ARCH CAPITAL GROUP LTD.
Form 10-Q
May 09, 2011
Table of Contents

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 March 31, 2011

Or

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

Commission file number: 001-26456

ARCH CAPITAL GROUP LTD.

(Exact name of registrant as specified in its charter)

Bermuda

(State or other jurisdiction of incorporation or organization)

Not Applicable

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

Wessex House, 45 Reid Street

Hamilton HM 12, Bermuda

(Address of principal executive offices)

(441) 278-9250

(Registrant s telephone number, including area code)

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

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

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

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

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

The number of the registrant s common shares (par value, $0.01 per share) outstanding as of May 4, 2011 was 43,987,362.

Table of Contents

ARCH CAPITAL GROUP LTD.

INDEX

	Page No.
PART I. Financial Information	
Item 1 Consolidated Financial Statements	
Report of Independent Registered Public Accounting Firm	2
Consolidated Balance Sheets March 31, 2011 (unaudited) and December 31, 2010	3
Consolidated Statements of Income For the three month periods ended March 31, 2011 and 2010 (unaudited)	4
Consolidated Statements of Comprehensive Income For the three month periods ended March 31, 2011 and 2010 (unaudited)	5
Consolidated Statements of Changes in Shareholders Equity For the three month periods ended March 31, 2011 and 2010 (unaudited)	6
Consolidated Statements of Cash Flows For the three month periods ended March 31, 2011 and 2010 (unaudited)	7
Notes to Consolidated Financial Statements (unaudited)	8
Item 2 Management s Discussion and Analysis of Financial Condition and Results of Operations	34
Item 3 Quantitative and Qualitative Disclosures About Market Risk	65
Item 4 Controls and Procedures	65
PART II. Other Information	
Item 1 Legal Proceedings	66
Item 2 Unregistered Sales of Equity Securities and Use of Proceeds	66
Item 5 Other Information	67
Item 6 Exhibits	67

Table of Contents

Report of Independent Registered Public Accounting Firm

To the Board of Directors and Shareholders of

Arch Capital Group Ltd.:

We have reviewed the accompanying consolidated balance sheet of Arch Capital Group Ltd. and its subsidiaries (the Company) as of March 31, 2011, and the related consolidated statements of income for the three-month periods ended March 31, 2011 and March 31, 2010, and the consolidated statements of comprehensive income, changes in shareholders equity and cash flows for the three-month periods ended March 31, 2011 and March 31, 2010. 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, 2010, and the related consolidated statements of income, comprehensive income, changes in shareholders equity, and cash flows for the year then ended (not presented herein), and in our report dated February 28, 2011, 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, 2010, is fairly stated in all material respects in relation to the consolidated balance sheet from which it has been derived.

/s/ PricewaterhouseCoopers LLP

New York, NY

May 9, 2011

Table of Contents

ARCH CAPITAL GROUP LTD. and Subsidiaries

Consolidated BALANCE SHEETS

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

	(Unaudited) March 31, 2011	December 31, 2010
Assets		
Investments:		
Fixed maturities available for sale, at market value (amortized cost: $8,842,786 and $8,896,957)	$ 9,033,408	$ 9,082,828
Short-term investments available for sale, at market value (amortized cost: $1,124,397 and $913,488)	1,130,142	915,841
Investment of funds received under securities lending agreements, at market value (amortized cost: $9,547 and $69,682)	9,951	69,660
TALF investments, at market value (amortized cost: $386,068 and $389,200)	400,970	402,449
Equity securities available for sale, at market value (cost: $393,645 and $346,019)	419,893	363,255
Other investments (cost: $362,020 and $326,324)	386,127	349,272
Investment funds accounted for using the equity method	395,258	434,600
Total investments	11,775,749	11,617,905
Cash	406,877	362,740
Accrued investment income	69,057	74,837
Investment in joint venture (cost: $100,000)	105,495	105,698
Fixed maturities and short-term investments pledged under securities lending agreements, at market value	198,418	75,575
Securities purchased under agreements to resell using funds received under securities lending agreements	185,176	
Premiums receivable	633,144	503,434
Unpaid losses and loss adjustment expenses recoverable	1,720,677	1,703,201
Paid losses and loss adjustment expenses recoverable	51,453	60,784
Prepaid reinsurance premiums	259,624	263,448
Deferred acquisition costs, net	302,271	277,861
Receivable for securities sold	749,708	56,145
Other assets	734,317	669,164
Total Assets	$ 17,191,966	$ 15,770,792
Liabilities		
Reserve for losses and loss adjustment expenses	$ 8,319,324	$ 8,098,454
Unearned premiums	1,504,162	1,370,075
Reinsurance balances payable	131,512	132,452
Senior notes	300,000	300,000
Revolving credit agreement borrowings	100,000	100,000
TALF borrowings, at market value (par: $322,514 and $326,219)	322,222	325,770
Securities lending payable	203,925	78,021
Payable for securities purchased	1,266,390	200,192
Other liabilities	718,896	652,825
Total Liabilities	12,866,431	11,257,789
Commitments and Contingencies		
Shareholders Equity		

