsidiaries. ACGL has the right to redeem all or a portion of each series of Preferred Shares at a redemption price of $25.00 per share on or after (1) February 1, 2011 for the Series A Preferred Shares and (2) May 15, 2011 for the Series B Preferred Shares. Dividends on the Preferred Shares are non-cumulative. Consequently, in the event dividends are not declared on the Preferred Shares for any dividend period, holders of Preferred Shares will not be entitled to receive a dividend for such period, and such undeclared dividend will not accrue and will

ARCH CAPITAL GROUP LTD. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)

not be payable. Holders of Preferred Shares will be entitled to receive dividend payments only when, as and if declared by ACGL s board of directors or a duly authorized committee of the board of directors. Any such dividends will be payable from the date of original issue on a non-cumulative basis, quarterly in arrears. To the extent declared, these dividends will accumulate, with respect to each dividend period, in an amount per share equal to 8.0% of the $25.00 liquidation preference per annum for the Series A Preferred Shares and 7.875% of the $25.00 liquidation preference per annum for the Series B Preferred Shares. During the nine month periods ended September 30, 2009 and 2008, the Company paid $19.4 million to holders of the Preferred Shares. At September 30, 2009, the Company had declared an aggregate of $3.3 million of dividends to be paid to holders of the Preferred Shares.

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 nine month periods ended September 30, 2009 and 2008, interest expense on the Senior Notes was $16.6 million. The market value of the Senior Notes at September 30, 2009 and December 31, 2008 was $282.5 million and $246.1 million, respectively.

Letter of Credit and Revolving Credit Facilities

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

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

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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 September 30, 2009. At such date, the Company had $712.1 million in outstanding letters of credit under the LOC Facilities, which were secured by investments with a market value of $848.1 million. In May 2008, the Company borrowed $100.0 million under the Credit Agreement at a Company-selected variable interest rate that is based on 1 month, 3 month or 6 month reset option terms and their corresponding term LIBOR rates plus 27.5 basis points. The proceeds from such borrowings, which are repayable in August 2011, were contributed as additional share capital to Arch Reinsurance Ltd. (Arch Re Bermuda) and used to fund the investment in Gulf Re. See Note 7, Investment in Joint Venture, for additional information.

Term Asset-Backed Securities Loan Facility Program

During the 2009 third quarter, the Company purchased asset-backed and commercial mortgage-backed securities under 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 September 30, 2009, the Company had $250.5 million of securities under TALF which are reflected as TALF investments, at market value and $219.8 million of secured financing from the FRBNY which is reflected as TALF borrowings, at market value. The maturity dates for the TALF borrowings vary between 3 to 5 years with floating or fixed coupons depending on the related TALF investments. See Note 8, Investment Information TALF Program, for additional information.

Interest Paid

During the nine month periods ended September 30, 2009 and 2008, the Company made interest payments of $12.0 million related to its debt and financing arrangements.

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5. Segment Information

The Company classifies its businesses into two underwriting segments insurance and reinsurance and corporate and other (non-underwriting). The Company s insurance and reinsurance operating segments each have segment managers who are responsible for the overall profitability of their respective segments and who are directly accountable to the Company s chief operating decision makers, the President and Chief Executive Officer of ACGL and the Chief Financial Officer of ACGL. The chief operating decision makers do not assess performance, measure return on equity or make resource allocation decisions on a line of business basis. The Company determined its reportable operating segments using the management approach described in 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. The insurance segment consists of eleven specialty product lines: casualty; construction; executive assurance; healthcare; national accounts casualty; professional liability; programs; property, energy marine and aviation; surety; travel and accident; and other (consisting of excess workers compensation, employers liability and collateral protection business).

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

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

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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:

(U.S. dollars in thousands)	Insurance	Three Months Ended September 30, 2009 Reinsurance	Total
Gross premiums written **(1)**	$ 673,986	$ 266,193	$ 937,328
Net premiums written **(1)**	473,676	253,632	727,308
Net premiums earned **(1)**	$ 443,319	$ 291,066	$ 734,385
Fee income	814	12	826
Losses and loss adjustment expenses	(303,304)	(141,610)	(444,914)
Acquisition expenses, net	(60,964)	(61,775)	(122,739)
Other operating expenses	(72,452)	(21,271)	(93,723)
Underwriting income	$ 7,413	$ 66,422	73,835
Net investment income			100,213
Net realized gains			70,638
Net impairment losses recognized in earnings			(4,643)
Equity in net income of investment funds accounted for using the equity method			69,119
Other income			5,687
Other expenses			(6,020)
Interest expense			(6,001)
Net foreign exchange losses			(19,755)
Income before income taxes			283,073
Income tax expense			(2,205)
Net income			280,868
Preferred dividends			(6,461)
Net income available to common shareholders			$ 274,407
Underwriting Ratios			
Loss ratio	68.4%	48.7%	60.6%
Acquisition expense ratio **(2)**	13.6%	21.2%	16.6%
Other operating expense ratio	16.3%	7.3%	12.8%
Combined ratio	98.3%	77.2%	90.0%

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(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 $2.8 million, respectively, of gross and net premiums written and $0.4 million and $3.0 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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(U.S. dollars in thousands)	Insurance	Three Months Ended September 30, 2008 Reinsurance	Total
Gross premiums written **(1)**	$ 678,338	$ 228,593	$ 903,533
Net premiums written **(1)**	466,115	226,577	692,692
Net premiums earned **(1)**	$ 441,049	$ 291,982	$ 733,031
Fee income	872	72	944
Losses and loss adjustment expenses	(337,456)	(211,430)	(548,886)
Acquisition expenses, net	(62,752)	(70,661)	(133,413)
Other operating expenses	(71,861)	(18,331)	(90,192)
Underwriting loss	$ (30,148)	$ (8,368)	(38,516)
Net investment income			117,022
Net realized losses			(23,001)
Net impairment losses recognized in earnings			(82,533)
Equity in net income (loss) of investment funds accounted for using the equity method			(1,731)
Other income			3,067
Other expenses			(5,460)
Interest expense			(6,241)
Net foreign exchange gains			68,395
Income before income taxes			31,002
Income tax benefit			1,849
Net income			32,851
Preferred dividends			(6,461)
Net income available to common shareholders			$ 26,390
Underwriting Ratios			
Loss ratio	76.5%	72.4%	74.9%
Acquisition expense ratio **(2)**	14.0%	24.2%	18.1%
Other operating expense ratio	16.3%	6.3%	12.3%
Combined ratio	106.8%	102.9%	105.3%

(1) Certain amounts included in the gross premiums written of each segment are related to intersegment transactions. Accordingly, the sum of gross premiums written for each segment does not agree to the total gross premiums written as shown in the table above due to the elimination of intersegment transactions in the total. The insurance segment and reinsurance segment results include nil and $3.4 million, respectively, of gross and net premiums written and nil and $7.2 million, respectively, of net premiums earned assumed through intersegment transactions.

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

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(U.S. dollars in thousands)	**Nine Months Ended September 30, 2009**		
	Insurance	**Reinsurance**	**Total**
Gross premiums written **(1)**	$ 1,949,040	$ 934,711	$ 2,874,219
Net premiums written **(1)**	1,334,580	909,445	2,244,025
Net premiums earned **(1)**	$ 1,261,870	$ 872,337	$ 2,134,207
Fee income	2,479	89	2,568
Losses and loss adjustment expenses	(860,669)	(383,645)	(1,244,314)
Acquisition expenses, net	(177,335)	(195,676)	(373,011)
Other operating expenses	(206,196)	(56,406)	(262,602)
Underwriting income	$ 20,149	$ 236,699	256,848
Net investment income			296,580
Net realized gains			53,681
Net impairment losses recognized in earnings			(61,640)
Equity in net income of investment funds accounted for using the equity method			135,428
Other income			14,588
Other expenses			(23,551)
Interest expense			(17,425)
Net foreign exchange losses			(48,208)
Income before income taxes			606,301
Income tax expense			(20,513)
Net income			585,788
Preferred dividends			(19,383)
Net income available to common shareholders			$ 566,405
Underwriting Ratios			
Loss ratio	68.2%	44.0%	58.3%
Acquisition expense ratio **(2)**	13.9%	22.4%	17.4%
Other operating expense ratio	16.3%	6.5%	12.3%
Combined ratio	98.4%	72.9%	88.0%

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(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 $9.4 million, respectively, of gross and net premiums written and $1.3 million and $11.3 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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		Nine Months Ended September 30, 2008	
(U.S. dollars in thousands)	**Insurance**	**Reinsurance**	**Total**
Gross premiums written **(1)**	$ 1,926,349	$ 935,738	$ 2,843,611
Net premiums written **(1)**	1,290,380	899,772	2,190,152
Net premiums earned **(1)**	$ 1,276,734	$ 870,206	$ 2,146,940
Fee income	2,634	616	3,250
Losses and loss adjustment expenses	(887,392)	(470,536)	(1,357,928)
Acquisition expenses, net	(170,041)	(197,237)	(367,278)
Other operating expenses	(217,064)	(56,660)	(273,724)
Underwriting income	$ 4,871	$ 146,389	151,260
Net investment income			356,335
Net realized gains			23,765
Net impairment losses recognized in earnings			(105,993)
Equity in net income (loss) of investment funds accounted for using the equity method			(4,461)
Other income			12,071
Other expenses			(21,693)
Interest expense			(17,553)
Net foreign exchange gains			45,106
Income before income taxes			438,837
Income tax expense			(11,360)
Net income			427,477
Preferred dividends			(19,383)
Net income available to common shareholders			$ 408,094
Underwriting Ratios			
Loss ratio	69.5%	54.1%	63.2%
Acquisition expense ratio **(2)**	13.1%	22.7%	17.0%
Other operating expense ratio	17.0%	6.5%	12.7%
Combined ratio	99.6%	83.3%	92.9%

(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 $0.1 million and $18.4 million, respectively, of gross and net premiums written and $0.2 million and $24.4 million, respectively, of net premiums earned assumed through intersegment transactions.

