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

SECURITIES AND EXCHANGE COMMISSION

WASHINGTON, D.C. 20549

FORM 10-Q

(Mark One)

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

For the quarterly period ended June 30, 2008

Or

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

For the transition period to

Commission file number: **0-26456**

ARCH CAPITAL GROUP LTD.

(Exact name of registrant as specified in its charter)

Bermuda	**Not Applicable**
(State or other jurisdiction of incorporation or organization)	(I.R.S. Employer Identification No.)

Wessex House, 45 Reid Street
Hamilton HM 12, Bermuda

(Address of principal executive offices)	(Zip Code)

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

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

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

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, or a smaller reporting company. See the definitions of large accelerated filer, accelerated filer and smaller reporting company in Rule 12b-2 of the Exchange Act.

Large accelerated filer x	Accelerated filer o
Non-accelerated filer o (Do not check if a smaller reporting coming)	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 August 1, 2008
Common Shares, $0.01 par value	60,111,444

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Report of Independent Registered Public Accounting Firm

To the Board of Directors and Shareholders of

Arch Capital Group Ltd.:

We have reviewed the accompanying consolidated balance sheets of Arch Capital Group Ltd. and its subsidiaries (the Company) as of June 30, 2008, and the related consolidated statements of income for each of the three-month and six-month periods ended June 30, 2008 and June 30, 2007, and the consolidated statements of changes in shareholders equity, comprehensive income and cash flows for the six-month periods ended June 30, 2008 and June 30, 2007. These interim financial statements are the responsibility of the Company s management.

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

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

We previously audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the consolidated balance sheet as of December 31, 2007, and the related consolidated statements of income, changes in shareholders equity, comprehensive income, and of cash flows for the year then ended (not presented herein), and in our report dated February 28, 2008, we expressed an unqualified opinion on those consolidated financial statements. In our opinion, the information set forth in the accompanying consolidated balance sheet information as of December 31, 2007, is fairly stated in all material respects in relation to the consolidated balance sheet from which it has been derived.

/s/ PricewaterhouseCoopers LLP

New York, New York

August 8, 2008

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ARCH CAPITAL GROUP LTD. AND SUBSIDIARIES

CONSOLIDATED BALANCE SHEETS

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

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

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

See Notes to Consolidated Financial Statements

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ARCH CAPITAL GROUP LTD. AND SUBSIDIARIES

CONSOLIDATED STATEMENTS OF INCOME

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

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

See Notes to Consolidated Financial Statements

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ARCH CAPITAL GROUP LTD. AND SUBSIDIARIES

CONSOLIDATED STATEMENTS OF CHANGES IN SHAREHOLDERS EQUITY

(U.S. dollars in thousands)

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

See Notes to Consolidated Financial Statements

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ARCH CAPITAL GROUP LTD. AND SUBSIDIARIES

CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME

(U.S. dollars in thousands)

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

See Notes to Consolidated Financial Statements

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ARCH CAPITAL GROUP LTD. AND SUBSIDIARIES

CONSOLIDATED STATEMENTS OF CASH FLOWS

(U.S. dollars in thousands)

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

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

See Notes to Consolidated Financial Statements

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ARCH CAPITAL GROUP LTD. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)

1. General

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

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

Certain information and footnote disclosures normally included in financial statements prepared in accordance with GAAP have been condensed or omitted; however, management believes that the disclosures are adequate to make the information presented not misleading. This report should be read in conjunction with the Company s Annual Report on Form 10-K for the year ended December 31, 2007, including the Company s audited consolidated financial statements and related notes and the section entitled Risk Factors.

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

2. Share Transactions

Share Repurchase Program

The board of directors of ACGL has authorized the investment of up to $1.5 billion in ACGL s common shares through a share repurchase program. Such amount consisted of a $1.0 billion authorization in February 2007 and a $500 million authorization in May 2008. Repurchases under the program may be effected from time to time in open market or privately negotiated transactions through February 2010. Since the inception of the share repurchase program, ACGL has repurchased approximately 13.4 million common shares for an aggregate purchase price of $926.8 million. During the 2008 second quarter and six months ended June 30, 2008, ACGL repurchased approximately 2.9 million and 5.6 million common shares, respectively, for an aggregate purchase price of $199.9 million and $389.8 million, respectively. As a result of share repurchase transactions, book value per common share was reduced by $2.09 per share at June 30, 2008. Weighted average shares outstanding for the 2008 second quarter and six months ended June 30, 2008 were reduced by 11.9 million and 10.6 million shares, respectively. Weighted average shares outstanding for the 2007 second quarter and six months ended June 30, 2007 were reduced by 1.8 million and 1.0 million shares, respectively.

