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/FONT> One year later 19 88 311 15 82 278 449 745 843 Two years later 33 216 311 19 141 437 811 1,332 Three years  
 later 64 216 311 24 172 596 1,110 Four years later 64 216 311 26 204 706 Five years  
 later 64 216 311 26 218 Six years later 64 216 311 25 Seven years later 64 216 311 Eight years  
 later 64 216 311 Nine years later 64 216 Ten years later 64  
 Net re-estimated reserve as of:

One year later 68 216 311 25 340 1,444 2,756 3,986 4,726 Two years later 65 216 311 25 335 1,353 2,614 3,809 Three years  
 later 64 216 311 27 335 1,259 2,487 Four years later 64 216 311 27 312 1,237 Five years  
 later 64 216 311 28 315 Six years later 64 216 311 26 Seven years later 64 216 311 Eight years  
 later 64 216 311 Nine years later 64 216 Ten years later 64 Cumulative net redundancy  
 (deficiency) \$7 \$(30)\$(2) \$(5)\$66 \$306 \$388 \$254 \$185





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Gross re-estimated reserve 64 246 367 186 562 1,561 3,053 5,203 \$6,209 Re-estimated reinsurance  
recoverable (30) (56) (160) (247) (324) (566) (1,394) (1,483)

Net re-estimated reserve 64 216 311 26 315 1,237 2,487 3,809 4,726

Gross re-estimated redundancy (deficiency) \$7 \$(30)\$(2) \$(75)\$30 \$351 \$440 \$250 \$254

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(a) Paid amounts include \$21.9 million of reserves related to our non-standard automobile business that was sold in 2004 (see " Our History").

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The following table represents an analysis of losses and loss adjustment expenses and a reconciliation of the beginning and ending reserve for losses and loss adjustment expenses.

	Years Ended December 31,		
	2007	2006	2005
<b>(U.S. dollars in thousands)</b>			
Reserve for losses and loss adjustment expenses at beginning of year	\$ 6,463,041	\$ 5,452,826	\$ 3,492,759
Unpaid losses and loss adjustment expenses recoverable	1,552,157	1,389,768	617,607
	4,910,884	4,063,058	2,875,152
Increase (decrease) in net losses and loss adjustment expenses incurred relating to losses occurring in:			
Current year	1,829,534	1,867,344	2,120,962
Prior years	(185,364)	(76,795)	(119,013)
	1,644,170	1,790,549	2,001,949
Foreign exchange losses (gains)	45,192	47,711	(55,854)
Less net losses and loss adjustment expenses paid relating to losses occurring in:			
Current year	274,102	245,856	308,954
Prior years	843,311	744,578	449,235
	1,117,413	990,434	758,189
Net reserve for losses and loss adjustment expenses at end of year	5,482,833	4,910,884	4,063,058
Unpaid losses and loss adjustment expenses recoverable	1,609,619	1,552,157	1,389,768
	7,092,452	6,463,041	5,452,826
Reserve for losses and loss adjustment expenses at end of year	\$ 7,092,452	\$ 6,463,041	\$ 5,452,826

Our reserving method to date has to a large extent been the expected loss method, which is commonly applied when limited loss experience exists. We select the initial expected loss and loss adjustment expense ratios based on information derived by our underwriters and actuaries during the initial pricing of the business, supplemented by industry data where appropriate. These ratios consider, among other things, rate changes and changes in terms and conditions that have been observed in the market. Any estimates and assumptions made as part of the reserving process could prove to be inaccurate due to several factors, including the fact that limited historical information has been reported to us through December 31, 2007. As actual loss information is reported to us and we develop our own loss experience, we will give more emphasis to other actuarial techniques.

During 2007, on a gross basis, we recorded a redundancy on reserves recorded in prior years of approximately \$253.7 million while, on a net basis, we recorded a redundancy on reserves recorded in prior years of approximately \$185.4 million. The net favorable development consisted of \$172.7 million from the reinsurance segment and \$12.7 million from the insurance segment. Of the net favorable development in the reinsurance segment, \$110.6 million came from short-tail lines, and \$62.1 million came from casualty and marine and aviation business. The development resulted from better than anticipated loss emergence. The net favorable development was partially offset by an increase in acquisition expenses of \$18.5 million, primarily as a result of the commutation of certain treaties. In addition, in its reserving process in 2002 and 2003, the reinsurance segment recognized that there is a possibility that the assumptions made could prove to be inaccurate due to several factors primarily related to the start up nature of its operations. Due to the availability of additional data, and based on reserve analyses, it was determined that it was no longer necessary to continue to include such factors

in 2004 or subsequent periods. Based on the level of claims activity reported to date, the reinsurance segment reduced the amount of reserves it had recorded in 2002 and 2003 by \$10.6 million in 2007. Except as discussed above, the estimated favorable development in the reinsurance segment's prior year reserves did not reflect any significant changes in the key assumptions it made to estimate these reserves at December 31, 2006. As a result of applying a small amount of weight to its own experience, the insurance segment reduced loss selections for some lines, in particular those written on a claims-made basis and for which it now believes it has a reasonable level of credible data. The insurance segment's net favorable development of \$12.7 million was primarily due to reductions in reserves in medium-tailed and long-tailed lines of business resulting from such changes, partially offset by adverse development of \$33.3 million from short-tail lines which primarily resulted from higher than expected claims development. The net favorable development was partially offset by an increase in acquisition expenses of \$9.5 million, primarily due to sliding scale arrangements on certain policies.

During 2006, on a gross basis, we recorded a deficiency on reserves recorded in prior years of approximately \$28.3 million while, on a net basis, we recorded a redundancy on reserves recorded in prior years of approximately \$76.8 million. The gross deficiency primarily resulted from adverse development on the 2005 catastrophic events while, on a net basis, a significant portion of the adverse development was covered by reinsurance. The net favorable development consisted of \$68.5 million from the reinsurance segment and \$8.3 million from the insurance segment. Of the net favorable development in the reinsurance segment, \$37.1 million came from short-tail lines, and \$31.4 million came from longer-tail lines. The development resulted from better than anticipated loss emergence and was net of \$38.1 million of adverse development on the 2005 catastrophic events, primarily in short-tail lines. The net favorable development was partially offset by an increase in acquisition expenses of \$7.8 million, primarily as a result of the commutation of certain treaties. As noted above, in its reserving process in 2002 and 2003, the reinsurance segment recognized that there is a possibility that the assumptions made could prove to be inaccurate due to several factors primarily related to the start up nature of its operations. Due to the availability of additional data, and based on reserve analyses, it was determined that it was no longer necessary to continue to include such factors. Following reserve reviews, and based on the level of claims activity reported to date, the reinsurance segment reduced the amount of reserves it had recorded in 2002 and 2003 by \$7.7 million in 2006. Except as discussed above, the estimated favorable development in the reinsurance segment's prior year reserves did not reflect any significant changes in the key assumptions it made to estimate these reserves at December 31, 2005. The insurance segment's net favorable development of \$8.3 million was primarily due to reductions in reserves in certain medium-tailed and long-tailed lines of business, in particular for those lines of business written on a claims-made basis and for which it now believes it has a reasonable level of credible data, partially offset by adverse development of \$44.0 million from short-tail lines which included \$30.8 million of adverse development on the 2005 catastrophic events.