Non-cumulative preferred shares - Series A and B	325,000	325,000
Common shares ($0.01 par, shares issued: 53,454,505 and 53,357,872)	535	534
Additional paid-in capital	120,109	110,325
Retained earnings	4,441,848	4,422,553
Accumulated other comprehensive income, net of deferred income tax	225,405	204,503
Common shares held in treasury, at cost (shares: 9,504,292 and 6,813,797)	(787,362)	(549,912)
Total Shareholders Equity	4,325,535	4,513,003
Total Liabilities and Shareholders Equity	$ 17,191,966	$ 15,770,792

See Notes to Consolidated Financial Statements

Table of Contents

ARCH CAPITAL GROUP LTD. AND SUBSIDIARIES

CONSOLIDATED STATEMENTS OF INCOME

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

	(Unaudited) Three Months Ended March 31, 2011	2010
Revenues		
Net premiums written	$ 764,278	$ 767,754
Change in unearned premiums	(130,583)	(97,837)
Net premiums earned	633,695	669,917
Net investment income	88,307	92,972
Net realized gains	20,695	47,782
Other-than-temporary impairment losses	(3,258)	(2,336)
Less investment impairments recognized in other comprehensive income, before taxes	578	730
Net impairment losses recognized in earnings	(2,680)	(1,606)
Fee income	815	794
Equity in net income of investment funds accounted for using the equity method	29,673	29,050
Other income	4,567	5,978
Total revenues	775,072	844,887
Expenses		
Losses and loss adjustment expenses	493,880	428,051
Acquisition expenses	108,754	117,624
Other operating expenses	102,420	106,806
Interest expense	7,721	7,260
Net foreign exchange losses (gains)	36,912	(38,601)
Total expenses	749,687	621,140
Income before income taxes	25,385	223,747
Income tax (benefit) expense	(371)	6,753
Net income	25,756	216,994
Preferred dividends	6,461	6,461
Net income available to common shareholders	$ 19,295	$ 210,533
Net income per common share		
Basic	$ 0.43	$ 3.97
Diluted	$ 0.41	$ 3.79
Weighted average common shares and common share equivalents outstanding		
Basic	44,499,747	53,039,026
Diluted	46,820,172	55,513,827

See Notes to Consolidated Financial Statements

Table of Contents

ARCH CAPITAL GROUP LTD. AND SUBSIDIARIES

CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME

(U.S. dollars in thousands)

	(Unaudited) Three Months Ended March 31, 2011	2010
Comprehensive Income		
Net income	$ 25,756	$ 216,994
Other comprehensive income, net of deferred income tax		
Unrealized appreciation in value of investments:		
Unrealized holding gains arising during period	40,370	42,847
Portion of other-than-temporary impairment losses recognized in other comprehensive income, net of deferred income tax	(578)	(730)
Reclassification of net realized gains, net of income taxes, included in net income	(20,176)	(37,607)
Foreign currency translation adjustments	1,286	(2,074)
Other comprehensive income	20,902	2,436
Comprehensive Income	**$** 46,658	**$** 219,430

See Notes to Consolidated Financial Statements

Table of Contents

ARCH CAPITAL GROUP LTD. AND SUBSIDIARIES

CONSOLIDATED STATEMENTS OF CHANGES IN SHAREHOLDERS EQUITY

(U.S. dollars in thousands)

	(Unaudited) Three Months Ended March 31, 2011	2010
Non-Cumulative Preferred Shares		
Balance at beginning and end of period	$ 325,000	$ 325,000
Common Shares		
Balance at beginning of year	534	548
Common shares issued, net	1	4
Purchases of common shares under share repurchase program		(25)
Balance at end of period	535	527
Additional Paid-in Capital		
Balance at beginning of year	110,325	253,466
Common shares issued	8	14
Exercise of stock options	4,127	16,700
Common shares retired		(181,350)
Amortization of share-based compensation	5,628	7,096
Other	21	
Balance at end of period	120,109	95,926
Retained Earnings		
Balance at beginning of year	4,422,553	3,605,809
Dividends declared on preferred shares	(6,461)	(6,461)
Net income	25,756	216,994
Balance at end of period	4,441,848	3,816,342
Accumulated Other Comprehensive Income		
Balance at beginning of year	204,503	138,526
Change in unrealized appreciation in value of investments, net of deferred income tax	20,194	5,240
Portion of other-than-temporary impairment losses recognized in other comprehensive income, net of deferred income tax	(578)	(730)
Foreign currency translation adjustments, net of deferred income tax	1,286	(2,074)
Balance at end of period	225,405	140,962
Common Shares Held in Treasury, at Cost		
Balance at beginning of year	(549,912)	
Shares repurchased for treasury	(237,450)	
Balance at end of period	(787,362)	
Total Shareholders Equity	$ 4,325,535	$ 4,378,757