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

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

INSURANCE SEGMENT (U.S. dollars in thousands)	Three Months Ended September 30, 2009 Amount	2009 % of Total	2008 Amount	2008 % of Total
Net premiums written (1)				
Property, energy, marine and aviation	$ 118,536	25.0	$ 91,461	19.6
Programs	66,964	14.1	78,045	16.7
Professional liability	66,002	13.9	70,778	15.2
Executive assurance	58,529	12.4	53,665	11.5
Construction	36,823	7.8	43,916	9.4
National accounts casualty	30,726	6.5	16,609	3.6
Casualty	26,753	5.6	28,456	6.1
Travel and accident	15,998	3.4	16,949	3.6
Surety	12,025	2.5	16,599	3.6
Healthcare	10,854	2.3	11,411	2.4
Other **(2)**	30,466	6.5	38,226	8.3
Total	$ 473,676	100.0	$ 466,115	100.0
Net premiums earned (1)				
Property, energy, marine and aviation	$ 94,471	21.3	$ 88,903	20.2
Programs	69,436	15.7	71,576	16.2
Professional liability	57,540	13.0	62,987	14.3
Executive assurance	56,094	12.7	47,237	10.7
Construction	42,495	9.6	45,601	10.3
National accounts casualty	19,969	4.5	13,503	3.1
Casualty	30,004	6.8	37,351	8.5
Travel and accident	18,193	4.1	17,671	4.0
Surety	12,239	2.8	13,891	3.1
Healthcare	12,303	2.8	12,292	2.8
Other **(2)**	30,575	6.7	30,037	6.8
Total	$ 443,319	100.0	$ 441,049	100.0
Net premiums written by client location (1)				
United States	$ 342,112	72.2	$ 348,306	74.7
Europe	68,109	14.4	57,155	12.3
Other	63,455	13.4	60,654	13.0
Total	$ 473,676	100.0	$ 466,115	100.0
Net premiums written by underwriting location (1)				
United States	$ 336,552	71.1	$ 354,002	75.9
Europe	117,900	24.9	97,548	20.9
Other	19,224	4.0	14,565	3.2
Total	$ 473,676	100.0	$ 466,115	100.0

(1) Insurance segment results include premiums written and earned assumed through intersegment transactions of nil and $0.4 million, respectively, for the 2009 third quarter and premiums written and earned of nil for the 2008 third quarter. Insurance segment results exclude premiums written and earned ceded through intersegment transactions of $2.8 million and $3.0 million, respectively, for the 2009 third quarter and $3.4 million and $7.2 million, respectively, for the 2008 third quarter.

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

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INSURANCE SEGMENT (U.S. dollars in thousands)	Nine Months Ended September 30, 2009 Amount	2009 % of Total	2008 Amount	2008 % of Total
Net premiums written (1)				
Property, energy, marine and aviation	$ 310,950	23.3	$ 278,372	21.6
Programs	214,050	16.0	205,830	16.0
Professional liability	175,783	13.2	188,442	14.6
Executive assurance	161,527	12.1	139,574	10.8
Construction	129,584	9.7	133,501	10.3
Casualty	80,509	6.0	88,160	6.8
National accounts casualty	62,535	4.7	39,080	3.0
Travel and accident	53,089	4.0	49,550	3.8
Surety	32,637	2.4	37,672	2.9
Healthcare	31,740	2.4	33,435	2.6
Other **(2)**	82,176	6.2	96,764	7.6
Total	$ 1,334,580	100.0	$ 1,290,380	100.0
Net premiums earned (1)				
Property, energy, marine and aviation	$ 246,881	19.6	$ 257,191	20.1
Programs	207,914	16.5	190,648	14.9
Professional liability	172,323	13.7	197,997	15.5
Executive assurance	156,198	12.4	136,141	10.7
Construction	126,279	10.0	127,543	10.0
Casualty	93,948	7.4	117,949	9.2
National accounts casualty	47,487	3.8	31,178	2.4
Travel and accident	49,547	3.9	49,150	3.8
Surety	37,771	3.0	39,447	3.1
Healthcare	34,061	2.7	38,874	3.0
Other **(2)**	89,461	7.0	90,616	7.3
Total	$ 1,261,870	100.0	$ 1,276,734	100.0
Net premiums written by client location (1)				
United States	$ 998,531	74.8	$ 957,715	74.2
Europe	208,631	15.6	200,112	15.5
Other	127,418	9.6	132,553	10.3
Total	$ 1,334,580	100.0	$ 1,290,380	100.0
Net premiums written by underwriting location (1)				
United States	$ 972,847	72.9	$ 959,440	74.4
Europe	301,518	22.6	279,413	21.7
Other	60,215	4.5	51,527	3.9
Total	$ 1,334,580	100.0	$ 1,290,380	100.0

(1) Insurance segment results include premiums written and earned assumed through intersegment transactions of $0.1 million and $1.3 million, respectively, for the 2009 period and premiums written and earned of $0.1 million and $0.2 million, respectively, for the 2008 period. Insurance segment results exclude premiums written and earned ceded through intersegment transactions of $9.4 million and $11.3 million,

respectively, for the 2009 period and $18.4 million and $24.4 million, respectively, for the 2008 period.

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

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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:

	Three Months Ended September 30,			
	2009		2008	
REINSURANCE SEGMENT (U.S. dollars in thousands)	**Amount**	**% of Total**	**Amount**	**% of Total**
Net premiums written (1)				
Property excluding property catastrophe **(2)**	$ 90,845	35.8	$ 56,105	24.8
Casualty **(3)**	85,084	33.5	82,497	36.4
Property catastrophe	50,539	19.9	44,591	19.7
Marine and aviation	16,187	6.4	18,727	8.3
Other specialty	10,595	4.2	24,013	10.6
Other	382	0.2	644	0.2
Total	$ 253,632	100.0	$ 226,577	100.0
Net premiums earned (1)				
Property excluding property catastrophe **(2)**	$ 94,837	32.6	$ 68,670	23.5
Casualty **(3)**	88,721	30.5	106,146	36.4
Property catastrophe	61,772	21.2	57,015	19.5
Marine and aviation	21,666	7.4	22,395	7.7
Other specialty	23,251	8.0	36,388	12.5
Other	819	0.3	1,368	0.4
Total	$ 291,066	100.0	$ 291,982	100.0
Net premiums written (1)				
Pro rata	$ 147,132	58.0	$ 149,023	65.8
Excess of loss	106,500	42.0	77,554	34.2
Total	$ 253,632	100.0	$ 226,577	100.0
Net premiums earned (1)				
Pro rata	$ 170,571	58.6	$ 187,656	64.3
Excess of loss	120,495	41.4	104,326	35.7
Total	$ 291,066	100.0	$ 291,982	100.0
Net premiums written by client location (1)				
United States	$ 174,932	69.0	$ 125,650	55.5
Europe	30,291	11.9	52,841	23.3
Bermuda	30,209	11.9	34,354	15.2
Other	18,200	7.2	13,732	6.0
Total	$ 253,632	100.0	$ 226,577	100.0
Net premiums written by underwriting location (1)				
Bermuda	$ 140,448	55.4	$ 131,777	58.2
United States	106,305	41.9	86,671	38.3
Other	6,879	2.7	8,129	3.5

Total	$	253,632	100.0	$	226,577	100.0

(1) Reinsurance segment results include premiums written and earned assumed through intersegment transactions of $2.8 million and $3.0 million, respectively, for the 2009 third quarter and $3.4 million and $7.2 million, respectively, for the 2008 third quarter. Reinsurance segment results exclude premiums written and earned ceded through intersegment transactions of nil and $0.4 million, respectively, for the 2009 third quarter and premiums written and earned of nil for the 2008 third quarter.

(2) Includes facultative business.