During 2005, on a gross and net basis, we recorded a redundancy on reserves recorded in prior years of approximately \$113.9 million and \$119.0 million, respectively. The net favorable development consisted of \$91.2 million from the reinsurance segment and \$27.8 million from the insurance segment. Of the net favorable development in the reinsurance segment, \$85.3 million was primarily due to short-tail lines, mainly property, and resulted from better than anticipated loss emergence. Such amount was partially offset by an increase in acquisition expenses of \$9.0 million, primarily as a result of the commutation of certain treaties. As noted above, in its reserving process in 2002 and 2003, the reinsurance segment recognized that there is a possibility that the assumptions made could prove to be inaccurate due to several factors primarily related to the start up nature of its operations. Following reserve reviews, and based on the level of claims activity reported to date, the reinsurance segment reduced the amount of reserves it had recorded in 2002 and 2003 by \$12.1 million in 2005. Except as discussed above, the estimated favorable development in the reinsurance segment's prior year reserves did not reflect any significant changes in the key assumptions it made to estimate these reserves at December 31, 2004. Prior to 2005, the insurance segment's reserving method relied heavily on industry

data. In 2005, the insurance segment began to give a relatively small amount of weight to its own experience. The insurance segment's net favorable development of \$27.8 million was primarily due to reductions in reserves in certain medium-tailed and long-tailed lines of business, in particular for those lines of business written on a claims-made basis and for which it now believes it has a reasonable level of credible data.

We are subject to credit risk with respect to our reinsurance and retrocessions because the ceding of risk to reinsurers and retrocessionaires does not relieve us of our liability to the clients or companies we insure or reinsure. Our failure to establish adequate reinsurance or retrocessional arrangements or the failure of our existing reinsurance or retrocessional arrangements to protect us from overly concentrated risk exposure could adversely affect our financial condition and results of operations. Although we monitor the financial condition of our reinsurers and retrocessionaires and attempt to place coverages only with substantial, financially sound carriers, we may not be successful in doing so. See "Management's Discussion and Analysis of Financial Condition and Results of Operations Critical Accounting Policies, Estimates and Recent Accounting Pronouncements Collection of Insurance-Related Balances and Provision for Doubtful Accounts."

## Investments

At December 31, 2007, consolidated cash and invested assets totaled approximately \$10.13 billion, consisting of \$939.0 million of cash and short-term investments, \$8.6 billion of fixed maturities and fixed maturities pledged under securities lending agreements and \$589.7 million of other investments. See "Management's Discussion and Analysis of Financial Condition and Results of Operations Critical Accounting Policies, Estimates and Recent Accounting Pronouncements Investments."

The following table summarizes the fair value of our cash and invested assets at December 31, 2007 and 2006:

	December 31,			
	2007		2006	
	Estimated Fair Value	% of Total	Estimated Fair Value	% of Total
<b>(U.S. dollars in thousands)</b>				
Cash and short-term investments(1)	\$ 938,951	9.3	\$ 1,274,715	13.7
Fixed maturities and fixed maturities pledged under securities lending agreements(1):				
Corporate bonds	2,452,527	24.2	1,504,989	16.2
Commercial mortgage backed securities	1,315,680	13.0	868,586	9.3
Mortgage backed securities	1,234,596	12.2	1,183,805	12.7
U.S. government and government agencies	1,165,423	11.5	1,922,511	20.6
Asset backed securities	1,008,030	9.9	907,829	9.7
Municipal bonds	990,325	9.8	815,204	8.8
Non-U.S. government securities	434,243	4.3	534,427	5.7
Sub-total	8,600,824	84.9	7,737,351	83.0
Short-term investments pledged under securities lending agreements, at fair value(1)	219	0.0		
Other investments	589,669	5.8	307,082	3.3
<b>Total cash and invested assets(1)(2)</b>	<b>\$ 10,129,663</b>	<b>100.0</b>	<b>\$ 9,319,148</b>	<b>100.0</b>

(1)

In our securities lending transactions, we receive collateral in excess of the fair value of the fixed maturities and short-term investments pledged under securities lending agreements. For purposes of this table, we have excluded \$1.5 billion and \$891.4 million, respectively, of collateral received





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which is reflected as "short-term investment of funds received under securities lending agreements, at fair value" and included \$1.46 billion and \$860.8 million, respectively, of "fixed maturities and short-term investments pledged under securities lending agreements, at fair value" at December 31, 2007 and 2006.

(2)

Includes certain securities transactions entered into but not settled at the balance sheet date. Net of such amounts, total cash and investments were approximately \$10.12 billion at December 31, 2007 and \$9.09 billion at December 31, 2006.

Our current investment guidelines and approach stress preservation of capital, market liquidity and diversification of risk. Our investments are subject to market-wide risks and fluctuations, as well as to risks inherent in particular securities. At December 31, 2007 and 2006, approximately 98% of our fixed maturities and fixed maturities pledged under securities lending agreements were rated investment grade by the major rating agencies, primarily Standard & Poor's Rating Services ("Standard & Poor's"). At December 31, 2007 and 2006, our fixed maturities, fixed maturities pledged under securities lending agreements and short-term investments had an average credit quality rating of "AA+" and "AAA", respectively, and an average effective duration of approximately 3.29 years and 3.23 years, respectively.

During the 2005 third quarter, we began a securities lending program under which certain of our 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." We maintain control over the securities we lend, retain the earnings and cash flows associated with the loaned securities and receive a fee from the borrower for the temporary use of the securities. Collateral received, primarily in the form of cash, is required at a rate of 102% of the fair value of the loaned securities (or 105% of the fair 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 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. At December 31, 2006, the fair value and amortized cost of fixed maturities and short-term investments pledged under securities lending agreements were \$860.8 million and \$854.8 million, respectively, while collateral received totaled \$891.4 million at fair value and amortized cost.