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

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ARCH CAPITAL GROUP LTD. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)

Non-Cumulative Preferred Shares

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

Share-Based Compensation

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

During the 2008 second quarter, the Company made a stock grant of 333,175 stock appreciation rights and stock options and 328,575 restricted shares and units to certain employees. The stock appreciation rights and stock options were valued at the grant date using the Black-Scholes option pricing model. The weighted average grant-date fair value of the stock appreciation rights and options and restricted shares and units granted were approximately $19.07 and $69.30 per share, respectively. Such value will be amortized over the respective substantive vesting period.

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ARCH CAPITAL GROUP LTD. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)

3. Debt and Financing Arrangements

Senior Notes

On May 4, 2004, ACGL completed a public offering of $300 million principal amount of 7.35% senior notes (Senior Notes) due May 1, 2034 and received net proceeds of $296.4 million. ACGL used $200 million of the net proceeds to repay all amounts outstanding under a revolving credit agreement. The Senior Notes are ACGL s senior unsecured obligations and rank equally with all of its existing and future senior unsecured indebtedness. Interest payments on the Senior Notes are due on May 1st and November 1st of each year. ACGL may redeem the Senior Notes at any time and from time to time, in whole or in part, at a make-whole redemption price. For the six months ended June 30, 2008 and 2007, interest expense on the Senior Notes was approximately $11.0 million. The fair value of the Senior Notes at June 30, 2008 and December 31, 2007 was $304.1 million and $325.4 million, respectively.

Letter of Credit and Revolving Credit Facilities

As of June 30, 2008, the Company had a $300 million unsecured revolving loan and letter of credit facility and a $1.0 billion secured letter of credit facility (the Credit Agreement). The $300 million unsecured revolving loan is also available for the issuance of unsecured letters of credit up to $100 million for Arch Reinsurance Company (Arch Re U.S.). Borrowings of revolving loans may be made by ACGL and Arch Re U.S. at a variable rate based on LIBOR or an alternative base rate at the option of the Company. Secured letters of credit are available for issuance on behalf of the Company s insurance and reinsurance subsidiaries. Issuance of letters of credit and borrowings under the Credit Agreement are subject to the Company s compliance with certain covenants and conditions, including absence of a material adverse change. These covenants require, among other things, that the Company maintain a debt to shareholders equity ratio of not greater than 0.35 to 1 and shareholders equity in excess of $1.95 billion plus 25% of future aggregate net income for each quarterly period (not including any future net losses) beginning after June 30, 2006 and 25% of future aggregate proceeds from the issuance of common or preferred equity and that the Company s principal insurance and reinsurance subsidiaries maintain at least a B++ rating from A.M. Best. In addition, certain of the Company s subsidiaries which are party to the Credit Agreement are required to maintain minimum shareholders equity levels. The Company was in compliance with all covenants contained in the Credit Agreement at June 30, 2008. The Credit Agreement expires on August 30, 2011.

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

Including the secured letter of credit portion of the Credit Agreement and another letter of credit facility (together, the LOC Facilities), the Company has access to letter of credit facilities for up to a total of $1.45 billion. The principal purpose of the LOC Facilities is to issue, as required, evergreen standby letters of credit in favor of primary insurance or reinsurance counterparties with which the Company has entered into reinsurance arrangements to ensure that such counterparties are permitted to take credit for reinsurance obtained from the Company s reinsurance subsidiaries in United States jurisdictions where such subsidiaries are not licensed or otherwise admitted as an insurer, as required under insurance regulations in the United States, and to comply with requirements of Lloyd s of London in connection with qualifying quota share and other arrangements. The amount of letters of credit issued is driven by, among other things, the timing and payment of catastrophe losses, loss development of existing reserves, the payment pattern of such reserves, the further expansion of the Company s business and the loss experience of such business. When issued, certain letters of credit are secured by a portion of the Company s investment portfolio. In addition, the LOC Facilities also require the maintenance

ARCH CAPITAL GROUP LTD. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)

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

4. Segment Information

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

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

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

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

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

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ARCH CAPITAL GROUP LTD. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)