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

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	Nine Months Ended September 30,			
	2009		2008	
REINSURANCE SEGMENT (U.S. dollars in thousands)	**Amount**	**% of Total**	**Amount**	**% of Total**
Net premiums written (1)				
Property excluding property catastrophe **(2)**	$ 300,502	33.0	$ 237,775	26.4
Casualty **(3)**	257,006	28.3	275,458	30.6
Property catastrophe	234,423	25.8	203,612	22.6
Marine and aviation	60,101	6.6	58,866	6.5
Other specialty	54,611	6.0	120,386	13.4
Other	2,802	0.3	3,675	0.5
Total	$ 909,445	100.0	$ 899,772	100.0
Net premiums earned (1)				
Property excluding property catastrophe **(2)**	$ 278,372	31.9	$ 199,456	22.9
Casualty **(3)**	258,745	29.7	319,993	36.8
Property catastrophe	179,136	20.5	158,792	18.2
Marine and aviation	71,559	8.2	76,772	8.8
Other specialty	82,613	9.5	110,930	12.7
Other	1,912	0.2	4,263	0.6
Total	$ 872,337	100.0	$ 870,206	100.0
Net premiums written (1)				
Pro rata	$ 469,293	51.6	$ 532,467	59.2
Excess of loss	440,152	48.4	367,305	40.8
Total	$ 909,445	100.0	$ 899,772	100.0
Net premiums earned (1)				
Pro rata	$ 540,754	62.0	$ 574,802	66.1
Excess of loss	331,583	38.0	295,404	33.9
Total	$ 872,337	100.0	$ 870,206	100.0
Net premiums written by client location (1)				
United States	$ 598,090	65.8	$ 495,935	55.1
Europe	171,574	18.9	255,133	28.4
Bermuda	100,441	11.0	109,198	12.1
Other	39,340	4.3	39,506	4.4
Total	$ 909,445	100.0	$ 899,772	100.0
Net premiums written by underwriting location (1)				
Bermuda	$ 520,940	57.3	$ 512,581	57.0
United States	331,650	36.5	333,780	37.1
Other	56,855	6.2	53,411	5.9
Total	$ 909,445	100.0	$ 899,772	100.0

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(1) Reinsurance segment results include premiums written and earned assumed through intersegment transactions of $9.4 million and $11.3 million, respectively, for the 2009 period and $18.4 million and $24.4 million, respectively, for the 2008 period. Reinsurance segment results

exclude premiums written and earned ceded through intersegment transactions of $0.1 million and $1.3 million, respectively, for the 2009 period and premiums written and earned of $0.1 million and $0.2 million, respectively, for the 2008 period.

(2) Includes facultative business.

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

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6. Reinsurance

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

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

(U.S. dollars in thousands)	Three Months Ended September 30, 2009	Three Months Ended September 30, 2008	Nine Months Ended September 30, 2009	Nine Months Ended September 30, 2008
Premiums Written				
Direct	$ 650,072	$ 635,063	$ 1,894,121	$ 1,833,555
Assumed	287,256	268,470	980,098	1,010,056
Ceded	(210,020)	(210,841)	(630,194)	(653,459)
Net	$ 727,308	$ 692,692	$ 2,244,025	$ 2,190,152
Premiums Earned				
Direct	$ 632,673	$ 625,343	$ 1,828,103	$ 1,871,373
Assumed	320,913	349,500	961,604	1,069,576
Ceded	(219,201)	(241,812)	(655,500)	(794,009)
Net	$ 734,385	$ 733,031	$ 2,134,207	$ 2,146,940
Losses and Loss Adjustment Expenses				
Direct	$ 368,515	$ 449,267	$ 1,119,934	$ 1,225,918
Assumed	141,349	293,622	415,076	620,970
Ceded	(64,950)	(194,003)	(290,696)	(488,960)
Net	$ 444,914	$ 548,886	$ 1,244,314	$ 1,357,928

The Company monitors the financial condition of its reinsurers and attempts to place coverages only with substantial, financially sound carriers. At September 30, 2009, approximately 89.8% of the Company s reinsurance recoverables on paid and unpaid losses (not including prepaid reinsurance premiums) of $1.77 billion were due from carriers which had an A.M. Best rating of A- or better and the largest reinsurance recoverables from any one carrier was less than 5.7% of the Company s total shareholders equity. At December 31, 2008, approximately 88.5% of the Company s reinsurance recoverables on paid and unpaid losses (not including prepaid reinsurance premiums) of $1.79 billion were due from carriers which had an A.M. Best rating of A- or better and the largest reinsurance recoverables from any one carrier was less than 7.3% of

the Company s total shareholders equity.

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On December 29, 2005, Arch Re Bermuda entered into a quota share reinsurance treaty with Flatiron Re Ltd. (Flatiron), a Bermuda reinsurance company, pursuant to which Flatiron assumed a 45% quota share (the Treaty) of certain lines of property and marine business underwritten by Arch Re Bermuda for unaffiliated third parties for the 2006 and 2007 underwriting years (January 1, 2006 to December 31, 2007). Effective June 28, 2006, the parties amended the Treaty to increase the percentage ceded to Flatiron from 45% to 70% of all covered business bound by Arch Re Bermuda from (and including) June 28, 2006 until (and including) August 15, 2006 provided such business did not incept beyond September 30, 2006. The ceding percentage for all business bound outside of this period continued to be 45%. On December 31, 2007, the Treaty expired by its terms. At September 30, 2009, $0.3 million of premiums ceded to Flatiron were unearned.

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

Arch Re Bermuda pays to Flatiron a reinsurance premium in the amount of the ceded percentage of the original gross written premium on the business reinsured less a ceding commission, which includes a reimbursement of direct acquisition expenses as well as a commission to Arch Re Bermuda for generating the business. The Treaty also provides for a profit commission to Arch Re Bermuda based on the underwriting results for the 2006 and 2007 underwriting years on a cumulative basis. For the 2009 third quarter, a de minimis amount of premiums written, $2.0 million of premiums earned and a reduction of $8.0 million of losses and loss adjustment expenses were ceded to Flatiron by Arch Re Bermuda, compared to a de minimis amount of premiums written, $26.1 million of premiums earned and $14.6 million of losses and loss adjustment expenses for the 2008 third quarter. For the nine months ended September 30, 2009, $4.5 million of premiums written, $22.4 million of premiums earned and a reduction of $5.9 million of losses and loss adjustment expenses were ceded to Flatiron by Arch Re Bermuda, compared to $21.1 million of premiums written, $130.8 million of premiums earned and $42.1 million of losses and loss adjustment expenses for the 2008 period. Reinsurance recoverables from Flatiron, which is not rated by A.M. Best, were $113.3 million at September 30, 2009, compared to $148.7 million at December 31, 2008. As noted above, Flatiron is required to contribute funds into a trust for the benefit of Arch Re Bermuda. The recoverable from Flatiron was fully collateralized through such trust at September 30, 2009 and December 31, 2008.

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7. Investment in Joint Venture

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

8. Investment Information

The following table summarizes the Company s invested assets:

(U.S. dollars in thousands)	September 30, 2009	December 31, 2008
Fixed maturities available for sale, at market value	$ 9,265,961	$ 8,122,221
Fixed maturities pledged under securities lending agreements, at market value **(1)**	609,334	626,501
Total fixed maturities	9,875,295	8,748,722
Short-term investments available for sale, at market value	706,157	479,586
Short-term investments pledged under securities lending agreements, at market value **(1)**		101,564
TALF investments, at market value	250,517	
Other investments	154,526	109,601
Investment funds accounted for using the equity method	376,381	301,027
Total investments **(1)**	11,362,876	9,740,500
Securities transactions entered into but not settled at the balance sheet date	(198,980)	(18,236)
Total investments, net of securities transactions	$ 11,163,896	$ 9,722,264

(1) In securities lending transactions, the Company receives collateral in excess of the market value of the fixed maturities and short-term investments pledged under securities lending agreements. For purposes of this table, the Company has excluded the collateral received at September 30, 2009 and December 31, 2008 of $611.5 million and $730.2 million, respectively, which is reflected as investment of funds received under securities lending agreements, at market value and included the $609.3 million and $728.1 million, respectively, of fixed maturities and short-term investments pledged under securities lending agreements, at market 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 summarizes the Company s fixed maturities and fixed maturities pledged under securities lending agreements, excluding TALF investments:

(U.S. dollars in thousands)	Estimated Market Value	Gross Unrealized Gains	Gross Unrealized Losses	Amortized Cost	OTTI Unrealized Losses (1)
September 30, 2009:					
Corporate bonds	$ 3,099,701	$ 142,953	$ (15,445)	$ 2,972,193	$ (21,736)
Mortgage backed securities	1,708,414	25,898	(60,721)	1,743,237	(45,577)
U.S. government and government agencies	1,480,190	24,338	(2,995)	1,458,847	(504)
Commercial mortgage backed securities	1,170,712	35,284	(10,946)	1,146,374	(3,750)
Non-U.S. government securities	1,008,082	54,444	(4,936)	958,574	(351)
Municipal bonds	910,903	55,911	(4)	854,996	(145)
Asset backed securities	497,293	22,763	(13,607)	488,137	(10,507)
Total	$ 9,875,295	$ 361,591	$ (108,654)	$ 9,622,358	$ (82,570)
December 31, 2008:					
Corporate bonds	$ 2,019,373	$ 51,131	$ (98,979)	$ 2,067,221	
Mortgage backed securities	1,581,736	23,306	(125,759)	1,684,189	
U.S. government and government agencies	1,463,897	77,762	(14,159)	1,400,294	
Commercial mortgage backed securities	1,219,737	16,128	(68,212)	1,271,821	
Non-U.S. government securities	527,972	33,690	(31,884)	526,166	
Municipal bonds	965,966	26,815	(1,730)	940,881	
Asset backed securities	970,041	1,121	(70,762)	1,039,682	
Total	$ 8,748,722	$ 229,953	$ (411,485)	$ 8,930,254	

(1) Represents the total other-than-temporary impairments (OTTI) recognized in accumulated other comprehensive income (AOCI). See discussion below regarding the adoption of recent accounting guidance regarding the recognition and presentation of OTTI.