The credit quality distribution of our fixed maturities and fixed maturities pledged under securities lending agreements at December 31, 2007 and 2006 are shown below:

(U.S. dollars in thousands)	December 31, 2007		December 31, 2006	
	Estimated Fair Value	% of Total	Estimated Fair Value	% of Total
AAA	\$ 6,600,258	76.7	\$ 6,366,059	82.3
AA	882,262	10.3	605,427	7.8
A	677,047	7.9	430,103	5.6
BBB	243,610	2.8	194,408	2.5
BB	25,390	0.3	32,572	0.4
B	128,459	1.5	64,636	0.8
Lower than B	11,321	0.1	11,149	0.2
Not rated	32,477	0.4	32,997	0.4
<b>Total</b>	<b>\$ 8,600,824</b>	<b>100.0</b>	<b>\$ 7,737,351</b>	<b>100.0</b>

(1)

Ratings as assigned by the major rating agencies.

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For 2007 and 2006, set forth below is the pre-tax total return (before investment expenses) of our investment portfolio (including fixed maturities, short-term investments and fixed maturities and short-term investments pledged under securities lending agreements) compared to the benchmark return against which we measured our portfolio during the year. Our investment expenses were approximately 0.15% of average invested assets in 2007 and 2006.

	<u>Arch Portfolio</u>	<u>Benchmark Return(1)</u>
Pre-tax total return (before investment expenses):		
Year ended December 31, 2007	6.52%	6.97%
Year ended December 31, 2006	5.24%	4.88%

- (1) The benchmark return is a weighted average of the benchmarks assigned to each of our investment managers. The benchmarks used vary based on the nature of the portfolios under management. In all but a few instances, the benchmarks used are Lehman indices.

### Ratings

The Company's ability to underwrite business is dependent upon the quality of its claims paying ability and financial strength ratings as evaluated by independent agencies. Such ratings from third party internationally recognized statistical rating organizations or agencies are instrumental in establishing the competitive positions of companies in our industry. The Company believes that the primary users of such ratings include commercial and investment banks, policyholders, brokers, ceding companies and investors. Insurance ratings are also used by insurance and reinsurance intermediaries as an important means of assessing the financial strength and quality of insurers and reinsurers, and have become an increasingly important factor in establishing the competitive position of insurance and reinsurance companies. These ratings are often an important factor in the decision by an insured or intermediary of whether to place business with a particular insurance or reinsurance provider. Periodically, rating agencies evaluate us to confirm that we continue to meet their criteria for the ratings assigned to us by them. A.M. Best Company maintains a letter scale rating system ranging from "A++" (Superior) to "F" (In Liquidation). Moody's Investors Service maintains a letter scale rating from "Aaa" (Exceptional) to "NP" (Not Prime). Standard & Poor's maintains a letter scale rating system ranging from "AAA" (Extremely Strong) to "R" (Under Regulatory Supervision). Our reinsurance subsidiaries, Arch Re U.S. and Arch Re Bermuda, and our principal insurance subsidiaries, Arch Insurance, Arch E&S, Arch Specialty and Arch-Europe, each currently has a financial strength rating of "A" (Excellent, the third highest out of fifteen rating levels) with a stable outlook from A.M. Best Company, "A2" (Good, the sixth highest out of 21 rating levels) with a stable outlook from Moody's Investors Service and "A" (Strong, the sixth highest out of 21 rating levels) with a positive outlook from Standard and Poor's. Fitch Ratings has assigned a financial strength rating of "A" (Strong, the sixth highest out of 24 rating levels) with a stable outlook to Arch Re Bermuda. A.M. Best Company has assigned a financial strength rating of "NR-3" (Rating Procedure Inapplicable) to Western Diversified, which currently is not writing business, and Moody's Investors Service and Standard & Poor's did not rate Western Diversified.

ACGL has received counterparty (issuer) credit ratings of "BBB+" (eighth highest out of 22 rating levels) with a positive outlook from Standard & Poor's, "Baa1" (eighth highest out of 21 rating levels) with a stable outlook from Moody's Investors Service and "A-" long term issuer rating (seventh highest out of 23 rating levels) with a stable outlook from Fitch Ratings. A counterparty credit rating provides an opinion on an issuer's overall capacity and willingness to meet its financial commitments as they become due, but is not specific to a particular financial obligation. ACGL's senior debt was assigned a rating of "BBB+" from Standard and Poors, "Baa1" from Moody's Investors Service and "BBB+" from Fitch Ratings. ACGL's series A non-cumulative preferred shares and series B non-cumulative

preferred shares were both assigned a "BBB-" rating by Standard & Poor's, a "Baa3" by Moody's Investors Service and a "BBB" rating by Fitch Ratings.

The objective of these ratings systems is to assist policyholders and to provide an opinion of an insurer's or reinsurer's financial strength and ability to meet ongoing obligations to its policyholders. The financial strength ratings assigned by rating agencies to insurance and reinsurance companies represent independent opinions of financial strength and ability to meet policyholder obligations and are not directed toward the protection of investors, nor are they recommendations to buy, hold or sell any securities. We can offer no assurances that our ratings will remain at their current levels, or that our security will be accepted by brokers and our insureds and reinsureds. A ratings downgrade or the potential for such a downgrade, or failure to obtain a necessary rating, could adversely affect both our relationships with agents, brokers, wholesalers and other distributors of our existing products and services and new sales of our products and services. In addition, under certain of the reinsurance agreements assumed by our reinsurance operations, upon the occurrence of a ratings downgrade or other specified triggering event with respect to our reinsurance operations, such as a reduction in surplus by specified amounts during specified periods, our ceding company clients may be provided with certain rights, including, among other things, the right to terminate the subject reinsurance agreement and/or to require that our reinsurance operations post additional collateral. In the event of a ratings downgrade or other triggering event, the exercise of such contract rights by our clients could have a material adverse effect on our financial condition and results of operations, as well as our ongoing business and operations. See "Management's Discussion and Analysis of Financial Condition and Results of Operations Liquidity and Capital Resources."

### **Competition**

The worldwide reinsurance and insurance businesses are highly competitive. We compete, and will continue to compete, with major U.S. and non-U.S. insurers and reinsurers, some of which have greater financial, marketing and management resources than we have and have had longer-term relationships with insureds and brokers than us. We compete with other insurers and reinsurers primarily on the basis of overall financial strength, ratings assigned by independent rating agencies, geographic scope of business, strength of client relationships, premiums charged, contract terms and conditions, products and services offered, speed of claims payment, reputation, employee experience, and qualifications and local presence. We also compete with new companies that continue to be formed to enter the insurance and reinsurance markets.