See Notes to Consolidated Financial Statements

Table of Contents

ARCH CAPITAL GROUP LTD. AND SUBSIDIARIES

CONSOLIDATED STATEMENTS OF CASH FLOWS

(U.S. dollars in thousands)

	(Unaudited) Three Months Ended March 31, 2011	(Unaudited) Three Months Ended March 31, 2010
Operating Activities		
Net income	$ 25,756	$ 216,994
Adjustments to reconcile net income to net cash provided by operating activities:		
Net realized gains	(22,481)	(49,483)
Net impairment losses recognized in earnings	2,680	1,606
Equity in net income of investment funds accounted for using the equity method and other income	(355)	(15,012)
Share-based compensation	5,628	7,096
Changes in:		
Reserve for losses and loss adjustment expenses, net of unpaid losses and loss adjustment expenses recoverable	155,477	91,247
Unearned premiums, net of prepaid reinsurance premiums	130,136	96,645
Premiums receivable	(118,688)	(116,571)
Deferred acquisition costs, net	(22,518)	(19,655)
Reinsurance balances payable	(7,122)	(36,669)
Other liabilities	33,366	41,448
Other items, net	42,701	(33,023)
Net Cash Provided By Operating Activities	224,580	184,623
Investing Activities		
Purchases of:		
Fixed maturity investments	(3,250,938)	(4,597,713)
Equity securities	(89,790)	(52,283)
Other investments	(92,777)	(132,819)
Proceeds from the sales of:		
Fixed maturity investments	3,376,248	4,443,108
Equity securities	52,316	11,725
Other investments	84,920	89,510
Proceeds from redemptions and maturities of fixed maturity investments	253,898	212,625
Net purchases of short-term investments	(267,904)	(102,921)
Change in investment of securities lending collateral	(125,904)	30,092
Purchases of furniture, equipment and other assets	(8,082)	(1,803)
Net Cash Used By Investing Activities	(68,013)	(100,479)
Financing Activities		
Purchases of common shares under share repurchase program	(237,173)	(181,272)
Proceeds from common shares issued, net	2,875	10,591
Proceeds from borrowings		214,526
Repayments of borrowings	(3,695)	(86,317)
Change in securities lending collateral	125,904	(30,092)
Other	714	5,061
Preferred dividends paid	(6,461)	(6,461)
Net Cash Used For Financing Activities	(117,836)	(73,964)

Effects of exchange rate changes on foreign currency cash		5,406		(6,043)
Increase in cash		44,137		4,137
Cash beginning of year		362,740		334,571
Cash end of period	$	406,877	$	338,708

See Notes to Consolidated Financial Statements

Table of Contents

ARCH CAPITAL GROUP LTD. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)

1. General

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

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

Certain information and footnote disclosures normally included in financial statements prepared in accordance with GAAP have been condensed or omitted; however, management believes that the disclosures are adequate to make the information presented not misleading. This report should be read in conjunction with the Company s Annual Report on Form 10-K for the year ended December 31, 2010, including the Company s audited consolidated financial statements and related notes.

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

2. Recent Accounting Pronouncements

In October 2010, the Financial Accounting Standards Board (FASB) issued an Accounting Standards Update (ASU) that modifies the definition of the types of costs incurred by insurance entities that can be capitalized in the acquisition of new or renewal insurance contracts. The amended guidance specifies that certain costs incurred in the successful acquisition of new and renewal insurance contracts should be capitalized. Those costs include incremental direct costs of contract acquisition that result directly from and are essential to the contract transaction and would not have been incurred had the contract transaction not occurred. All other acquisition-related costs, such as costs incurred for soliciting business, administration, and unsuccessful acquisition or renewal efforts should be charged to expense as incurred. Administrative costs, including rent, depreciation, occupancy, equipment, and all other general overhead costs are considered indirect costs and should also be charged to expense as incurred. This ASU is effective for fiscal years, and interim periods within those fiscal years, beginning after December 15, 2011. Earlier adoption is permitted. Retrospective application to all prior periods presented upon the date of adoption is also permitted but is not required. The Company is evaluating the impact this new guidance will have on its consolidated statement of financial position and results of operations.