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

(U.S. dollars in thousands)	September 30, 2009		December 31, 2008	
Maturity	Estimated Market Value	Amortized Cost	Estimated Market Value	Amortized Cost

Due in one year or less	$ 254,101	$ 245,206	$ 173,168	$ 169,187
Due after one year through five years	3,811,264	3,679,281	2,451,062	2,452,344
Due after five years through 10 years	2,011,029	1,917,794	1,726,742	1,686,575
Due after 10 years	422,482	402,329	626,236	626,456
	6,498,876	6,244,610	4,977,208	4,934,562
Mortgage backed securities	1,708,414	1,743,237	1,581,736	1,684,189
Commercial mortgage backed securities	1,170,712	1,146,374	1,219,737	1,271,821
Asset backed securities	497,293	488,137	970,041	1,039,682
Total	$ 9,875,295	$ 9,622,358	$ 8,748,722	$ 8,930,254

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

(U.S. dollars in thousands)	Less than 12 Months Estimated Market Value	Less than 12 Months Gross Unrealized Losses	12 Months or More Estimated Market Value	12 Months or More Gross Unrealized Losses	Total Estimated Market Value	Total Gross Unrealized Losses
September 30, 2009:						
Corporate bonds	$ 250,304	$ (9,001)	$ 85,422	$ (6,444)	$ 335,726	$ (15,445)
Mortgage backed securities	409,727	(40,241)	92,937	(20,480)	502,664	(60,721)
U.S. government and government agencies	118,206	(2,995)			118,206	(2,995)
Commercial mortgage backed securities	114,223	(3,223)	114,321	(7,723)	228,544	(10,946)
Non-U.S. government securities	81,103	(4,936)			81,103	(4,936)
Municipal bonds	3,010	(4)			3,010	(4)
Asset backed securities	9,251	(10,341)	24,053	(3,266)	33,304	(13,607)
Total	985,824	(70,741)	316,733	(37,913)	1,302,557	(108,654)
Other investments	2,992	(206)	28,662	(6,271)	31,654	(6,477)
Short-term investments	10,655	(217)			10,655	(217)
Total	$ 999,471	$ (71,164)	$ 345,395	$ (44,184)	$ 1,344,866	$ (115,348)
December 31, 2008:						
Corporate bonds	$ 870,093	$ (89,446)	$ 30,608	$ (9,533)	$ 900,701	$ (98,979)
Mortgage backed securities	417,373	(105,154)	23,295	(20,605)	440,668	(125,759)
U.S. government and government agencies	356,719	(14,159)			356,719	(14,159)
Commercial mortgage backed securities	714,497	(68,210)	52	(2)	714,549	(68,212)
Non-U.S. government securities	223,314	(31,882)	142	(2)	223,456	(31,884)
Municipal bonds	93,072	(1,730)			93,072	(1,730)
Asset backed securities	888,908	(63,845)	26,185	(6,917)	915,093	(70,762)
Total	3,563,976	(374,426)	80,282	(37,059)	3,644,258	(411,485)
Other investments	20,510	(3,649)	13,715	(20,919)	34,225	(24,568)
Short-term investments	33,080	(2,535)			33,080	(2,535)
Total	$ 3,617,566	$ (380,610)	$ 93,997	$ (57,978)	$ 3,711,563	$ (438,588)

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Other-Than-Temporary Impairments

Adoption of Recent Accounting Guidance

In April 2009, the FASB issued guidance regarding the recognition and presentation of other-than-temporary impairments, which requires entities to separate an other-than-temporary impairment (OTTI) of a debt security into two components when there are credit related losses associated with the impaired debt security for which the Company asserts that it does not have the intent to sell the security, and it is more likely than not that it will not be required to sell the security before recovery of its cost basis. Prior to January 1, 2009, the Company had to determine whether it had the intent and ability to hold the investment for a sufficient period of time for the value to recover. The Company s process for identifying declines in the market value of investments that were considered other-than-temporary involved consideration of several factors. These factors included (i) an analysis of the liquidity, business prospects and overall financial condition of the issuer, (ii) the time period in which there was a significant decline in value, and (iii) the significance of the decline. When the analysis of such factors resulted in the Company s conclusion that declines in market values were other-than-temporary, the cost of the securities was written down to market value and the reduction in value was reflected as a realized loss. Effective under this guidance, the amount of the OTTI related to a credit loss is recognized in earnings, and the amount of the OTTI related to other factors (*e.g.*, interest rates, market conditions, etc.) is recorded as a component of other comprehensive income (loss). In instances where no credit loss exists but it is more likely than not that the Company will have to sell the debt security prior to the anticipated recovery, the decline in market value below amortized cost is recognized as an OTTI in earnings. In periods after the recognition of an OTTI on debt securities, the Company accounts for such securities as if they had been purchased on the measurement date of the OTTI at an amortized cost basis equal to the previous amortized cost basis less the OTTI recognized in earnings. For debt securities for which OTTI were recognized in earnings, the difference between the new amortized cost basis and the cash flows expected to be collected will be accreted or amortized into net investment income. This guidance was effective for periods ending after June 15, 2009, with early adoption permitted for periods ending after March 15, 2009. The Company elected to adopt this guidance effective for its interim period ended March 31, 2009.

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

2009 and 2008 Periods

The Company performed quarterly reviews of its investments in the 2009 and 2008 periods in order to determine whether declines in market value below the amortized cost basis were considered other-than-temporary in accordance with applicable guidance. For the 2009 third quarter and nine months ended September 30, 2009, the Company recorded $4.6 million and $61.6 million of net impairment losses recognized in earnings, respectively.

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

(U.S. dollars in thousands)

Three Months Ended September 30, 2009:		
Beginning balance at July 1, 2009	$	75,708
Credit loss impairments recognized on securities not previously impaired		529
Credit loss impairments recognized on securities previously impaired		4,115
Reductions for increases in cash flows expected to be collected that are recognized over the remaining life of the security		
Credit loss impairments previously recognized in AOCI on securities sold during the period		(383)
Ending balance at September 30, 2009	$	79,969
Nine Months Ended September 30, 2009:		
Beginning balance at January 1, 2009	$	35,474
Credit loss impairments recognized on securities not previously impaired		15,875
Credit loss impairments recognized on securities previously impaired		31,384
Reductions for increases in cash flows expected to be collected that are recognized over the remaining life of the security		
Credit loss impairments previously recognized in AOCI on securities sold during the period		(2,764)
Ending balance at September 30, 2009	$	79,969

At September 30, 2009, the Company did not have the intent to sell such securities, and determined that it is more likely than not that the Company will not be required to sell the securities before recovery of their cost basis. A description of the methodology and significant inputs used to measure the amount of OTTI related to credit losses of $4.6 million and $61.6 million, respectively, in the 2009 third quarter and nine months ended September 30, 2009 is as follows:

- Corporate bonds the Company recorded a minimal amount of OTTI related to credit losses in the 2009 third quarter, and $3.8 million for the nine months ended September 30, 2009. The Company reviewed the business prospects, credit ratings, estimated loss given default factors and incorporated available information received from asset managers and rating agencies for each security. The amortized cost basis of the corporate bonds were adjusted down, if required, to the expected recovery value calculated in the OTTI review process;