In our insurance business, we compete with insurers that provide specialty property and casualty lines of insurance, including: ACE Limited, Allied World Assurance Company, Ltd., American International Group, Inc., AXIS Capital Holdings Limited, Berkshire Hathaway, Inc., Chubb Corporation, Endurance Specialty Holdings Ltd., The Hartford Financial Services Group, Inc., HCC Insurance Holdings, Inc., Lloyd's of London, The St. Paul Travelers Companies, W.R. Berkley Corp., XL Capital Ltd. and Zurich Insurance Group. In our reinsurance business, we compete with reinsurers that provide property and casualty lines of reinsurance, including ACE Limited, AXIS Capital Holdings Limited, Berkshire Hathaway, Inc., Endurance Specialty Holdings Ltd., Everest Re Group Ltd., Hannover Rückversicherung AG, Lloyd's of London, Montpelier Re Holdings Ltd., Munich Re Group, PartnerRe Ltd., Platinum Underwriters Holdings, Ltd., RenaissanceRe Holdings Ltd., Swiss Reinsurance Company, Transatlantic Holdings, Inc. and XL Capital Ltd. We do not believe that we have a significant market share in any of our markets.

**Regulation**

*U.S. Insurance Regulation*

*General.* In common with other insurers, our U.S.-based insurance subsidiaries are subject to extensive governmental regulation and supervision in the various states and jurisdictions in which they are domiciled and licensed and/or approved to conduct business. The laws and regulations of the state of domicile have the most significant impact on operations. This regulation and supervision is designed to protect policyholders rather than investors. Generally, regulatory authorities have broad regulatory powers over such matters as licenses, standards of solvency, premium rates, policy forms, marketing practices, claims practices, investments, security deposits, methods of accounting, form and content of financial statements, reserves and provisions for unearned premiums, unpaid losses and loss adjustment expenses, reinsurance, minimum capital and surplus requirements, dividends and other distributions to shareholders, periodic examinations and annual and other report filings. In addition, transactions among affiliates, including reinsurance agreements or arrangements, as well as certain third party transactions, require prior regulatory approval from, or prior notice to, the applicable regulator under certain circumstances. Certain insurance regulatory requirements are highlighted below. In addition, regulatory authorities conduct periodic financial, claims and market conduct examinations. Arch-Europe is also subject to certain governmental regulation and supervision in the various states where it has been approved as an excess and surplus lines insurer.

The New York Attorney General, various state insurance regulatory authorities and others are investigating contingent commission payments to brokers (and the disclosures relating to such payments), alleged "bid-rigging," "steering," and other practices in the insurance industry involving brokers and agents, as well as certain finite insurance and/or reinsurance products. Although certain brokers have announced new fee structures in response to the industry investigations and, as part of these new initiatives, have requested that our insurance subsidiaries enter into standardized payment arrangements, we have determined to negotiate payment arrangements with our brokers on a case by case basis. We cannot predict the effect that these investigations, and any changes in industry practice, including future legislation or regulations that may become applicable to us, will have on the insurance industry or our business. See "Risk Factors Risks Relating to Our Industry Our reliance on brokers subjects us to their credit risk."

*Credit for Reinsurance.* Arch Re U.S. is subject to insurance regulation and supervision that is similar to the regulation of licensed primary insurers. However, except for certain mandated provisions that must be included in order for a ceding company to obtain credit for reinsurance ceded, the terms and conditions of reinsurance agreements generally are not subject to regulation by any governmental authority. This contrasts with admitted primary insurance policies and agreements, the rates and terms of which generally are regulated by state insurance regulators. As a practical matter, however, the rates charged by primary insurers do have an effect on the rates that can be charged by reinsurers.

A primary insurer ordinarily will enter into a reinsurance agreement only if it can obtain credit for the reinsurance ceded on its U.S. statutory-basis financial statements. In general, credit for reinsurance is allowed in the following circumstances:

if the reinsurer is licensed in the state in which the primary insurer is domiciled or, in some instances, in certain states in which the primary insurer is licensed;

if the reinsurer is an "accredited" or otherwise approved reinsurer in the state in which the primary insurer is domiciled or, in some instances, in certain states in which the primary insurer is licensed;

in some instances, if the reinsurer (a) is domiciled in a state that is deemed to have substantially similar credit for reinsurance standards as the state in which the primary insurer is domiciled and (b) meets certain financial requirements; or

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if none of the above apply, to the extent that the reinsurance obligations of the reinsurer are collateralized appropriately, typically through the posting of a letter of credit for the benefit of the primary insurer or the deposit of assets into a trust fund established for the benefit of the primary insurer.

As a result of the requirements relating to the provision of credit for reinsurance, Arch Re U.S. and Arch Re Bermuda are indirectly subject to certain regulatory requirements imposed by jurisdictions in which ceding companies are licensed.

As of February 15, 2008: (1) Arch Re U.S. is licensed or is an accredited or otherwise approved reinsurer in 50 states and the District of Columbia; (2) Arch Insurance is licensed as an insurer in 50 states, the District of Columbia, Puerto Rico and, the U.S. Virgin Islands with a branch office in Canada; (3) Arch Specialty is licensed in one state and approved as an excess and surplus lines insurer in 49 states, the District of Columbia, Puerto Rico and the U.S. Virgin Islands; (4) Arch E&S is licensed in one state and approved as an excess and surplus lines insurer in 46 states and the District of Columbia; (5) Western Diversified is licensed as an insurer in 48 states and the District of Columbia; and (6) Arch-Europe is approved as an excess and surplus lines insurer in 14 states. Arch Re Bermuda does not expect to become, licensed, accredited or so approved in any U.S. jurisdiction.

*Holding Company Acts.* All states have enacted legislation that regulates insurance holding company systems. These regulations generally provide that each insurance company in the system is required to register with the insurance department of its state of domicile and furnish information concerning the operations of companies within the holding company system which may materially affect the operations, management or financial condition of the insurers within the system. All transactions within a holding company system affecting insurers must be fair and reasonable. Notice to the insurance departments is required prior to the consummation of transactions affecting the ownership or control of an insurer and of certain material transactions between an insurer and any entity in its holding company system. In addition, certain of such transactions cannot be consummated without the applicable insurance department's prior approval.

*Regulation of Dividends and Other Payments from Insurance Subsidiaries.* The ability of an insurer to pay dividends or make other distributions is subject to insurance regulatory limitations of the insurance company's state of domicile. Generally, such laws limit the payment of dividends or other distributions above a specified level. Dividends or other distributions in excess of such thresholds are "extraordinary" and are subject to prior regulatory approval. Such dividends or distributions may be subject to applicable withholding or other taxes. See "Management's Discussion and Analysis of Financial Condition and Results of Operations - Liquidity and Capital Resources" and note 15, "Statutory Information," of the notes accompanying our financial statements.