3. Share Transactions

Share Repurchases

The board of directors of ACGL has authorized the investment in ACGL s common shares through a share repurchase program. Authorizations have consisted of a $1.0 billion authorization in February 2007, a $500 million authorization in May 2008, a $1.0 billion authorization in November 2009 and a $1.0 billion

Table of Contents

ARCH CAPITAL GROUP LTD. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)

authorization in February 2011. Repurchases under the program may be effected from time to time in open market or privately negotiated transactions through December 2012. Since the inception of the share repurchase program, ACGL has repurchased approximately 34.4 million common shares for an aggregate purchase price of $2.51 billion. During the 2011 first quarter, ACGL repurchased 2.7 million common shares for an aggregate purchase price of $237.2 million, compared to 2.5 million common shares for an aggregate purchase price of $181.3 million during the 2010 first quarter.

At March 31, 2011, approximately $992.4 million of share repurchases were available under the program. The timing and amount of the repurchase transactions under this program will depend on a variety of factors, including market conditions and corporate and regulatory considerations.

Treasury Shares

In May 2010, ACGL s shareholders approved amendments to the bye-laws to permit ACGL to hold its own acquired shares as treasury shares in lieu of cancellation, as determined by ACGL s board of directors. From May 5, 2010 to March 31, 2011, all repurchases of ACGL s common shares in connection with the share repurchase plan noted above and other share-based transactions were held in the treasury under the cost method, and the cost of the common shares acquired is included in Common shares held in treasury, at cost. Prior to May 5, 2010, such acquisitions were reflected as a reduction in additional paid-in capital. At March 31, 2011, the Company held 9.5 million shares for an aggregate cost of $787.4 million in treasury.

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. ACGL has the right to redeem all or a portion of the Series A Preferred Shares at a redemption price of $25.00 per share currently and the right to redeem all or a portion of the Series B Preferred Shares on or after May 15, 2011. During the 2011 first quarter and 2010 first quarter, the Company paid $6.5 million to holders of the Preferred Shares. At March 31, 2011, the Company had declared an aggregate of $3.3 million of dividends to be paid to holders of the Preferred Shares. Certain executive officers and directors of the Company own less than 1% of the aggregate outstanding Preferred Shares.

Table of Contents

ARCH CAPITAL GROUP LTD. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)

4. Debt and Financing Arrangements

Senior Notes

On May 4, 2004, ACGL completed a public offering of $300 million principal amount of 7.35% senior notes (Senior Notes) due May 1, 2034 and received net proceeds of $296.4 million. ACGL used $200 million of the net proceeds to repay all amounts outstanding under a revolving credit agreement. The Senior Notes are ACGL s senior unsecured obligations and rank equally with all of its existing and future senior unsecured indebtedness. Interest payments on the Senior Notes are due on May 1st and November 1st of each year. ACGL may redeem the Senior Notes at any time and from time to time, in whole or in part, at a make-whole redemption price. For the 2011 first quarter and 2010 first quarter, interest expense on the Senior Notes was $5.5 million. The market value of the Senior Notes at March 31, 2011 and December 31, 2010 was $311.6 million and $310.9 million, respectively.

Letter of Credit and Revolving Credit Facilities

As of March 31, 2011, the Company had a $300 million unsecured revolving loan and letter of credit facility and a $1.0 billion secured letter of credit facility (the Credit Agreement). Under the terms of the agreement, Arch Reinsurance Company (Arch Re U.S.) is limited to issuing $100 million of unsecured letters of credit as part of the $300 million unsecured revolving loan. Borrowings of revolving loans may be made by ACGL and Arch Re U.S. at a variable rate based on LIBOR or an alternative base rate at the option of the Company. Secured letters of credit are available for issuance on behalf of the Company s insurance and reinsurance subsidiaries. The Credit Agreement and related documents are structured such that each party that requests a letter of credit or borrowing does so only for itself and for only its own obligations. Issuance of letters of credit and borrowings under the Credit Agreement are subject to the Company s compliance with certain covenants and conditions, including absence of a material adverse change. These covenants require, among other things, that the Company maintain a debt to total capital ratio of not greater than 0.35 to 1 and shareholders equity in excess of $1.95 billion plus 25% of future aggregate net income for each quarterly period (not including any future net losses) beginning after June 30, 2006 and 25% of future aggregate proceeds from the issuance of common or preferred equity and that the Company s principal insurance and reinsurance subsidiaries maintain at least a B++ rating from A.M. Best. In addition, certain of the Company s subsidiaries which are party to the Credit Agreement are required to maintain minimum shareholders equity levels. The Company was in compliance with all covenants contained in the Credit Agreement at March 31, 2011. The Credit Agreement expires on August 30, 2011.