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

	Three Months Ended June 30, 2008 Insurance	Reinsurance	Total
Gross premiums written **(1)**	$ 621,663	$ 273,318	$ 886,926
Net premiums written **(1)**	421,501	264,617	686,118
Net premiums earned **(1)**	$ 416,585	$ 289,090	$ 705,675
Fee income	880	358	1,238
Losses and loss adjustment expenses	(262,633)	(141,992)	(404,625)
Acquisition expenses	(55,400)	(63,826)	(119,226)
Other operating expenses	(71,566)	(20,091)	(91,657)
Underwriting income	$ 27,866	$ 63,539	91,405
Net investment income			117,120
Net realized losses			(12,669)
Equity in net income (loss) of investment funds accounted for using the equity method			19,583
Other income			4,968
Other expenses			(10,921)
Interest expense			(5,788)
Net foreign exchange gains			298
Income before income taxes			203,996
Income tax expense			(5,253)
Net income			198,743
Preferred dividends			(6,461)
Net income available to common shareholders			$ 192,282
Underwriting Ratios			
Loss ratio	63.0%	49.1%	57.3%
Acquisition expense ratio **(2)**	13.1%	22.1%	16.8%
Other operating expense ratio	17.2%	6.9%	13.0%
Combined ratio	93.3%	78.1%	87.1%

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

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

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ARCH CAPITAL GROUP LTD. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)

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

(1) Certain amounts included in the gross premiums written of each segment are related to intersegment transactions. Accordingly, the sum of gross premiums written for each segment does not agree to the total gross premiums written as shown in the table above due to the elimination of intersegment transactions in the total. The insurance segment and reinsurance segment results include $0.3 million and $9.6 million, respectively, of gross and net premiums written and $0.3 million and $10.8 million, respectively, of net premiums earned assumed through intersegment transactions.

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

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

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

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

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

(1) Certain amounts included in the gross premiums written of each segment are related to intersegment transactions. Accordingly, the sum of gross premiums written for each segment does not agree to the total gross premiums written as shown in the table above due to the elimination of intersegment transactions in the total. The insurance segment and reinsurance segment results include $0.8 million and $18.3 million, respectively, of gross and net premiums written and $0.8 million and $21.4 million, respectively, of net premiums earned assumed through intersegment transactions.

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

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)

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

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

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

(1) Insurance segment results include premiums written and earned assumed through intersegment transactions of $0.1 million for the 2008 second quarter and $0.3 million for the 2007 second quarter. Insurance segment results exclude premiums written and earned ceded through intersegment transactions of $8.0 million and $8.5 million, respectively, for the 2008 second quarter and $9.6 million and $10.8 million, respectively, for the 2007 second quarter.

(2) Includes excess workers compensation and employers liability business and travel and accident business.

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

(1) Insurance segment results include premiums written and earned assumed through intersegment transactions of $0.1 million and $0.2 million, respectively, for the 2008 period and $0.8 million for the 2007 period. Insurance segment results exclude premiums written and earned ceded through intersegment transactions of $15.0 million and $17.2 million, respectively, for the 2008 period and $18.3 million and $21.4 million, respectively, for the 2007 period.

(2) Includes excess workers compensation and employers liability business and travel and accident business.

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ARCH CAPITAL GROUP LTD. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)

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

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

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

(1) Reinsurance segment results include premiums written and earned assumed through intersegment transactions of $8.0 million and $8.5 million, respectively, for the 2008 second quarter and $9.6 million and $10.8 million, respectively, for the 2007 second quarter. Reinsurance segment results exclude premiums written and earned ceded through intersegment transactions of $0.1 million for the 2008 second quarter and $0.3 million for the 2007 second quarter.

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

(3) Includes facultative business.

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)

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

Total	$	673,195	100.0	$	749,468	100.0

(1) Reinsurance segment results include premiums written and earned assumed through intersegment transactions of $15.0 million and $17.2 million, respectively, for the 2008 period and $18.3 million and $21.4 million, respectively, for the 2007 period. Reinsurance segment results exclude premiums written and earned ceded through intersegment transactions of $0.1 million and $0.2 million, respectively, for the 2008 period and $0.8 million for the 2007 period.

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

(3) Includes facultative business.