*Insurance Regulatory Information System Ratios.* The National Association of Insurance Commissioners ("NAIC") Insurance Regulatory Information System ("IRIS") was developed by a committee of state insurance regulators and is intended primarily to assist state insurance departments in executing their statutory mandates to oversee the financial condition of insurance companies operating in their respective states. IRIS identifies 13 industry ratios (referred to as "IRIS ratios") and specifies "usual values" for each ratio. Departure from the usual values of the IRIS ratios can lead to inquiries from individual state insurance commissioners as to certain aspects of an insurer's business. For 2007, certain of our U.S.-based subsidiaries generated IRIS ratios that were outside of the usual values. To date, none of these subsidiaries has received any notice of regulatory review but there is no assurance that we may not be notified in the future.

*Accreditation.* The NAIC has instituted its Financial Regulatory Accreditation Standards Program ("FRASP") in response to federal initiatives to regulate the business of insurance. FRASP provides a set of standards designed to establish effective state regulation of the financial condition of insurance

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companies. Under FRASP, a state must adopt certain laws and regulations, institute required regulatory practices and procedures, and have adequate personnel to enforce such items in order to become an "accredited" state. If a state is not accredited, other states may not accept certain financial examination reports of insurers prepared solely by the regulatory agency in such unaccredited state. The respective states in which Arch Re U.S., Arch Insurance, Arch E&S, Arch Specialty and Western Diversified are domiciled are accredited states.

*Risk-Based Capital Requirements.* In order to enhance the regulation of insurer solvency, the NAIC adopted in December 1993 a formula and model law to implement risk-based capital requirements for property and casualty insurance companies. These risk-based capital requirements are designed to assess capital adequacy and to raise the level of protection that statutory surplus provides for policyholder obligations. The risk-based capital model for property and casualty insurance companies measures three major areas of risk facing property and casualty insurers:

underwriting, which encompasses the risk of adverse loss developments and inadequate pricing;

declines in asset values arising from credit risk; and

declines in asset values arising from investment risks.

An insurer will be subject to varying degrees of regulatory action depending on how its statutory surplus compares to its risk-based capital calculation. Equity investments in common stock typically are valued at 85% of their market value under the risk-based capital guidelines. For equity investments in an insurance company affiliate, the risk-based capital requirements for the equity securities of such affiliate would generally be our U.S. insurance subsidiaries' proportionate share of the affiliate's risk-based capital requirement.

Under the approved formula, an insurer's total adjusted capital is compared to its authorized control level risk-based capital. If this ratio is above a minimum threshold, no company or regulatory action is necessary. Below this threshold are four distinct action levels at which a regulator can intervene with increasing degrees of authority over an insurer as the ratio of surplus to risk-based capital requirement decreases. The four action levels include:

insurer is required to submit a plan for corrective action;

insurer is subject to examination, analysis and specific corrective action;

regulators may place insurer under regulatory control; and

regulators are required to place insurer under regulatory control.

Each of our U.S. insurance subsidiaries' surplus (as calculated for statutory purposes) is above the risk-based capital thresholds that would require either company or regulatory action.

*Guaranty Funds and Assigned Risk Plans.* Most states require all admitted insurance companies to participate in their respective guaranty funds which cover certain claims against insolvent insurers. Solvent insurers licensed in these states are required to cover the losses paid on behalf of insolvent insurers by the guaranty funds and are generally subject to annual assessments in the states by the guaranty funds to cover these losses. Participation in state-assigned risk plans may take the form of reinsuring a portion of a pool of policies or the direct issuance of policies to insureds. The calculation of an insurer's participation in these plans is usually based on the amount of premium for that type of coverage that was written by the insurer on a voluntary basis in a prior year. Assigned risk pools tend to produce losses which result in assessments to insurers writing the same lines on a voluntary basis.

*Federal Regulation.* Although state regulation is the dominant form of regulation for insurance and reinsurance business, the federal government has shown increasing concern over the adequacy of state regulation. It is not possible to predict the future impact of any potential federal regulations or

other possible laws or regulations on our U.S. subsidiaries' capital and operations, and such laws or regulations could materially adversely affect their business.

*Terrorism Risk Insurance Program Reauthorization Act of 2007.* On November 26, 2002, President Bush signed into law the Terrorism Risk Insurance Act of 2002, which was amended and extended by the Terrorism Risk Insurance Extension Act of 2005 and amended and extended again by the Terrorism Risk Insurance Program Reauthorization Act of 2007 ("TRIPRA") through December 31, 2014. TRIPRA provides a federal backstop for insurance-related losses resulting from any act of terrorism on U.S. soil or against certain U.S. air carriers, vessels or foreign missions. Under TRIPRA, all U.S.-based property and casualty insurers are required to make terrorism insurance coverage available in specified commercial property and casualty insurance lines. Under TRIPRA, the federal government will pay 85% of covered losses after an insurer's losses exceed a deductible determined by a statutorily prescribed formula, up to a combined annual aggregate limit for the federal government and all insurers of \$100 billion. If an act (or acts) of terrorism result in covered losses exceeding the \$100 billion annual limit, insurers with losses exceeding their deductibles will not be responsible for additional losses. The deductible for each year is based on the insurer's direct commercial earned premiums for property and casualty insurance, excluding certain lines of business such as commercial auto, surety, professional liability and earthquake lines of business, for the prior calendar year multiplied by 20%. The specified percentages for prior periods were 7% for 2003, 10% for 2004, 15% for 2005, 17.5% for 2006 and 20% for 2007, which extends through 2014.

Our U.S.-based property and casualty insurers, Arch Insurance, Arch Specialty, Arch E&S and Western Diversified, are subject to TRIPRA. TRIPRA specifically excludes reinsurance business and, accordingly, does not apply to our reinsurance operations. Our U.S. insurance group's deductible for 2007 was approximately \$274 million (i.e., 20.0% of earned premiums). Based on 2007 direct commercial earned premiums, our U.S. insurance group's deductible for 2008 is approximately \$261.7 million (i.e., 20.0% of such earned premiums).

*The Gramm-Leach-Bliley Act.* The Gramm-Leach-Bliley Act of 1999 ("GLBA"), which implements fundamental changes in the regulation of the financial services industry in the United States, was enacted on November 12, 1999. The GLBA permits the transformation of the already converging banking, insurance and securities industries by permitting mergers that combine commercial banks, insurers and securities firms under one holding company, a "financial holding company." Bank holding companies and other entities that qualify and elect to be treated as financial holding companies may engage in activities, and acquire companies engaged in activities, that are "financial" in nature or "incidental" or "complementary" to such financial activities. Such financial activities include acting as principal, agent or broker in the underwriting and sale of life, property, casualty and other forms of insurance and annuities.