In addition, the Company had access to secured letter of credit facilities of approximately $180 million as of March 31, 2011, which were primarily used to support the Company s syndicate at Lloyd s of London, and to other secured letter of credit facilities, some of which are available on a limited basis and for limited purposes (together with the secured portion of the Credit Agreement and these letter of credit facilities, the LOC Facilities). The principal purpose of the LOC Facilities is to issue, as required, evergreen standby letters of credit in favor of primary insurance or reinsurance counterparties with which the Company has entered into reinsurance arrangements to ensure that such counterparties are permitted to take credit for reinsurance obtained from the Company s reinsurance subsidiaries in United States jurisdictions where such subsidiaries are not licensed or otherwise admitted as an insurer, as required under insurance regulations in the United States, and to comply with requirements of Lloyd s of London in connection with qualifying quota share and other arrangements. The amount of letters of credit issued is driven by, among other things, the timing and payment of catastrophe losses, loss development of existing reserves, the payment pattern of such reserves, the further expansion of the Company s business and the loss experience of such business. When issued, certain letters of credit are secured by a portion of the Company s investment portfolio. In addition, the LOC Facilities also require the maintenance of certain covenants, which the Company was in compliance with at March 31, 2011. At such date, the Company had $692.2 million in outstanding letters of credit under the LOC Facilities, which

Table of Contents

ARCH CAPITAL GROUP LTD. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)

were secured by investments with a market value of $780.1 million. At March 31, 2011, the Company had $100.0 million of borrowings outstanding under the Credit Agreement at a Company-selected variable interest rate that is based on 1 month, 3 month or 6 month reset option terms and their corresponding term LIBOR rates plus 27.5 basis points.

TALF Program

The Company participates in the Federal Reserve Bank of New York s (FRBNY) Term Asset-Backed Securities Loan Facility (TALF). TALF provides secured financing for asset-backed securities backed by certain types of consumer and small business loans and for legacy commercial mortgage-backed securities. TALF financing is non-recourse to the Company, except in certain limited instances, and is collateralized by the purchased securities and provides financing for the purchase price of the securities, less a haircut that varies based on the type of collateral. The Company can deliver the collateralized securities to a special purpose vehicle created by the FRBNY in full defeasance of the borrowings. TALF began operation in March 2009 and was closed for new loan extensions against newly issued commercial mortgage-backed securities on June 30, 2010, and for new loan extensions against all other types of collateral on March 31, 2010.

The Company elected to carry the securities and related borrowings at fair value under the fair value option afforded by accounting guidance regarding the fair value option for financial assets and financial liabilities. As of March 31, 2011, the Company had $401.0 million of securities under TALF which are reflected as TALF investments, at market value and $322.2 million of secured financing from the FRBNY which is reflected as TALF borrowings, at market value. As of December 31, 2010, the Company had $402.4 million of TALF investments and $325.8 million of TALF borrowings. The maturity dates for the TALF borrowings vary between 1.3 to 4.0 years from March 31, 2011 with floating or fixed coupons depending on the related TALF investments.

Interest Paid

During the 2011 first quarter, the Company made interest payments of $2.2 million related to its debt and financing arrangements, compared to $1.8 million for the 2010 first quarter.

Table of Contents

ARCH CAPITAL GROUP LTD. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)

5. Segment Information

The Company classifies its businesses into two underwriting segments insurance and reinsurance and corporate and other (non-underwriting). The Company s insurance and reinsurance operating segments each have segment managers who are responsible for the overall profitability of their respective segments and who are directly accountable to the Company s chief operating decision makers, the Chairman, President and Chief Executive Officer of ACGL and the Chief Financial Officer of ACGL. The chief operating decision makers do not assess performance, measure return on equity or make resource allocation decisions on a line of business basis. The Company determined its reportable operating segments using the management approach described in accounting guidance regarding disclosures about segments of an enterprise and related information.

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

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

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

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

Table of Contents

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

	Three Months Ended March 31, 2011 Insurance	Reinsurance	Total
Gross premiums written (1)	$ 634,583	$ 331,013	$ 964,566
Net premiums written	449,291	314,987	764,278
Net premiums earned	407,591	226,104	633,695
Fee income	778	37	815
Losses and loss adjustment expenses	(297,723)	(196,157)	(493,880)
Acquisition expenses, net	(61,415)	(47,339)	(108,754)
Other operating expenses	(74,737)	(20,657)	(95,394)
Underwriting loss	$ (25,506)	$ (38,012)	(63,518)
Net investment income			88,307
Net realized gains			20,695
Net impairment losses recognized in earnings			(2,680)
Equity in net income of investment funds accounted for using the equity method			29,673
Other income			4,567
Other expenses			(7,026)
Interest expense			(7,721)
Net foreign exchange losses			(36,912)
Income before income taxes			25,385
Income tax benefit			371
Net income			25,756
Preferred dividends			(6,461)
Net income available to common shareholders			$ 19,295
Underwriting Ratios			
Loss ratio	73.0%	86.8%	77.9%
Acquisition expense ratio (2)	14.9%	20.9%	17.0%
Other operating expense ratio	18.3%	9.1%	15.1%
Combined ratio	106.2%	116.8%	110.0%

(1) Certain amounts included in the gross premiums written of each segment are related to intersegment transactions. Accordingly, the sum of gross premiums written for each segment does not agree to the total gross premiums written as shown in the table above due to the elimination of intersegment transactions in the total.