- Asset backed securities the Company recorded $0.5 million of OTTI related to credit losses in the 2009 third quarter, and $23.9 million for the nine months ended September 30, 2009. The Company utilized underlying data, where available, for each security provided by asset managers and additional information from credit agencies in order to determine an expected recovery value for each security. The analysis provided by the asset managers on home equity asset backed securities includes expected cash flow projections under base case and stress case scenarios which modify expected default expectations and loss severities and slow down prepayment assumptions. The significant inputs in the models include the expected default rates, delinquency rates and foreclosure costs. In the 2009 first and second quarters, the expected recovery values were reduced on a number of asset backed securities backed by sub-prime or Alt-A collateral due to reductions in the expected recovery values on such securities in each period. In the 2009 third quarter, the declines in expected recovery values were, in general, more moderate than

in the earlier periods. These reductions followed the quarterly review of information received which indicated increases in expected default rates, foreclosure costs and other factors. On an ongoing basis, the Company reviews the process used by each asset manager in developing their analysis and, following such reviews, the Company determines what the expected recovery values are for each security, which incorporates both base case and stress case scenarios. For non-home equity asset backed securities, the Company used reports and analysis from asset managers

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and rating agencies in order to determine an expected recovery value for such securities. The amortized cost basis of the asset backed securities were adjusted down, if required, to the expected recovery value calculated in the OTTI review process;

- Mortgage backed securities the Company recorded $2.7 million of OTTI related to credit losses in the 2009 third quarter, and $16.1 million for the nine months ended September 30, 2009. The Company utilized underlying data, where available, for each security provided by asset managers and additional information from credit agencies in order to determine an expected recovery value for each security. The analysis provided by the asset managers includes expected cash flow projections under base case and stress case scenarios which modify expected default expectations and loss severities and slow down prepayment assumptions. The significant inputs in the models include the expected default rates, delinquency rates and foreclosure costs. In the 2009 first quarter, the expected recovery values were reduced on a number of mortgage backed securities due to reductions in the expected recovery values on such securities in each period. In the 2009 second and third quarters, the declines in expected recovery values were, in general, more moderate than in the 2009 first quarter. These reductions followed the quarterly review of information received which indicated increases in expected default expectations and foreclosure costs. On an ongoing basis, the Company reviews the process used by each asset manager in developing their analysis and, following such reviews, the Company determines what the expected recovery values are for each security, which incorporates both base case and stress case scenarios. The amortized cost basis of the mortgage backed securities were adjusted down, if required, to the expected recovery value calculated in the OTTI review process;

- Investment of funds received under securities lending agreements the Company recorded $1.4 million of OTTI related to credit losses in the 2009 third quarter, and $3.5 million for the nine months ended September 30, 2009. At September 30, 2009, the reinvested collateral included sub-prime securities with a market value of $20.8 million and an average credit quality of BBB- from Standard & Poor s and Ba3 from Moody s. The Company utilized analysis from its securities lending program manager in order to determine an expected recovery value for certain securities which are on a watch-list. The analysis provided expected cash flow projections for the securities using similar criteria as described in the mortgage backed securities section above. The amortized cost basis of the investment of funds received under securities lending agreements was adjusted down, if required, to the expected recovery value calculated in the OTTI review process;

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

The Company believes that the $82.6 million of OTTI included in accumulated other comprehensive income at September 30, 2009 on the securities which were considered by the Company to be impaired was due to market and sector-related factors, including limited liquidity and wide credit spreads (*i.e.*, not credit losses).

For the 2008 third quarter and nine months ended September 30, 2008, the Company recorded $82.5 million and $106.0 million, respectively, of OTTI as a charge against earnings. Such amounts were recorded prior to the adoption of the recent accounting pronouncement discussed above and included a portion related to credit losses and a portion related to all other factors.

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ARCH CAPITAL GROUP LTD. AND SUBSIDIARIES

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Securities Lending Agreements

The Company operates a securities lending program under which certain of its fixed income portfolio securities are loaned to third parties, primarily major brokerage firms, for short periods of time through a lending agent. Such securities have been reclassified as Fixed maturities and short-term investments pledged under securities lending agreements. The Company maintains legal control over the securities it lends, retains the earnings and cash flows associated with the loaned securities and receives a fee from the borrower for the temporary use of the securities. Collateral received, primarily in the form of cash, is required at a rate of 102% of the market value of the loaned securities (or 105% of the market value of the loaned securities when the collateral and loaned securities are denominated in non-U.S. currencies) including accrued investment income and is monitored and maintained by the lending agent. Such collateral is reinvested and is reflected as Investment of funds received under securities lending agreements, at market value. At September 30, 2009, the market value and amortized cost of fixed maturities and short-term investments pledged under securities lending agreements were $609.3 million and $602.0 million, respectively. At December 31, 2008, the market value and amortized cost of fixed maturities and short-term investments pledged under securities lending agreements were $728.1 million and $717.2 million, respectively.

At September 30, 2009, the market value and amortized cost of the reinvested collateral, shown as Investment of funds received under securities lending agreements, totaled $611.5 million and $621.1 million, respectively, compared to $730.2 million and $750.3 million, respectively, at December 31, 2008. At September 30, 2009, the reinvested collateral included sub-prime securities with a market value of $20.8 million and an average credit quality of BBB- from Standard & Poor s and Ba3 from Moody s, compared to $45.7 million at December 31, 2008 with an average credit quality of AAA from Standard & Poor s and AA+ from Moody s.

TALF Program

During the 2009 third quarter, the Company purchased asset-backed and commercial mortgage-backed securities under the TALF program. 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 FRBNY in full defeasance of the borrowing.

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 September 30, 2009, the Company had $250.5 million of securities under TALF which are reflected as TALF investments, at market value and $219.8 million of secured financing from the FRBNY which is reflected as TALF borrowings, at market value. Changes in market value for both the securities and borrowings are included in Net realized gains (losses) while interest income on the TALF investments is reflected in net investment income and interest expense on the TALF borrowings is reflected in interest expense. The Company recorded net realized gains for the 2009 third quarter and nine months ended September 30, 2009 of $2.2 million on the TALF program, consisting of $2.2 million on changes in market value on the TALF investments.

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Other Investments

The following table details the Company s other investments:

(U.S. dollars in thousands)	September 30, 2009 Estimated Market Value	September 30, 2009 Cost	December 31, 2008 Estimated Market Value	December 31, 2008 Cost
Fixed income mutual funds	$ 55,646	$ 54,415	$ 39,858	$ 63,618
Privately held securities and other	98,880	93,053	69,743	62,240
Total	$ 154,526	$ 147,468	$ 109,601	$ 125,858

Other investments include: (i) mutual funds which invest in fixed maturity securities and (ii) privately held securities and other which include the Company s investment in Aeolus LP (see Note 12) and an equity portfolio which was added in the 2009 third quarterThe Company elected to carry the equity portfolio at fair value under the fair value option afforded by accounting guidance regarding the fair value option for financial assets and financial liabilities. During the nine months ended September 30, 2009, the Company recorded a $14.3 million OTTI provision in earnings on a Euro-denominated bank loan fund which was written down to zero as the fund was forced to wind down and enter liquidation during the period.

Investment Funds Accounted for Using the Equity Method

The Company recorded $69.1 million of equity in net income related to investment funds accounted for using the equity method for the 2009 third quarter, compared to $1.7 million of equity in net losses for the 2008 third quarter. For the nine months ended September 30, 2009, the Company recorded $135.4 million of equity in net income related to investment funds accounted for using the equity method, compared to $4.5 million of equity in net losses for the 2008 period. Due to the ownership structure of these investment funds, which invest in fixed maturity securities, the Company uses the equity method. In applying the equity method, these investments are initially recorded at cost and are subsequently adjusted based on the Company s proportionate share of the net income or loss of the funds (which include changes in the market value of the underlying securities in the funds). Such investments are generally recorded on a one month lag with some investments reported for on a three month lag based on the availability of reports from the investment funds. Changes in the carrying value of such investments are recorded in net income as Equity in net income (loss) of investment funds accounted for using the equity method while changes in the carrying value of the Company s other fixed income investments are recorded as an unrealized gain or loss component of accumulated other comprehensive income in shareholders equity. As such, fluctuations in the carrying value of the investment funds accounted for using the equity method may increase the volatility of the Company s reported results of operations. Investment funds accounted for using the equity method totaled $376.4 million at September 30, 2009, compared to $301.0 million at December 31, 2008. The Company s investment commitments relating to investment funds accounted for using the equity method and other investments totaled approximately $80.9 million at September 30, 2009.

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)

Restricted Assets

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

(U.S. dollars in thousands)	September 30, 2009	December 31, 2008
Assets used for collateral or guarantees	$ 1,019,281	$ 804,934
Deposits with U.S. regulatory authorities	280,536	264,988
Trust funds	134,307	153,182
Deposits with non-U.S. regulatory authorities	71,710	57,336
Total restricted assets	$ 1,505,834	$ 1,280,440

In addition, certain of the Company s operating subsidiaries maintain assets in trust accounts as collateral for insurance and reinsurance transactions with affiliated companies. At September 30, 2009 and December 31, 2008, such amounts approximated $4.45 billion and $4.03 billion, respectively.