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5. Reinsurance

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

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

The Company monitors the financial condition of its reinsurers and attempts to place coverages only with substantial, financially sound carriers. At June 30, 2008 and December 31, 2007, approximately 86.2% and 88.5%, respectively, of the Company s reinsurance recoverables on paid and unpaid losses (not including prepaid reinsurance premiums) of $1.70 billion and $1.74 billion, respectively, were due from carriers which had an A.M. Best rating of A- or better. At June 30, 2008 and December 31, 2007, the largest reinsurance recoverables from any one carrier were less than 5.8% and 5.2%, respectively, of the Company s total shareholders equity.

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

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ARCH CAPITAL GROUP LTD. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)

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

Arch Re Bermuda pays to Flatiron Re Ltd. a reinsurance premium in the amount of the ceded percentage of the original gross written premium on the business reinsured less a ceding commission, which includes a reimbursement of direct acquisition expenses as well as a commission to Arch Re Bermuda for generating the business. The Treaty also provides for a profit commission to Arch Re Bermuda based on the underwriting results for the 2006 and 2007 underwriting years on a cumulative basis. For the 2008 second quarter, $7.0 million of premiums written, $45.9 million of premiums earned and $15.7 million of losses and loss adjustment expenses were ceded to Flatiron Re Ltd. by Arch Re Bermuda, compared to $115.9 million of premiums written, $72.5 million of premiums earned and $28.0 million of losses and loss adjustment expenses for the 2007 second quarter. For the six months ended June 30, 2008, $25.4 million of premiums written, $104.7 million of premiums earned and $27.5 million of losses and loss adjustment expenses were ceded to Flatiron Re Ltd. by Arch Re Bermuda, compared to $224.8 million of premiums written, $138.5 million of premiums earned and $53.4 million of losses and loss adjustment expenses for 2007 period. At June 30, 2008, $65.6 million of premiums ceded to Flatiron Re Ltd. were unearned. Reinsurance recoverables from Flatiron Re Ltd., which is not rated by A.M. Best, were $180.1 million at June 30, 2008, compared to $152.6 million at December 31, 2007. As noted above, Flatiron Re Ltd. is required to contribute funds into a trust for the benefit of Arch Re Bermuda. The recoverable from Flatiron Re Ltd. was fully collateralized through such trust at June 30, 2008 and December 31, 2007.

6. Investment Information

The following table summarizes the Company s invested assets:

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

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

(1) In securities lending transactions, the Company receives collateral in excess of the fair value of the fixed maturities and short-term investments pledged under securities lending agreements. For purposes of this table, the Company has excluded the collateral received at June 30, 2008 and December 31, 2007 of $918.2 million and $1.5 billion, respectively, which is reflected as short-term investment of funds received under securities lending agreements, at fair value and included the $890.8 million and $1.46 billion, respectively, of fixed maturities and short-term investments pledged under securities lending agreements, at fair value.

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ARCH CAPITAL GROUP LTD. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)

Fixed Maturities and Fixed Maturities Pledged Under Securities Lending Agreements

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

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

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

As of June 30, 2008, the Company held insurance enhanced municipal bonds, net of prerefunded bonds that are escrowed in U.S. government obligations, in the amount of approximately $387.5 million, which represented approximately 3.9% of the Company s total invested assets. These securities had an average rating of Aa2 by Moody s and AA+ by Standard & Poor s. Giving no effect to the insurance enhancement, the overall credit quality of the Company s insured municipal bond portfolio was an average underlying rating of Aa3 by Moody s and AA- by Standard & Poor s. Guarantors of the Company s $387.5 million of insurance enhanced municipal bonds, net of prerefunded bonds that are escrowed in U.S. government obligations, include MBIA Insurance Corporation ($148.0 million), Financial Security Assurance Inc. ($86.4 million), Ambac Financial Group, Inc. ($76.7 million), Financial Guaranty Insurance Company ($53.3 million) and the Texas Permanent School Fund ($23.1 million). The Company does not have a significant exposure to insurance enhanced asset-backed or mortgage-backed securities. The Company does not have any significant investments in companies which guarantee securities at June 30, 2008.