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

Table of Contents

ARCH CAPITAL GROUP LTD. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)

	Three Months Ended March 31, 2010		
	Insurance	Reinsurance	Total
Gross premiums written (1)	$ 633,576	$ 323,477	$ 953,687
Net premiums written	452,924	314,830	767,754
Net premiums earned	429,477	240,440	669,917
Fee income	753	41	794
Losses and loss adjustment expenses	(312,011)	(116,040)	(428,051)
Acquisition expenses, net	(67,431)	(50,193)	(117,624)
Other operating expenses	(80,720)	(20,398)	(101,118)
Underwriting income (loss)	$ (29,932)	$ 53,850	23,918
Net investment income			92,972
Net realized gains			47,782
Net impairment losses recognized in earnings			(1,606)
Equity in net income of investment funds accounted for using the equity method			29,050
Other income			5,978
Other expenses			(5,688)
Interest expense			(7,260)
Net foreign exchange gains			38,601
Income before income taxes			223,747
Income tax expense			(6,753)
Net income			216,994
Preferred dividends			(6,461)
Net income available to common shareholders			$ 210,533
Underwriting Ratios			
Loss ratio	72.6%	48.3%	63.9%
Acquisition expense ratio (2)	15.5%	20.9%	17.4%
Other operating expense ratio	18.8%	8.5%	15.1%
Combined ratio	106.9%	77.7%	96.4%

(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.

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

Table of Contents

ARCH CAPITAL GROUP LTD. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)

	Three Months Ended March 31,			
	2011		2010	
INSURANCE SEGMENT	**Amount**	**% of Total**	**Amount**	**% of Total**
Net premiums written				
Property, energy, marine and aviation	$ 76,418	17.0	$ 100,665	22.2
Programs	74,396	16.6	70,498	15.6
Professional liability	69,543	15.5	58,726	13.0
Executive assurance	45,910	10.2	61,355	13.5
National accounts casualty	40,191	8.9	30,809	6.8
Construction	31,509	7.0	36,322	8.0
Casualty	30,134	6.7	25,463	5.6
Travel and accident	21,501	4.8	21,806	4.8
Lenders products	21,074	4.7	16,319	3.6
Surety	9,734	2.2	8,091	1.8
Healthcare	9,117	2.0	8,524	1.9
Other (1)	19,764	4.4	14,346	3.2
Total	$ 449,291	100.0	$ 452,924	100.0
Net premiums earned				
Property, energy, marine and aviation	$ 73,599	18.1	$ 95,037	22.1
Programs	67,018	16.4	66,159	15.4
Professional liability	73,127	17.9	62,245	14.5
Executive assurance	48,843	12.0	56,322	13.1
National accounts casualty	21,162	5.2	21,773	5.1
Construction	28,391	7.0	34,485	8.0
Casualty	28,427	7.0	28,069	6.5
Travel and accident	15,599	3.8	16,078	3.7
Lenders products	18,236	4.5	16,807	3.9
Surety	9,779	2.4	10,258	2.4
Healthcare	8,652	2.1	9,943	2.3
Other (1)	14,758	3.6	12,301	3.0
Total	$ 407,591	100.0	$ 429,477	100.0
Net premiums written by client location				
United States	$ 305,216	67.9	$ 303,168	66.9
Europe	100,091	22.3	102,489	22.6
Other	43,984	9.8	47,267	10.5
Total	$ 449,291	100.0	$ 452,924	100.0
Net premiums written by underwriting location				
United States	$ 295,043	65.7	$ 302,437	66.8
Europe	135,536	30.2	133,739	29.5
Other	18,712	4.1	16,748	3.7
Total	$ 449,291	100.0	$ 452,924	100.0

(1) Includes excess workers compensation, employers liability, alternative markets and accident and health business.

15

Table of Contents

ARCH CAPITAL GROUP LTD. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)