Net Investment Income

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

(U.S. dollars in thousands)	Three Months Ended September 30, 2009	Three Months Ended September 30, 2008	Nine Months Ended September 30, 2009	Nine Months Ended September 30, 2008
Fixed maturities	$ 104,943	$ 111,530	$ 305,250	$ 329,662
Short-term investments	411	5,751	2,234	18,352
Other **(1)**	768	3,615	3,805	18,830
Gross investment income	106,122	120,896	311,289	366,844
Investment expenses	(5,909)	(3,874)	(14,709)	(10,509)
Net investment income	$ 100,213	$ 117,022	$ 296,580	$ 356,335

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

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Net Realized Gains (Losses)

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

(U.S. dollars in thousands)	Three Months Ended September 30, 2009	Three Months Ended September 30, 2008	Nine Months Ended September 30, 2009	Nine Months Ended September 30, 2008
Fixed maturities	$ 65,154	$ (30,137)	$ 57,004	$ 41,936
Other investments	817	(5,159)	585	(10,375)
Other **(1)**	4,667	12,295	(3,908)	(7,796)
Net realized gains (losses)	$ 70,638	$ (23,001)	$ 53,681	$ 23,765

(1) Primarily consists of net realized gains or losses related to investment-related derivatives and foreign currency forward contracts as well as $2.2 million of net realized gains for the TALF program in the 2009 periods.

Proceeds from the sales of fixed maturities during the 2009 third quarter were $6.07 billion, compared to $3.66 billion for the 2008 third quarter. Gross gains of $125.0 million and $36.9 million were realized on those transactions during the 2009 and 2008 third quarters, respectively, while gross losses were $59.8 million and $67.1 million, respectively. Proceeds from the sales of fixed maturities during the nine months ended September 30, 2009 were $14.72 billion, compared to $10.51 billion for the 2008 period. Gross gains of $260.9 million and $167.0 million were realized on those transactions during the nine month periods ended September 30, 2009 and 2008, respectively, while gross losses were $203.9 million and $125.1 million, respectively. Realized gains or losses on fixed maturities include changes in the market value of certain hybrid securities pursuant to applicable guidance. The fair market values of such securities at September 30, 2009 were approximately $80.5 million, compared to $43.7 million at December 31, 2008. The Company recorded realized gains of $6.9 million and $16.6 million on such securities for the 2009 third quarter and nine month periods ended September 30, 2009, respectively, compared to realized losses of $1.9 million and $1.8 million for the 2008 third quarter and nine month periods ended September 30, 2008, respectively.

Fair Value

Accounting guidance regarding fair value measurements 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. It 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. In addition, it 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).

ARCH CAPITAL GROUP LTD. AND SUBSIDIARIES

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The three levels are defined as follows:

Level 1: Inputs to the valuation methodology are observable inputs that reflect quoted prices (unadjusted) for *identical* assets or liabilities in *active markets*

Level 2: Inputs to the valuation methodology include quoted prices for similar assets and liabilities in active markets, and inputs that are observable for the asset or liability, either directly or indirectly, for substantially the full term of the financial instrument

Level 3: Inputs to the valuation methodology are unobservable and significant to the fair value measurement

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

The Company determines the existence of an active market based on its judgment as to whether transactions for the financial instrument occur in such market with sufficient frequency and volume to provide reliable pricing information. The independent pricing sources obtain market quotations and actual transaction prices for securities that have quoted prices in active markets. The Company uses quoted values and other data provided by nationally recognized independent pricing sources as inputs into its process for determining fair values of its fixed maturity investments. To validate the techniques or models used by pricing sources, the Company s review process includes, but is not limited to: (i) quantitative analysis (*e.g.*, comparing the quarterly return for each managed portfolio to its target benchmark, with significant differences identified and investigated); (ii) a review of the average number of prices obtained in the pricing process and the range of resulting market values; (iii) initial and ongoing evaluation of methodologies used by outside parties to calculate fair value including a review of deep dive reports on selected securities which indicated the use of observable inputs in the pricing process; (iv) comparing the fair value estimates to its knowledge of the current market; (v) a comparison of the pricing services fair values to other pricing services fair values for the same investments; and (vi) back-testing, which includes randomly selecting purchased or sold securities and comparing the executed prices to the fair value estimates from the pricing service. At September 30, 2009, the Company obtained an average of 2.7 quotes per investment, compared to 2.6 quotes at December 31, 2008. Where multiple quotes or prices were obtained, a price source hierarchy was maintained in order to determine which price source provided the fair value (i.e., a price obtained from a pricing service with more seniority in the hierarchy will be used from a less senior one in all cases). The hierarchy prioritizes pricing services based on availability and reliability and assigns the highest priority to index providers. Based on the above review, the Company will challenge any prices for a security or portfolio which are considered not to be representative of fair value. The Company did not adjust the prices or quotes provided by the pricing services at September 30, 2009 or December 31, 2008.

The independent pricing sources obtain market quotations and actual transaction prices for securities that have quoted prices in active markets. Each source has its own proprietary method for determining the fair value of securities that are not actively traded. In general, these methods involve the use of matrix pricing in which the independent pricing source uses observable market inputs including, but not limited to, investment yields, credit risks and spreads, benchmarking of like securities, broker-dealer quotes, reported trades and sector groupings to determine a reasonable fair market value. In addition, pricing vendors use model processes, such as an Option Adjusted Spread model, to develop prepayment and interest rate scenarios. The Option Adjusted Spread model is commonly used to estimate fair value for securities such as mortgage backed and asset backed securities. In certain circumstances, when fair market values are unavailable from these independent pricing sources, quotes are obtained directly from broker-dealers who are active in the corresponding markets. Such quotes are subject to the validation procedures noted above. Of the $11.13 billion of financial assets and liabilities measured at fair value, approximately $1.02 billion, or 9.2%,

were priced using non-binding broker-dealer quotes.

ARCH CAPITAL GROUP LTD. AND SUBSIDIARIES

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In April 2009, the FASB issued guidance regarding the determination of fair value when the volume and level of activity for the asset or liability have significantly decreased and the identification of transactions that are not orderly. This affirms that the objective of fair value when the market for an asset is not active is the price that would be received to sell the asset in an orderly transaction, and clarifies and includes additional factors for determining whether there has been a significant decrease in market activity for an asset when the market for that asset is not active. Under this guidance, if an entity determines that there has been a significant decrease in the volume and level of activity for the asset or the liability in relation to the normal market activity for the asset or liability (or similar assets or liabilities), then transactions or quoted prices may not accurately reflect fair value. In addition, if there is evidence that the transaction for the asset or liability is not orderly, the entity shall place little, if any weight on that transaction price as an indicator of fair value. This guidance also expanded certain disclosure requirements. This guidance was effective for periods ending after June 15, 2009, with early adoption permitted for periods ending after March 15, 2009. The Company elected to adopt this pronouncement effective for its interim period ending March 31, 2009, and its adoption did not have a material impact on the Company s consolidated financial condition or results of operations.

The Company reviews its securities measured at fair value and discusses the proper classification of such investments with investment advisors and others. Upon adoption of the accounting guidance regarding fair value measurement and at September 30, 2009, the Company determined that Level 1 securities included highly liquid, recent issue U.S. Treasuries and certain of its short-term investments held in highly liquid money market-type funds where it believes that quoted prices are available in an active market.

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

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

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ARCH CAPITAL GROUP LTD. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)

The following table presents the Company s financial assets and liabilities measured at fair value by level:

		Fair Value Measurement Using:		
(U.S. dollars in thousands)	**Estimated Market Value**	**Quoted Prices in Active Markets for Identical Assets (Level 1)**	**Significant Other Observable Inputs (Level 2)**	**Significant Unobservable Inputs (Level 3)**
September 30, 2009:				
Fixed maturities: **(1)**				
Corporate bonds	$ 3,099,701	$	$ 2,910,277	$ 189,424**(2)**
Mortgage backed securities	1,708,414		1,708,414	
U.S. government and government agencies	1,480,190	377,923	1,102,267	
Commercial mortgage backed securities	1,170,712		1,170,712	
Non-U.S. government securities	1,008,082		1,008,082	
Municipal bonds	910,903		910,903	
Asset backed securities	497,293		497,293	
Total	9,875,295	377,923	9,307,948	189,424
Short-term investments **(1)**	706,157	690,409	15,748	
TALF investments, at market value	250,517		250,517	
TALF borrowings, at market value	219,843		219,843	
Other investments **(3)**	82,989		35,962	47,027
Total	$ 11,134,801	$ 1,068,332	$ 9,830,018	$ 236,451
December 31, 2008:				
Fixed maturities: **(1)**				
Corporate bonds	$ 2,019,373	$	$ 1,876,802	$ 142,571**(2)**
Mortgage backed securities	1,581,736		1,581,736	
U.S. government and government agencies	1,463,897	241,851	1,222,046	
Commercial mortgage backed securities	1,219,737		1,219,737	
Non-U.S. government securities	527,972		527,972	
Municipal bonds	965,966		965,966	
Asset backed securities	970,041		970,041	
Total	8,748,722	241,851	8,364,300	142,571
Short-term investments **(1)**	581,150	474,504	106,646	
Other investments **(3)**	36,913		(3,426)	40,339
Total	$ 9,366,785	$ 716,355	$ 8,467,520	$ 182,910

(1) In securities lending transactions, the Company receives collateral in excess of the fair value of the fixed maturities and short-term investments pledged under securities lending agreements. For purposes of this table, the Company has excluded the collateral received at September 30, 2009 and December 31, 2008 of $611.5 million and $730.2 million, respectively, which is reflected as investment of funds received under securities lending agreements, at market value and included the $609.3 million and $728.1 million, respectively, of fixed maturities and short-term investments pledged under securities lending agreements, at market value.