Until the passage of the GLBA, the Glass-Steagall Act of 1933 had limited the ability of banks to engage in securities-related businesses, and the Bank Holding Company Act of 1956 had restricted banks from being affiliated with insurers. With the passage of the GLBA, among other things, bank holding companies may acquire insurers, and insurance holding companies may acquire banks. The ability of banks to affiliate with insurers may affect our U.S. subsidiaries' product lines by substantially increasing the number, size and financial strength of potential competitors.

*Legislative and Regulatory Proposals.* From time to time various regulatory and legislative changes have been proposed in the insurance and reinsurance industry. Among the proposals that have in the past been or are at present being considered are the possible introduction of federal regulation in addition to, or in lieu of, the current system of state regulation of insurers. In addition, there are a variety of proposals being considered by various state legislatures. We are unable to predict whether any of these proposed laws and regulations will be adopted, the form in which any such laws and regulations would be adopted, or the effect, if any, these developments would have on our operations and financial condition. See " U.S. Insurance Regulation General."

***Bermuda Insurance Regulation***

*The Insurance Act 1978, as Amended, and Related Regulations of Bermuda (the "Insurance Act").* As a holding company, ACGL is not subject to Bermuda insurance regulations. The Insurance Act, which regulates the insurance business of Arch Re Bermuda, provides that no person shall carry on any insurance business in or from within Bermuda unless registered as an insurer under the Insurance Act by the Bermuda Monetary Authority (the "BMA"), which is responsible for the day-to-day supervision of insurers. Under the Insurance Act, insurance business includes reinsurance business. The registration of an applicant as an insurer is subject to its complying with the terms of its registration and such other conditions as the BMA may impose from time to time.

The Insurance Act imposes solvency and liquidity standards and auditing and reporting requirements on Bermuda insurance companies and grants to the BMA powers to supervise, investigate and intervene in the affairs of insurance companies. Certain significant aspects of the Bermuda insurance regulatory framework are set forth below.

*Classification of Insurers.* The Insurance Act distinguishes between insurers carrying on long-term business and insurers carrying on general business. There are four classifications of insurers carrying on general business, with Class 4 insurers subject to the strictest regulation. Arch Re Bermuda is registered as both a long-term insurer and a Class 4 insurer in Bermuda, which we refer to in this annual report as a composite insurer, and is regulated as such under the Insurance Act.

*Cancellation of Insurer's Registration.* An insurer's registration may be canceled by the BMA on certain grounds specified in the Insurance Act, including failure of the insurer to comply with its obligations under the Insurance Act or if, in the opinion of the BMA, the insurer has not been carrying on business in accordance with sound insurance principles. We believe we are in compliance with applicable regulations under the Insurance Act.

*Principal Representative.* An insurer is required to maintain a principal office in Bermuda and to appoint and maintain a principal representative in Bermuda. It is the duty of the principal representative upon reaching the view that there is a likelihood of the insurer for which the principal representative acts becoming insolvent or that a reportable "event" has, to the principal representative's knowledge, occurred or is believed to have occurred, to immediately notify the BMA and to make a report in writing to the BMA within 14 days setting out all the particulars of the case that are available to the principal representative.

*Approved Independent Auditor.* Every registered insurer must appoint an independent auditor who annually audits and reports on the statutory financial statements and the statutory financial return of the insurer, both of which, in the case of Arch Re Bermuda, are required to be filed annually with the BMA. The independent auditor must be approved by the BMA.

*Approved Actuary.* Arch Re Bermuda, as a registered long-term insurer, is required to submit an annual actuary's certificate when filing its statutory financial returns. The actuary, who is normally a qualified life actuary, must be approved by the BMA.

*Approved Loss Reserve Specialist.* As a registered Class 4 insurer, Arch Re Bermuda is required to submit an opinion of its approved loss reserve specialist with its statutory financial return in respect of its loss and loss expense provisions. The loss reserve specialist, who will normally be a qualified casualty actuary, must be approved by the BMA.

*Annual Statutory Financial Statements.* An insurer must prepare annual statutory financial statements. The Insurance Act prescribes rules for the preparation and substance of such statutory financial statements (which include, in statutory form, a balance sheet, an income statement, a statement of capital and surplus and notes thereto). The insurer is required to give detailed



information and analyses regarding premiums, claims, reinsurance and investments. The statutory financial statements are not prepared in accordance with GAAP and are distinct from the financial statements prepared for presentation to the insurer's shareholders under the Companies Act 1981 of Bermuda (the "Companies Act"), which financial statements are prepared in accordance with GAAP. Arch Re Bermuda, as a general business insurer, is required to submit the annual statutory financial statements as part of the annual statutory financial return.

*Annual Statutory Financial Return.* Arch Re Bermuda is required to file with the BMA in Bermuda a statutory financial return no later than four months after its financial year end (unless specifically extended upon application to the BMA). The statutory financial return for a Class 4 insurer includes, among other matters, a report of the approved independent auditor on the statutory financial statements of such insurer, solvency certificates, the statutory financial statements themselves, the opinion of the loss reserve specialist and a schedule of reinsurance ceded.

*Minimum Solvency Margin and Restrictions on Dividends and Distributions.* Under the Insurance Act, Arch Re Bermuda must ensure that the value of its long-term business assets exceed the amount of its long-term business liabilities by at least \$250,000. The Insurance Act also provides that the value of the general business assets of Arch Re Bermuda, as a Class 4 insurer, must exceed the amount of its general business liabilities by an amount greater than the prescribed minimum solvency margin. Arch Re Bermuda:

is required, with respect to its general business, to maintain a minimum solvency margin (the prescribed amount by which the value of its general business assets must exceed its general business liabilities) equal to the greatest of:

- (A) \$100 million,
- (B) 50% of net premiums written (being gross premiums written less any premiums ceded by Arch Re Bermuda but Arch Re Bermuda may not deduct more than 25% of gross premiums when computing net premiums written), and
- (C) 15% of loss and other insurance reserves;

is prohibited from declaring or paying any dividends during any financial year if it is in breach of its minimum solvency margin or minimum liquidity ratio or if the declaration or payment of such dividends would cause it to fail to meet such margin or ratio (if it has failed to meet its minimum solvency margin or minimum liquidity ratio on the last day of any financial year, Arch Re Bermuda will be prohibited, without the approval of the BMA, from declaring or paying any dividends during the next financial year);

is prohibited from declaring or paying in any financial year dividends of more than 25% of its total statutory capital and surplus (as shown on its previous financial year's statutory balance sheet) unless it files (at least 7 days before payment of such dividends) with the BMA an affidavit stating that it will continue to meet the required margins;

is prohibited, without the approval of the BMA, from reducing by 15% or more its total statutory capital as set out in its previous year's financial statements and any application for such approval must include an affidavit stating that it will continue to meet the required margins;

is required, at any time it fails to meet its solvency margin, within 30 days (45 days where total statutory capital and surplus falls to \$75 million or less) after becoming aware of that failure or having reason to believe that such failure has occurred, to file with the BMA a written report containing certain information;

is required to establish and maintain a long-term business fund; and

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is required to obtain a certain certification from its approved actuary prior to declaring or paying any dividends and such certificate will not be given unless the value of its long-term business assets exceeds its long-term business liabilities, as certified by its approved actuary, by the amount of the dividend and at least \$250,000. The amount of any such dividend shall not exceed the aggregate of the excess referenced in the preceding sentence and other funds properly available for the payment of dividends, being funds arising out of its business, other than its long-term business.