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

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

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

Securities Lending Agreements

The Company participates in a securities lending program under which certain of its fixed income portfolio securities are loaned to third parties, primarily major brokerage firms, for short periods of time through a lending agent. Such securities have been reclassified as Fixed maturities and short-term investments pledged under securities lending agreements, at fair value. The Company maintains control over the securities it lends, retains the earnings and cash flows associated with the loaned securities and receives a fee from the borrower for the temporary use of the securities. Collateral received, which to date has only been cash, is required at a rate of 102% of the market value of the loaned securities (or 105% of the market value of the loaned securities when the collateral and loaned securities are denominated in non-U.S. currencies) including accrued investment income and is monitored and maintained by the lending agent. Such collateral is reinvested and is reflected as Short-term investment of funds received under securities lending agreements, at fair value. At June 30, 2008, the fair value and amortized cost of fixed maturities and short-term investments pledged under securities lending agreements were $890.8 million and $892.2 million, respectively, while collateral received totaled $918.2 million at fair value and amortized cost. At December 31, 2007, the fair value and amortized cost of fixed maturities and short-term investments pledged under securities lending agreements were $1.46 billion and $1.44 billion, respectively, while collateral received totaled $1.5 billion at fair value and amortized cost.

Investment-Related Derivatives

The Company s investment strategy allows for the use of derivative securities. Derivative instruments may be used to enhance investment performance, replicate investment positions or manage market exposures and duration risk that would be allowed under the Company s investment guidelines if implemented in other ways. The fair values of those derivatives are based on quoted market prices. At June 30, 2008, the notional value of the net short position for equity futures was nil, compared to a net long position for equity futures of $91.2 million at December 31, 2007. At June 30, 2008 and December 31, 2007, the notional value of the net long position for Treasury note futures was nil and $61.7 million, respectively. For the 2008 second quarter and six months ended June 30, 2008, the Company recorded net realized losses of $11.0 million and $16.8 million, respectively, related to changes in the fair value of all futures contracts, compared to net realized gains of $4.8 million and $3.9 million, respectively, for the 2007 second quarter and six months ended June 30, 2007.

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Other Investments

The following table details the Company s other investments:

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

Other investments include: (i) mutual funds which invest in fixed maturity securities and international equity index funds; and (ii) privately held securities and other which include the Company s investment in Aeolus LP (see Note 9). The Company s investment commitments relating to its other investments and investment funds accounted for using the equity method totaled approximately $53.3 million at June 30, 2008.

Investment Funds Accounted for Using the Equity Method

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

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

Investment in Joint Venture

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

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Restricted Assets

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

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

In addition, certain of the Company s operating subsidiaries maintain assets in trust accounts as collateral for insurance and reinsurance transactions with affiliated companies. At June 30, 2008 and December 31, 2007, such amounts approximated $3.85 billion and $3.8 billion, respectively.

Net Investment Income

The components of net investment income were as follows:

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

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

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

Net Realized Gains (Losses)

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

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

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

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

Certain of the Company s investments, primarily those included in other investments and investment funds accounted for using the equity method on the Company s balance sheet, may use leverage to achieve a higher rate of return. While leverage presents opportunities for increasing the total return of such investments, it may increase losses as well. Accordingly, any event that adversely affects the value of the underlying securities held by such investments would be magnified to the extent leverage is used and the Company s potential losses from such investments would be magnified.

Fair Value

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

In addition, effective January 1, 2008, the Company adopted and implemented SFAS No. 157, Fair Value Measurements (SFAS No. 157), which addresses how companies should measure fair value when they are required to use a fair value measure for recognition or disclosure purposes under GAAP and provides a common definition of fair value to be used throughout GAAP. SFAS No. 157 defines fair value as the price that would be received to sell an asset or paid to transfer a liability in an orderly fashion between market participants at the measurement date.

SFAS No. 157 establishes a three-level valuation hierarchy for the disclosure of fair value measurements. The valuation hierarchy is based upon the transparency of inputs to the valuation of an asset or liability as of the measurement date. The level in the hierarchy within which a given fair value measurement falls is determined based on the lowest level input that is significant to the measurement (Level 1 being the highest priority and Level 3 being the lowest priority). The three levels are defined as follows:

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

Level 2:

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

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

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

The Company uses quoted values and other data provided by nationally recognized independent pricing sources as inputs into its process for determining fair values of its fixed maturity investments. To validate the techniques or models used by pricing sources, the Company s review process includes, but is not limited to: (i) quantitative analysis (e.g., comparing the quarterly return for each managed portfolio to its target benchmark, with significant differences identified and investigated); (ii) initial and ongoing evaluation of methodologies used by outside parties to calculate fair value; (iii) comparing the fair value estimates to its knowledge of the current market; and (iv) back-testing, which includes randomly selecting purchased or sold securities and comparing the executed prices to the fair value estimates from the pricing service. Based on the above review, the Company will challenge any prices for a security or portfolio which are considered not to be representative of fair value.