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

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

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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:

	Fair Value Measurements Using: Significant Unobservable Inputs (Level 3)		
(U.S. dollars in thousands)	**Corporate Bonds**	**Other Investments**	**Total**
Three Months Ended September 30, 2009:			
Beginning balance at July 1, 2009	$ 158,451	$ 41,111	$ 199,562
Total gains or (losses) (realized/unrealized)			
Included in earnings **(1)**	(1,258)	29	(1,229)
Included in other comprehensive income	32,231	6,240	38,471
Purchases, issuances and settlements		(353)	(353)
Transfers in and/or out of Level 3			
Ending balance at September 30, 2009	$ 189,424	$ 47,027	$ 236,451
Three Months Ended September 30, 2008:			
Beginning balance at July 1, 2008	$ 6,479	$ 9,642	$ 16,121
Total gains or (losses) (realized/unrealized)			
Included in earnings **(1)**	(92)		(92)
Included in other comprehensive income		(1,123)	(1,123)
Purchases, issuances and settlements			
Transfers in and/or out of Level 3			
Ending balance at September 30, 2008	$ 6,387	$ 8,519	$ 14,906
Nine Months Ended September 30, 2009:			
Beginning balance at January 1, 2009	$ 142,571	$ 40,339	$ 182,910
Total gains or (losses) (realized/unrealized)			
Included in earnings **(1)**	(68)	(14,278)	(14,346)
Included in other comprehensive income	46,921	21,433	68,354
Purchases, issuances and settlements		(467)	(467)
Transfers in and/or out of Level 3			
Ending balance at September 30, 2009	$ 189,424	$ 47,027	$ 236,451
Nine Months Ended September 30, 2008:			
Beginning balance at January 1, 2008	$ 3,752	$ 11,504	$ 15,256
Total gains or (losses) (realized/unrealized)			
Included in earnings **(1)**	(168)	459	291
Included in other comprehensive income		(2,912)	(2,912)
Purchases, issuances and settlements	2,803	(532)	2,271
Transfers in and/or out of Level 3			
Ending balance at September 30, 2008	$ 6,387	$ 8,519	$ 14,906

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

The amount of total losses for the 2009 third quarter and nine months ended September 30, 2009 included in earnings attributable to the change in unrealized gains or losses relating to assets still held at September 30, 2009 was $1.2 million and $0.1 million, respectively. The amount of total losses for the 2008 third quarter included in earnings attributable to the change in unrealized gains or losses relating to assets still held at September 30, 2008 was $0.1 million. The amount of total gains for the nine months ended September 30, 2008 included in earnings attributable to the change in unrealized gains or losses relating to assets still held at September 30, 2008 was $0.3 million.

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9. Derivative Instruments

The Company s investment strategy allows for the use of derivative securities. The Company s derivative instruments are recorded on its consolidated balance sheets at market value. The market values of those derivatives are based on quoted market prices. All realized and unrealized contract gains and losses are reflected in the Company s results of operations.

The Company utilizes exchange traded U.S. Treasury note, Eurodollar and other futures contracts and commodity futures to manage portfolio duration or replicate investment positions in its portfolios. In addition, certain of the Company s corporate bonds are managed in a global bond portfolio which incorporates the use of foreign currency forward contracts which are intended to provide an economic hedge against foreign currency movements on the portfolio s non-U.S. Dollar denominated holdings.

In addition, the Company purchases to-be-announced mortgage backed securities (TBAs) as part of its investment strategy. TBAs represent commitments to purchase a future issuance of agency mortgage backed securities. For the period between purchase of a TBA and issuance of the underlying security, the Company s position is accounted for as a derivative. The Company purchases TBAs in both long and short positions to enhance investment performance and as part of its overall investment strategy.

The Company did not hold any derivatives which were designated as hedging instruments at September 30, 2009 or December 31, 2008. The following table summarizes information on the balance sheet locations, market values and notional values of the Company s derivative instruments at September 30, 2009:

		Asset Derivatives		Liability Derivatives	
(U.S. dollars in thousands)	**Balance Sheet Location**	**Estimated Market Value**	**Notional Value**	**Estimated Market Value**	**Notional Value**
Derivatives not designated as hedging instruments					
Futures contracts	Other investments	$ 848	$ 2,070,082	$ (8)	$ 69,744
Foreign currency forward contracts	Other investments	602	18,298	(12,717)	139,376
TBAs	Fixed maturities	722,186	696,600	(674,771)	651,000
Other	Other investments	45	16,098		
Total		$ 723,681		$ (687,496)	

The following table summarizes information on the balance sheet locations, market values and notional values of the Company s derivative instruments at December 31, 2008:

(U.S. dollars in thousands)	Balance Sheet Location	Asset Derivatives Estimated Market Value	Asset Derivatives Notional Value	Liability Derivatives Estimated Market Value	Liability Derivatives Notional Value
Derivatives not designated as hedging instruments					
Futures contracts	Other investments	$ 647	$ 363,297	$ (1,541)	$ 556,268
Foreign currency forward contracts	Other investments	3,485	15,294	(14,332)	135,426
Total		$ 4,132		$ (15,873)	

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The following table summarizes derivative instrument activity in the consolidated statements of operations for the three months and nine months ended September 30, 2009:

(U.S. dollars in thousands)	Location of Gain or (Loss) Recognized in Income on Derivative	Three Months Ended September 30, 2009	Nine Months Ended September 30, 2009
Derivatives not designated as hedging instruments			
Futures contracts	Net realized gains (losses)	$ 8,604	$ (887)
Foreign currency forward contracts	Net realized gains (losses)	(6,631)	(6,209)
TBAs	Net realized gains (losses)	683	3,328
Other	Net realized gains (losses)	455	455
Total		$ 3,111	$ (3,313)

10. Earnings Per Common Share

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

(U.S. dollars in thousands, except share data)	Three Months Ended September 30, 2009	2008	Nine Months Ended September 30, 2009	2008
Net income	$ 280,868	$ 32,851	$ 585,788	$ 427,477
Preferred dividends	(6,461)	(6,461)	(19,383)	(19,383)
Net income available to common shareholders (numerator)	$ 274,407	$ 26,390	$ 566,405	$ 408,094
Weighted average common shares and effect of dilutive common share equivalents used in the computation of earnings per common share:				
Weighted average common shares outstanding basic (denominator)	60,156,219	60,109,932	60,295,144	62,790,514
Effect of dilutive common share equivalents:				
Nonvested restricted shares	262,306	256,552	284,611	251,149
Stock options **(1)**	2,115,291	2,464,426	2,010,473	2,488,907
Weighted average common shares and common share equivalents outstanding diluted (denominator)	62,533,816	62,830,910	62,590,228	65,530,570

Earnings per common share:								
Basic	$	4.56	$	0.44	$	9.39	$	6.50
Diluted	$	4.39	$	0.42	$	9.05	$	6.23

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(1) Certain stock options were not included in the computation of diluted earnings per share where the exercise price of the stock options exceeded the average market price and would have been anti-dilutive or where, when applying the treasury stock method to in-the-money options, the sum of the proceeds, including unrecognized compensation, exceeded the average market price and would have been anti-dilutive. For the 2009 third quarter and nine months ended September 30, 2009, the number of stock options excluded were 926,655 and 836,704, respectively. For the 2008 third quarter and nine months ended September 30, 2008, the number of stock options excluded were 635,303 and 498,172, respectively.

ARCH CAPITAL GROUP LTD. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)

11. Income Taxes

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

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

The Company s income tax provision resulted in an effective tax rate on income before income taxes of 3.4% for the nine months ended September 30, 2009, compared to 2.6% for the nine months ended September 30, 2008. The Company s effective tax rate, which is based upon the expected annual effective tax rate, may fluctuate from period to period based on the relative mix of income reported by jurisdiction due primarily to the varying tax rates in each jurisdiction.

The Company had a net deferred tax asset of $55.0 million at September 30, 2009, compared to $60.2 million at December 31, 2008. In addition, the Company paid $26.4 million and $12.4 million for income taxes, net of recoveries, during the nine month periods ended September 30, 2009 and 2008, respectively.

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. The Company incurred $3.3 million of federal excise taxes in the 2009 and 2008 third quarters and $9.7 million for the nine month periods ended September 30, 2009 and 2008. Such amounts are reflected as acquisition expenses in the Company s consolidated statements of income.