*Minimum Liquidity Ratio.* The Insurance Act provides a minimum liquidity ratio for general business insurers such as Arch Re Bermuda. An insurer engaged in general business is required to maintain the value of its relevant assets at not less than 75% of the amount of its relevant liabilities. Relevant assets include cash and time deposits, quoted investments, unquoted bonds and debentures, first liens on real estate, investment income due and accrued, accounts and premiums receivable and reinsurance balances receivable. The relevant liabilities are total general business insurance reserves and total other liabilities less deferred income tax and sundry liabilities (by interpretation, those not specifically defined).

*Long-Term Business Fund.* An insurer carrying on long-term business is required to keep its accounts in respect of its long-term business separate from any accounts kept in respect of any other business and all receipts of its long-term business form part of its long-term business fund. No payment may be made directly or indirectly from an insurer's long-term business fund for any purpose other than a purpose related to the insurer's long-term business, unless such payment can be made out of any surplus certified by the insurer's approved actuary to be available for distribution otherwise than to policyholders. Arch Re Bermuda may not declare or pay a dividend to any person other than a policyholder unless the value of the assets in its long-term business fund, as certified by its approved actuary, exceeds the liabilities of the insurer's long-term business (as certified by the insurer's approved actuary) by the amount of the dividend and at least the \$250,000 minimum solvency margin prescribed by the Insurance Act, and the amount of any such dividend may not exceed the aggregate of that excess (excluding the said \$250,000) and any other funds properly available for payment of dividends, such as funds arising out of business of the insurer other than long-term business.

*Restrictions on Transfer of Business and Winding-Up.* Arch Re Bermuda, as a long-term insurer, is subject to the following provisions of the Insurance Act:

all or any part of the long-term business, other than long-term business that is reinsurance business, may be transferred only with and in accordance with the sanction of the applicable Bermuda court; and

an insurer or reinsurer carrying on long-term business may only be wound-up or liquidated by order of the applicable Bermuda court, and this may increase the length of time and costs incurred in the winding-up of Arch Re Bermuda when compared with a voluntary winding-up or liquidation.

*Supervision, Investigation and Intervention.* The BMA may appoint an inspector with extensive powers to investigate the affairs of an insurer if the BMA believes that an investigation is required in the interest of the insurer's policyholders or persons who may become policyholders. In order to verify or supplement information otherwise provided to the BMA, the BMA may direct an insurer to produce documents or information relating to matters connected with the insurer's business.

If it appears to the BMA that there is a risk of the insurer becoming insolvent, or that it is in breach of the Insurance Act or any conditions imposed upon its registration, the BMA may, among other things, direct the insurer (1) not to take on any new insurance business, (2) not to vary any insurance contract if the effect would be to increase the insurer's liabilities, (3) not to make certain investments, (4) to realize certain investments, (5) to maintain in, or transfer to the custody of, a

specified bank, certain assets, (6) not to declare or pay any dividends or other distributions or to restrict the making of such payments and/or (7) to limit its premium income.

*Shareholder Controllers.* Any person who, directly or indirectly, becomes a holder of at least 10%, 20%, 33% or 50% of the common shares of ACGL must notify the BMA in writing within 45 days of becoming such a holder or 30 days from the date such person has knowledge of having such a holding, whichever is later. The BMA may, by written notice, object to such a person if it appears to the BMA that the person is not fit and proper to be such a holder. The BMA may require the holder to reduce their holding of common shares in ACGL and direct, among other things, that voting rights attaching to the common shares shall not be exercisable. A person that does not comply with such a notice or direction from the BMA will be guilty of an offense.

For so long as ACGL has as a subsidiary an insurer registered under the Insurance Act, the BMA may at any time, by written notice, object to a person holding 10% or more of its common shares if it appears to the BMA that the person is not or is no longer fit and proper to be such a holder. In such a case, the BMA may require the shareholder to reduce its holding of common shares in ACGL and direct, among other things, that such shareholder's voting rights attaching to the common shares shall not be exercisable. A person who does not comply with such a notice or direction from the BMA will be guilty of an offense.

#### *Certain Bermuda Law Considerations*

ACGL and Arch Re Bermuda have been designated as non-resident for exchange control purposes by the BMA and are required to obtain the permission of the BMA for the issue and transfer of all of their shares. The BMA has given its consent for:

the issue and transfer of ACGL's shares, up to the amount of its authorized capital from time to time, to and among persons that are non-residents of Bermuda for exchange control purposes; and

the issue and transfer of up to 20% of ACGL's shares in issue from time to time to and among persons resident in Bermuda for exchange control purposes.

Transfers and issues of ACGL's common shares to any resident in Bermuda for exchange control purposes may require specific prior approval under the Exchange Control Act 1972. Arch Re Bermuda's common shares cannot be issued or transferred without the consent of the BMA. Because we are designated as non-resident for Bermuda exchange control purposes, we are allowed to engage in transactions, and to pay dividends to Bermuda non-residents who are holders of our common shares, in currencies other than the Bermuda Dollar.

In accordance with Bermuda law, share certificates are issued only in the names of corporations or individuals. In the case of an applicant acting in a special capacity (for example, as an executor or trustee), certificates may, at the request of the applicant, record the capacity in which the applicant is acting. Notwithstanding the recording of any such special capacity, we are not bound to investigate or incur any responsibility in respect of the proper administration of any such estate or trust. We will take no notice of any trust applicable to any of our common shares whether or not we have notice of such trust.

ACGL and Arch Re Bermuda are incorporated in Bermuda as "exempted companies." As a result, they are exempt from Bermuda laws restricting the percentage of share capital that may be held by non-Bermudians, but they may not participate in certain business transactions, including (1) the acquisition or holding of land in Bermuda (except that required for their business and held by way of lease or tenancy for terms of not more than 50 years) without the express authorization of the Bermuda legislature, (2) the taking of mortgages on land in Bermuda to secure an amount in excess of \$50,000 without the consent of the Minister of Finance, (3) the acquisition of any bonds or debentures

secured by any land in Bermuda, other than certain types of Bermuda government securities or (4) the carrying on of business of any kind in Bermuda, except in furtherance of their business carried on outside Bermuda or under license granted by the Minister of Finance. While an insurer is permitted to reinsure risks undertaken by any company incorporated in Bermuda and permitted to engage in the insurance and reinsurance business, generally it is not permitted without a special license granted by the Minister of Finance to insure Bermuda domestic risks or risks of persons of, in or based in Bermuda.