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

The Company reviews its securities measured at fair value and discusses the proper classification of such investments with investment advisors and others. Upon adoption of SFAS No. 157 and at June 30, 2008, the Company determined that Level 1 securities would include highly liquid, recent issue U.S. Treasuries and certain of its short-term investments held in highly liquid money market-type funds where it believes that quoted prices are available in an active market.

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

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

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

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

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

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

(1) In securities lending transactions, the Company receives collateral in excess of the fair value of the fixed maturities and short-term investments pledged under securities lending agreements. For purposes of this table, the Company has excluded the collateral received of $918.2 million which is reflected as short-term investment of funds received under securities lending agreements, at fair value and included the $890.8 million of fixed maturities and short-term investments pledged under securities lending agreements, at fair value.

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

The following table presents a reconciliation of the beginning and ending balances for all investments measured at fair value on a recurring basis using Level 3 inputs for the 2008 second quarter and six months ended June 30, 2008:

	Fair Value Measurements Using: Significant Unobservable Inputs (Level 3)		
	Fixed Maturities	Other Investments	Total
Three Months Ended June 30, 2008:			
Beginning balance at April 1, 2008	$ 5,136	$ 11,145	$ 16,281
Total gains or (losses) (realized/unrealized)			
Included in earnings **(1)**	(38)	222	184
Included in other comprehensive income		(1,486)	(1,486)
Purchases, issuances and settlements	1,381	(239)	1,142

Transfers in and/or out of Level 3			
Ending balance at June 30, 2008	$ 6,479	$ 9,642	$ 16,121
Six Months Ended June 30, 2008:			
Beginning balance at January 1, 2008	$ 3,752	$ 11,504	$ 15,256
Total gains or (losses) (realized/unrealized)			
Included in earnings **(1)**	(76)	459	383
Included in other comprehensive income		(1,789)	(1,789)
Purchases, issuances and settlements	2,803	(532)	2,271
Transfers in and/or out of Level 3			
Ending balance at June 30, 2008	$ 6,479	$ 9,642	$ 16,121

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

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

7. Earnings Per Common Share

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

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

(1) Certain stock options were not included in the computation of diluted earnings per share where the exercise price of the stock options exceeded the average market price and would have been anti-dilutive or where, when applying the treasury stock method to in-the-money options, the sum of the proceeds, including unrecognized compensation, exceeded the average market price and would have been anti-dilutive. For the 2008 second quarter and six months ended June 30, 2008, the number of stock options excluded were 0.5 million and 0.4 million, respectively. For the 2007 second quarter and six months ended June 30, 2007, the number of stock options excluded were 0.2 million and 0.1 million, respectively.

8. Income Taxes

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

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

The Company s income tax provision resulted in an effective tax rate on income before income taxes of 2.6% and 3.2%, respectively, for the 2008 second quarter and six months ended June 30, 2008, compared to 2.8% and 3.4%, respectively, for the 2007 second quarter and six months ended June 30, 2007. The Company s effective tax rate, which is based upon the expected annual effective tax rate, may fluctuate from period to period based on the relative mix of income reported by jurisdiction due primarily to the varying tax rates in each jurisdiction.

The United States also imposes an excise tax on insurance and reinsurance premiums paid to non-U.S. insurers or reinsurers with respect to risks located in the United States. The rates of tax, unless reduced by an applicable U.S. tax treaty, are four percent for non-life insurance premiums and one percent for life insurance and all reinsurance premiums. The Company incurs federal excise taxes on certain of its reinsurance transactions, including amounts ceded through intercompany transactions. For the 2008 second quarter and six months ended June 30, 2008, the Company withheld and paid approximately $4.3 million and $7.2 million, respectively, of federal excise taxes, compared to $2.7 million and $6.6 million, respectively, for the 2007 second quarter and six months ended June 30, 2007.