ARCH CAPITAL GROUP LTD. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)

12. 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 6.7% of the Company s outstanding voting shares as of September 30, 2009. In addition, one of the founders of Aeolus is Peter Appel, former President and CEO and a former director of the Company. During the 2009 first quarter, the Company received a distribution of $14.0 million from Aeolus as part of a repurchase agreement. Following such receipt, the Company s preferred interest percentage decreased to approximately 4.4%.

13. Contingencies Relating to the Sale of Prior Reinsurance Operations

On May 5, 2000, the Company sold the prior reinsurance operations of Arch Re U.S. pursuant to an agreement entered into as of January 10, 2000 with White Mountains Reinsurance Company of America, formerly known as Folksamerica Reinsurance Company, and a related holding company (collectively, WTM Re). WTM Re assumed Arch Re U.S. s liabilities under the reinsurance agreements transferred in the asset sale and Arch Re U.S. transferred to WTM Re assets estimated in an aggregate amount equal in book value to the book value of the liabilities assumed. The WTM Re transaction was structured as a transfer and assumption agreement (and not reinsurance) and, accordingly, the loss reserves (and any related reinsurance recoverables) relating to the transferred business are not included as assets or liabilities on the Company s balance sheet. WTM Re assumed Arch Re U.S. s rights and obligations under the reinsurance agreements transferred in the asset sale. The reinsureds under such agreements were notified that WTM Re had assumed Arch Re U.S. s obligations and that, unless the reinsureds object to the assumption, Arch Re U.S. will be released from its obligations to those 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. WTM Re has agreed to indemnify the Company for any losses arising out of the reinsurance agreements transferred to WTM Re in the asset sale. However, in the event that WTM Re refuses or is unable to perform its obligations to the Company, Arch Re U.S. may incur losses relating to the reinsurance agreements transferred in the asset sale. WTM Re s A.M. Best rating was A- (Excellent) at September 30, 2009. WTM Re reported policyholders surplus of $708.8 million at December 31, 2008.

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

ARCH CAPITAL GROUP LTD. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)

14. Commitments and Contingencies

Variable Interest Entities

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

15. 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 September 30, 2009, the Company was not a party to any material litigation or arbitration other than as a part of the ordinary course of business in relation to claims and reinsurance recoverable matters, none of which is expected by management to have a significant adverse effect on the Company s results of operations and financial condition and liquidity.

16. Subsequent Events

In November 2009, the board of directors of ACGL authorized the investment of up to an additional $1.0 billion in ACGL s common shares through a share repurchase program. Repurchases under this authorization may be effected from time to time in open market or privately negotiated transactions through December 31, 2011. The board of directors of ACGL had previously authorized the investment of up to $1.5 billion in ACGL s common shares, of which $350.1 million was available at September 30, 2009. See Note 3, Share Transactions Share Repurchases for information on share repurchase activity.

The Company has completed its subsequent events evaluation for the period subsequent to the balance sheet date of September 30, 2009 through November 9, 2009, the date the consolidated financial statements were issued.

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

Arch Capital Group Ltd. (ACGL and, together with its subsidiaries, we or us) is a Bermuda public limited liability company with over $4.86 billion in capital at September 30, 2009 and, through operations in Bermuda, the United States, Europe and Canada, writes insurance and reinsurance on a worldwide basis. While we are positioned to provide a full range of property and casualty insurance and reinsurance lines, we focus on writing specialty lines of insurance and reinsurance. It is our belief that our underwriting platform, our experienced management team and our strong capital base that is unencumbered by significant pre-2002 risks have enabled us to establish a strong presence in the insurance and reinsurance markets.

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

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

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

Current Outlook

During the second half of 2008, the financial markets experienced significant adverse credit events and a loss of liquidity, which have reduced the amount and availability of capital in the insurance industry. In addition, certain of our competitors have experienced significant financial difficulties. During the first six months of 2009, we experienced rate stabilization and some improvements in rates. However, with no significant catastrophic activity in the 2009 third quarter and substantial improvements in market values across most

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investment sectors, the degree of rate improvement we saw in the first six months of 2009 was moderated and the pricing environment is basically unchanged. The current economic conditions could continue to have a material impact on the frequency and severity of claims and therefore could negatively impact our underwriting returns. In addition, volatility in the financial markets could continue to significantly affect our investment returns, reported results and shareholders equity. We consider the potential impact of economic trends in the estimation process for establishing unpaid losses and loss adjustment expenses (LAE) and in determining our investment strategies.

We continue to believe that the most attractive area from a pricing point of view remains U.S. catastrophe-related property business. We expect that our writings in property and marine lines of business will continue to represent a significant proportion of our overall book of business in future periods, which could increase the volatility of our results of operations. We seek to limit the probable maximum pre-tax loss to a specific level for severe catastrophic events. Currently, we generally seek to limit the probable maximum pre-tax loss to approximately 25% of total shareholders equity for a severe catastrophic event in any geographic zone that could be expected to occur once in every 250 years, although we reserve the right to change this threshold at any time. As of October 1, 2009, the probable maximum pre-tax loss for a catastrophic event in any geographic zone arising from a 1-in-250 year event was approximately $826 million, compared to $763 million as of January 1, 2009. There can be no assurances that we will not suffer pre-tax losses greater than 25% of our total shareholders equity from one or more catastrophic events due to several factors, including the inherent uncertainties in estimating the frequency and severity of such events and the margin of error in making such determinations resulting from potential inaccuracies and inadequacies in the data provided by clients and brokers, the modeling techniques and the application of such techniques or as a result of a decision to change the percentage of shareholders equity exposed to a single catastrophic event. In addition, actual losses may increase if reinsurers dispute or fail to meet their obligations to us or the reinsurance protections purchased by us are exhausted or are otherwise unavailable. See Risk Factors Risk Relating to Our Industry and Management s Discussion and Analysis of Financial Condition and Results of Operations Natural and Man-Made Catastrophic Events contained in our Annual Report on Form 10-K for the year ended December 31, 2008.

CRITICAL ACCOUNTING POLICIES, ESTIMATES AND RECENT ACCOUNTING PRONOUNCEMENTS

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

RESULTS OF OPERATIONS

Three Months Ended September 30, 2009 and 2008

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

(U.S. dollars in thousands, except share data)	Three Months Ended September 30, 2009	2008
Net income available to common shareholders	$ 274,407	$ 26,390

Diluted net income per common share	$	4.39	$	0.42
Diluted weighted average common shares and common share equivalents outstanding		62,533,816		62,830,910

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Net income available to common shareholders was $274.4 million for the 2009 third quarter, compared to $26.4 million for the 2008 third quarter. The increase in net income was primarily due to an increase in underwriting income from our insurance and reinsurance operations as discussed in Segment Information below, a decrease in the net impairment losses recognized in earnings and an increase in the equity in net income (loss) of investment funds accounted for using the equity method. Our net income available to common shareholders for the 2009 third quarter represented a 28.0% annualized return on average common equity, compared to 3.1% for the 2008 third quarter. For purposes of computing return on average common equity, average common equity has been calculated as the average of common shareholders equity outstanding at the beginning and ending of each period.

Diluted weighted average common shares and common share equivalents outstanding, used in the calculation of net income per common share, were 62.5 million in the 2009 third quarter, compared to 62.8 million in the 2008 third quarter. The lower level of weighted average shares outstanding in the 2009 third quarter was primarily due to the impact of share repurchases which reduced weighted average shares outstanding for the 2009 third quarter by 15.7 million shares, compared to 14.9 million shares for the 2008 third quarter.

Segment Information

We classify our businesses into two underwriting segments insurance and reinsurance and corporate and other (non-underwriting). Accounting guidance regarding disclosures about segments of an enterprise and related information requires certain disclosures about operating segments in a manner that is consistent with how management evaluates the performance of the segment. For a description of our underwriting segments, refer to Note 5, Segment Information, of the notes accompanying our consolidated financial statements. Management measures segment performance based on underwriting income or loss.

Insurance Segment

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

	Three Months Ended September 30,	
	2009	**2008**
Gross premiums written	$ 673,986	$ 678,338
Net premiums written	473,676	466,115
Net premiums earned	$ 443,319	$ 441,049
Fee income	814	872
Losses and loss adjustment expenses	(303,304)	(337,456)
Acquisition expenses, net	(60,964)	(62,752)
Other operating expenses	(72,452)	(71,861)
Underwriting income (loss)	$ 7,413	$ (30,148)
Underwriting Ratios		
Loss ratio	68.4%	76.5%
Acquisition expense ratio **(1)**	13.6%	14.0%

Other operating expense ratio	16.3%	16.3%
Combined ratio	98.3%	106.8%

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

The insurance segment s underwriting income was $7.4 million for the 2009 third quarter, compared to an underwriting loss of $30.1 million for the 2008 third quarter. The combined ratio for the insurance segment was 98.3% for the 2009 third quarter, compared to 106.8% for the 2008 third quarter. In the 2008 third quarter, the

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