	Three Months Ended March 31,					
	2011			2010		
REINSURANCE SEGMENT		**Amount**	**% of Total**		**Amount**	**% of Total**
Net premiums written						
Casualty (1)	$	81,802	26.0	$	72,582	23.1
Property excluding property catastrophe (2)		71,150	22.6		74,927	23.8
Other specialty		67,204	21.3		54,762	17.4
Property catastrophe		66,961	21.3		88,802	28.2
Marine and aviation		24,164	7.7		21,238	6.7
Other		3,706	1.1		2,519	0.8
Total	$	314,987	100.0	$	314,830	100.0
Net premiums earned						
Casualty (1)	$	49,705	22.0	$	70,436	29.3
Property excluding property catastrophe (2)		63,006	27.9		79,239	33.0
Other specialty		37,758	16.7		17,769	7.4
Property catastrophe		51,642	22.8		53,873	22.4
Marine and aviation		21,626	9.6		18,072	7.5
Other		2,367	1.0		1,051	0.4
Total	$	226,104	100.0	$	240,440	100.0
Net premiums written						
Pro rata	$	105,492	33.5	$	118,037	37.5
Excess of loss		209,495	66.5		196,793	62.5
Total	$	314,987	100.0	$	314,830	100.0
Net premiums earned						
Pro rata	$	106,653	47.2	$	130,871	54.4
Excess of loss		119,451	52.8		109,569	45.6
Total	$	226,104	100.0	$	240,440	100.0
Net premiums written by client location						
United States	$	167,215	53.1	$	171,001	54.3
Europe		125,700	39.9		107,142	34.0
Bermuda		4,379	1.4		22,675	7.2
Other		17,693	5.6		14,012	4.5
Total	$	314,987	100.0	$	314,830	100.0
Net premiums written by underwriting location						
Bermuda	$	146,596	46.5	$	164,934	52.4
United States		113,756	36.1		103,726	32.9
Other		54,635	17.4		46,170	14.7
Total	$	314,987	100.0	$	314,830	100.0

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

(2) Includes facultative business.

Table of Contents

ARCH CAPITAL GROUP LTD. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)

6. Reinsurance

In the normal course of business, the Company s insurance subsidiaries cede a portion of their premium on a pro rata or excess of loss basis through treaty or facultative reinsurance agreements. The Company s reinsurance subsidiaries also obtain reinsurance whereby another reinsurer contractually agrees to indemnify it for all or a portion of the reinsurance risks it underwrites. Such arrangements, where one reinsurer provides reinsurance to another reinsurer, are usually referred to as retrocessional reinsurance arrangements. In addition, 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. 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 March 31, 2011		Three Months Ended March 31, 2010	
Premiums Written				
Direct	$	627,174	$	617,935
Assumed		337,392		335,752
Ceded		(200,288)		(185,933)
Net	$	764,278	$	767,754
Premiums Earned				
Direct	$	573,006	$	600,645
Assumed		245,135		262,535
Ceded		(184,446)		(193,263)
Net	$	633,695	$	669,917
Losses and Loss Adjustment Expenses				
Direct	$	393,584	$	398,951
Assumed		243,743		107,167
Ceded		(143,447)		(78,067)
Net	$	493,880	$	428,051

The Company monitors the financial condition of its reinsurers and attempts to place coverages only with substantial, financially sound carriers. At March 31, 2011, approximately 90.7% of the Company s reinsurance recoverables on paid and unpaid losses (not including prepaid reinsurance premiums) of $1.77 billion were due from carriers which had an A.M. Best rating of A- or better and the largest reinsurance recoverables from any one carrier was less than 5.9% of the Company s total shareholders equity. At December 31, 2010, approximately 91.1% of the Company s reinsurance recoverables on paid and unpaid losses (not including prepaid reinsurance premiums) of $1.76 billion were due from carriers which had an A.M. Best rating of A- or better and the largest reinsurance recoverables from any one carrier was less than 5.5% of the Company s total shareholders equity.

Table of Contents

ARCH CAPITAL GROUP LTD. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)

7. Investment Information

The following table summarizes the Company s invested assets:

	March 31, 2011	December 31, 2010
Fixed maturities available for sale, at market value	$ 9,033,408	$ 9,082,828
Fixed maturities pledged under securities lending agreements, at market value (1)	161,888	75,575
Total fixed maturities	9,195,296	9,158,403
Short-term investments available for sale, at market value	1,130,142	915,841
Short-term investments pledged under securities lending agreements, at market value (1)	36,530	
TALF investments, at market value	400,970	402,449
Equity securities available for sale, at market value	419,893	363,255
Other investments	386,127	349,272
Investment funds accounted for using the equity method	395,258	434,600
Total investments (1)	11,964,216	11,623,820
Securities transactions entered into but not settled at the balance sheet date	(516,682)	(144,047)
Total investments, net of securities transactions	$ 11,447,534	$ 11,479,773

(1) In securities lending transactions, the Company receives collateral in excess of the market value of the fixed maturities and short-term investments pledged under securities lending agreements. For purposes of this table, the Company has excluded the collateral received and reinvested of $195.1 million and $69.7 million at March 31, 2011 and December 31, 2010, respectively, and included the $198.4 million and $75.6 million, respectively, of fixed maturities and short-term investments pledged under securities lending agreements, at market value.