9. Transactions with Related Parties

The Company made an investment of $50.0 million in Aeolus LP (Aeolus) in 2006. Aeolus operates as an unrated reinsurance platform that provides property catastrophe protection to insurers and reinsurers on both an ultimate net loss and industry loss warranty basis. In return for its investment, included in Other investments on the Company s balance sheet, the Company received an approximately 4.9% preferred interest in Aeolus and a pro rata share of certain founders interests. The Company made its investment in Aeolus on the same economic terms as a fund affiliated with Warburg Pincus, which has invested $350 million in Aeolus. Funds affiliated with Warburg Pincus owned 12.1% of the Company s outstanding voting shares as of June 30, 2008. In addition, one of the founders of Aeolus is Peter Appel, former President and CEO and a former director of the Company.

10. Contingencies Relating to the Sale of Prior Reinsurance Operations

On May 5, 2000, the Company sold the prior reinsurance operations of Arch Re U.S. pursuant to an agreement entered into as of January 10, 2000 with Folksamerica Reinsurance Company and Folksamerica Holding Company (collectively, Folksamerica). Folksamerica Reinsurance Company assumed Arch Re U.S. s

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liabilities under the reinsurance agreements transferred in the asset sale and Arch Re U.S. transferred to Folksamerica Reinsurance Company assets estimated in an aggregate amount equal in book value to the book value of the liabilities assumed. The Folksamerica transaction was structured as a transfer and assumption agreement (and not reinsurance) and, accordingly, the loss reserves (and any related reinsurance recoverables) relating to the transferred business are not included as assets or liabilities on the Company s balance sheet. Folksamerica assumed Arch Re U.S. s rights and obligations under the reinsurance agreements transferred in the asset sale. The reinsureds under such agreements were notified that Folksamerica had assumed Arch Re U.S. s obligations and that, unless the reinsureds object to the assumption, Arch Re U.S. will be released from its obligations to those reinsured. None of such reinsureds objected to the assumption. However, Arch Re U.S. will continue to be liable under those reinsurance agreements if the notice is found not to be an effective release by the reinsureds. Folksamerica has agreed to indemnify the Company for any losses arising out of the reinsurance agreements transferred to Folksamerica Reinsurance Company in the asset sale. However, in the event that Folksamerica refuses or is unable to perform its obligations to the Company, Arch Re U.S. may incur losses relating to the reinsurance agreements transferred in the asset sale. Folksamerica s A.M. Best rating was A- (Excellent) at June 30, 2008.

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

11. Commitments and Contingencies

Variable Interest Entities

On December 29, 2005, Arch Re Bermuda entered into a quota share reinsurance treaty with Flatiron Re Ltd., a newly-formed Bermuda reinsurance company, pursuant to which Flatiron Re Ltd. assumed a 45% quota share (the Treaty) of certain lines of property and marine business underwritten by Arch Re Bermuda for unaffiliated third parties for the 2006 and 2007 underwriting years (January 1, 2006 to December 31, 2007). As a result of the terms of the Treaty, the Company determined that Flatiron Re Ltd. is a variable interest entity. However, Arch Re Bermuda is not the primary beneficiary of Flatiron Re Ltd. and, as such, the Company is not required to consolidate the assets, liabilities and results of operations of Flatiron Re Ltd. per FIN 46R. On December 31, 2007, the Treaty expired by its terms. See Note 5, Reinsurance for information on the Treaty with Flatiron Re Ltd.

12. Legal Proceedings

The Company, in common with the insurance industry in general, is subject to litigation and arbitration in the normal course of its business. As of June 30, 2008, the Company was not a party to any material litigation or arbitration other than as a part of the ordinary course of business in relation to claims and reinsurance

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

recoverable matters, none of which is expected by management to have a significant adverse effect on the Company s results of operations and financial condition and liquidity.

13. Recent Accounting Pronouncements

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

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

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

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

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

GENERAL

Overview

Arch Capital Group Ltd. (ACGL and, together with its subsidiaries, we or us) is a Bermuda public limited liability company with approximately $4.3 billion in capital at June 30, 2008 and, through operations in Bermuda, the United States, Europe and Canada, writes insurance and reinsurance on a worldwide basis. While we are positioned to provide a full range of property and casualty insurance and reinsurance lines, we focus on writing specialty lines of insurance and reinsurance. It is our belief that our underwriting platform, our experienced management team and our strong capital base that is unencumbered by significant pre-2002 risks have enabled us to establish a strong presence in the insurance and reinsurance markets.

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

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

In general, market conditions improved during 2002 and 2003 in the insurance and reinsurance marketplace. This reflected improvement in pricing, terms and conditions following significant industry losses arising from the events of September 11, 2001, as well as the recognition that intense competition in the late 1990s led to inadequate pricing and overly broad terms, conditions and coverages. Such industry developments resulted in poor financial results and erosion of the industry s capital base. Consequently, many established insurers and reinsurers reduced their participation in, or exited from, certain markets and, as a result, premium rates escalated in many lines of business. These developments provided relatively new insurers and reinsurers, like us, with an opportunity to provide needed underwriting capacity. Beginning in late 2003 and continuing through 2005, additional capacity emerged in many classes of business and, consequently, premium rate increases decelerated significantly and, in many classes of business, premium rates decreased. The weather-related catastrophic events that occurred in the second half of 2005 caused significant industry losses and led to

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a strengthening of rating agency capital requirements for catastrophe-exposed business. The 2005 events also resulted in substantial improvements in market conditions in property and certain marine lines of business and slowed declines in premium rates in other lines. During 2006 and 2007, excellent industry results led to a significant increase in capacity and, accordingly, competition intensified in 2007 and prices, in general, declined in all lines of business, including property. This trend has continued in 2008.

Current Outlook

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

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

We believe that the most attractive area from a pricing point of view remains catastrophe-related property business. We seek to limit the probable maximum pre-tax loss to a specific level for severe catastrophic events. Currently, we generally seek to limit the probable maximum pre-tax loss to approximately 25% of total shareholders equity for a severe catastrophic event in any geographic zone that could be expected to occur once in every 250 years, although we reserve the right to change this threshold at any time. In July 2008, the probable maximum pre-tax loss for a catastrophic event in any geographic zone arising from a 1-in-250 year event was approximately $815 million, compared to $765 million in February 2008. There can be no assurances that we will not suffer pre-tax losses greater than 25% of our total shareholders equity from one or more catastrophic events due to several factors, including the inherent uncertainties in estimating the frequency and severity of such events and the margin of error in making such determinations resulting from potential inaccuracies and inadequacies in the data provided by clients and brokers, the modeling techniques and the application of such techniques or as a result of a decision to change the percentage of shareholders equity exposed to a single catastrophic event. See Risk Factors Risk Relating to Our Industry and Management s Discussion and Analysis of Financial Condition and Results of Operations Natural and Man-Made Catastrophic Events contained in our Annual Report on Form 10-K for the year ended December 31, 2007.

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CRITICAL ACCOUNTING POLICIES, ESTIMATES AND RECENT ACCOUNTING PRONOUNCEMENTS

Critical accounting policies, estimates and recent accounting pronouncements are discussed in Management s Discussion and Analysis of Financial Condition and Results of Operations contained in our Annual Report on Form 10-K for the year ended December 31, 2007, updated where applicable in the notes accompanying our consolidated financial statements.

RESULTS OF OPERATIONS

Three Months Ended June 30, 2008 and 2007

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

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

Net income available to common shareholders was $192.3 million for the 2008 second quarter, compared to $199.4 million for the 2007 second quarter. The decrease in net income was primarily due to a decrease in underwriting income from our insurance and reinsurance operations, as discussed in Segment Information below. Our net income available to common shareholders for the 2008 second quarter represented a 21.2% annualized return on average common equity, compared to 23.3% for the 2007 second quarter. For purposes of computing return on average common equity, average common equity has been calculated as the average of common shareholders equity outstanding at the beginning and ending of each period.

Diluted weighted average common shares and common share equivalents outstanding, used in the calculation of net income per common share, were 65.7 million in the 2008 second quarter, compared to 75.3 million in the 2007 second quarter. The lower level of weighted average shares outstanding in the 2008 second quarter was primarily due to the impact of share repurchases. As a result of the share repurchase transactions to date, weighted average shares outstanding for the 2008 second quarter were reduced by 11.9 million shares, compared to 1.8 million shares for the 2007 second quarter.

Segment Information

We classify our businesses into two underwriting segments insurance and reinsurance and corporate and other (non-underwriting). SFAS No. 131, Disclosures About Segments of an Enterprise and Related Information, requires certain disclosures about operating segments in a manner that is consistent with how management evaluates the performance of the segment. For a description of our underwriting segments, refer to note 4, Segment Information, of the notes accompanying our consolidated financial statements. Management measures segment performance based on underwriting income or loss.

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Insurance Segment

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

	Three Months Ended June 30, 2008		2007
Gross premiums written	$	621,663	