Table of Contents

ARCH CAPITAL GROUP LTD. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)

Fixed Maturities and Equity Securities

The following table summarizes the Company s fixed maturities and fixed maturities pledged under securities lending agreements (excluding TALF investments), and equity securities:

	Estimated Market Value	Gross Unrealized Gains	Gross Unrealized Losses	Cost or Amortized Cost	OTTI Unrealized Losses (1)
At March 31, 2011					
Fixed maturities and fixed maturities pledged under securities lending agreements:					
Corporate bonds	$ 2,885,398	$ 98,498	$ (13,879)	$ 2,800,779	$ (17,776)
Mortgage backed securities	1,789,776	14,533	(22,430)	1,797,673	(18,931)
Municipal bonds	1,170,113	39,020	(4,552)	1,135,645	(125)
Commercial mortgage backed securities	1,164,745	25,817	(5,796)	1,144,724	(3,453)
U.S. government and government agencies	788,000	13,974	(2,441)	776,467	(207)
Non-U.S. government securities	779,416	43,697	(12,237)	747,956	(72)
Asset backed securities	617,848	23,681	(4,199)	598,366	(3,927)
Total	$ 9,195,296	$ 259,220	$ (65,534)	$ 9,001,610	$ (44,491)
Equity securities	$ 419,893	$ 33,442	$ (7,194)	$ 393,645	
At December 31, 2010					
Fixed maturities and fixed maturities pledged under securities lending agreements:					
Corporate bonds	$ 2,839,344	$ 97,400	$ (18,343)	$ 2,760,287	$ (18,047)
Mortgage backed securities	1,806,813	18,801	(26,893)	1,814,905	(21,147)
Municipal bonds	1,182,100	40,410	(6,958)	1,148,648	(125)
Commercial mortgage backed securities	1,167,299	31,743	(6,028)	1,141,584	(3,481)
U.S. government and government agencies	872,149	20,150	(5,696)	857,695	(207)
Non-U.S. government securities	732,666	39,539	(11,894)	705,021	(72)
Asset backed securities	558,032	20,672	(3,990)	541,350	(3,954)
Total	$ 9,158,403	$ 268,715	$ (79,802)	$ 8,969,490	$ (47,033)
Equity securities	$ 363,255	$ 20,660	$ (3,424)	$ 346,019	

(1) Represents the total other-than-temporary impairments (OTTI) recognized in accumulated other comprehensive income (AOCI). It does not include the change in market value subsequent to the impairment measurement date. At March 31, 2011, the net unrealized gain related to securities for which a non-credit OTTI was recognized in AOCI was $1.8 million, compared to a net unrealized loss of $7.1 million at December 31, 2010.

Table of Contents

ARCH CAPITAL GROUP LTD. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)

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

	Less than 12 Months		12 Months or More		Total	
	Estimated Market Value	Gross Unrealized Losses	Estimated Market Value	Gross Unrealized Losses	Estimated Market Value	Gross Unrealized Losses
At March 31, 2011						
Fixed maturities and fixed maturities pledged under securities lending agreements:						
Corporate bonds	$ 729,974	$ (12,180)	$ 42,603	$ (1,699)	$ 772,577	$ (13,879)
Mortgage backed securities	870,558	(18,123)	38,531	(4,307)	909,089	(22,430)
Municipal bonds	289,375	(3,939)	8,363	(613)	297,738	(4,552)
Commercial mortgage backed securities	380,147	(5,238)	11,223	(558)	391,370	(5,796)
U.S. government and government agencies	264,821	(2,441)			264,821	(2,441)
Non-U.S. government securities	349,955	(9,082)	47,359	(3,155)	397,314	(12,237)
Asset backed securities	111,381	(1,321)	8,468	(2,878)	119,849	(4,199)
	2,996,211	(52,324)	156,547	(13,210)	3,152,758	(65,534)
Equity securities	103,279	(7,136)	585	(58)	103,864	(7,194)
Other investments	52,704	(1,551)	3,015	(281)	55,719	(1,832)
Short-term investments	19,757	(390)			19,757	(390)
Total	$ 3,171,951	$ (61,401)	$ 160,147	$ (13,549)	$ 3,332,098	$ (74,950)
At December 31, 2010						
Fixed maturities and fixed maturities pledged under securities lending agreements:						
Corporate bonds	$ 530,956	$ (16,580)	$ 20,351	$ (1,763)	$ 551,307	$ (18,343)
Mortgage backed securities	913,138	(20,331)	57,895	(6,562)	971,033	(26,893)
Municipal bonds	294,978	(6,440)	8,465	(518)	303,443	(6,958)
Commercial mortgage backed securities	311,703	(5,273)	22,030	(755)	333,733	(6,028)
U.S. government and government agencies	190,497	(5,696)			190,497	(5,696)
Non-U.S. government securities	271,446	(7,418)	45,884	(4,476)	317,330	(11,894)
Asset backed securities	75,655	(827)	8,126	(3,163)	83,781	(3,990)
	2,588,373	(62,565)	162,751	(17,237)	2,751,124	(79,802)
Equity securities	68,629	(3,424)			68,629	(3,424)
Other investments	46,750					