ACGL and Arch Re Bermuda also need to comply with the provisions of the Companies Act regulating the payment of dividends and making distributions from contributed surplus. A company shall not declare or pay a dividend, or make a distribution out of contributed surplus, if there are reasonable grounds for believing that: (a) the company is, or would after the payment be, unable to pay its liabilities as they become due; or (b) the realizable value of the company's assets would thereby be less than the aggregate of its liabilities and its issued share capital and share premium accounts. See "Management's Discussion and Analysis of Financial Condition and Results of Operations Liquidity and Capital Resources" and note 15, "Statutory Information," of the notes accompanying our financial statements.

Under Bermuda law, only persons who are Bermudians, spouses of Bermudians, holders of a permanent resident's certificate or holders of a working resident's certificate ("exempted persons") may engage in gainful occupation in Bermuda without an appropriate governmental work permit. Our success may depend in part upon the continued services of key employees in Bermuda. Certain of our current key employees are not exempted persons and, as such, require specific approval to work for us in Bermuda. A work permit may be granted or extended upon showing that, after proper public advertisement, no exempted person is available who meets the minimum standards reasonably required by the employer. The Bermuda government has a policy that places a six-year term limit on individuals with work permits, subject to certain exemptions for key employees.

### ***United Kingdom Insurance Regulation***

*General.* The Financial Services Authority (the "FSA") regulates insurance and reinsurance companies operating in the U.K. under the Financial Services and Markets Act 2000 (the "FSMA"), including Arch-Europe, our U.K.-based subsidiary. In May 2004, Arch-Europe was licensed and authorized by the FSA. It holds the relevant permissions for the classes of insurance business which it underwrites in the U.K. All U.K. companies are also subject to a range of statutory provisions, including the laws and regulations of the Companies Acts 1985 (as amended) (the "Companies Acts").

The primary statutory goals of the FSA are to maintain and promote confidence in the U.K. financial system, secure the appropriate degree of protection for consumers and reduce financial crime. The FSA regulatory regime imposes risk management, solvency and capital requirements on U.K. insurance companies. The FSA has broad authority to supervise and regulate insurance companies which extends to enforcement of the provisions of the FSMA and intervention in the operations of an insurance company. The FSA regime is based on principles from which all of its rules and guidance derive. Among these principles, the FSA increasingly emphasizes a "culture of compliance" in those firms it regulates. The FSA carries out regular Advanced Risk Responsive Operating Framework ("ARROW") assessments of regulated firms to ensure that compliance with its rules and guidance. The FSA conducted a risk assessment of Arch-Europe in 2004 and in 2006, and will continue to do so again on a regular schedule. The assessment provided the FSA's views on Arch-Europe's risk profile and its regulatory capital requirements. In some cases, the FSA may require remedial action or adjustments to a company's management, operations, capital requirements, claims management or business plan. The FSA recently announced that greater focus will be placed on senior management arrangements, systems and controls, the fair treatment of clients and making further progress towards the development of enhanced risk-based minimum capital requirements for non life insurance companies, working together

with the regulatory bodies of the Member States of the European Union ("EU") and the European Commission, which acts as the initiator of action and executive body of the EU.

*Financial Resources.* Arch-Europe is required to demonstrate to the FSA that it has adequate financial assets to meet the financial resources requirement for its category. On an annual basis, Arch-Europe is required to provide the FSA with its own risk-based assessment of its capital needs, taking into account comprehensive risk factors, including market, credit, operational, liquidity and group risks to generate a revised calculation of its expected liabilities which, in turn, enable the FSA to provide individual capital guidance to Arch-Europe. Arch-Europe's surplus is above the risk-based capital threshold allowed by the FSA's individual capital assessment of Arch-Europe. The FSA requires that Arch-Europe maintain a margin of solvency calculation based on the classes of business for which it is authorized and within its premium income projections applied to its worldwide general business.

*Reporting Requirements.* Like all U.K. companies, Arch-Europe must file and submit its annual audited financial statements and related reports to the Registrar of Companies under the Companies Acts together with an annual return of certain core corporate information and changes from the prior year. This requirement is in addition to the regulatory returns required to be filed annually with the FSA.

*Restrictions on Payment of Dividends.* Under U.K. law, all U.K. companies are restricted from declaring a dividend to their shareholders unless they have "profits available for distribution." The calculation as to whether a company has sufficient profits is based on its accumulated realized profits minus its accumulated realized losses. U.K. insurance regulatory laws do not prohibit the payment of dividends, but the FSA requires that insurance companies maintain certain solvency margins and may restrict the payment of a dividend by Arch-Europe. See "Management's Discussion and Analysis of Financial Condition and Results of Operations Liquidity and Capital Resources" and note 15, "Statutory Information," of the notes accompanying our financial statements.

*European Union Considerations.* As a licensed insurance company in the U.K., a Member State of the EU, Arch-Europe's authorization as an insurer is recognized throughout the European Economic Area ("EEA"), subject only to certain notification and application requirements. This authorization enables Arch-Europe to establish a branch in any other Member State of the EU, where it will be subject to the insurance regulations of each such Member State with respect to the conduct of its business in such Member State, but remain subject only to the financial and operational supervision by the FSA. The framework for the establishment of branches in Member States of the EU other than the U.K. was generally set forth, and remains subject to, directives by the European Council, the legislative body of the EU, which directives are then implemented in each Member State. Arch-Europe currently has branches in Germany, Italy, Spain and Denmark, and may establish branches in other Member States of the EU in the future. Further, as an insurer in an EU Member State, Arch-Europe has the freedom to provide insurance services anywhere in the EEA subject to compliance with certain rules governing such provision, including notification to the FSA.

#### ***Canada Insurance Regulation***

The Canadian branch office of Arch Insurance is subject to federal, as well as provincial and territorial, regulation in Canada. The Office of the Superintendent of Financial Institutions ("OSFI") is the federal regulatory body that, under the Insurance Companies Act (Canada), regulates federal Canadian and non-Canadian insurance companies operating in Canada. The primary goal of OSFI is to supervise the safety and soundness of insurance companies with the aim of securing the appropriate level of protection of insureds by imposing risk management, solvency and capital requirements on such companies. In addition, the Canadian branch is subject to regulation in the provinces and territories in which it underwrites insurance, and the primary goal of insurance regulation at the provincial and territorial levels is to govern the market conduct of insurance companies. The Canadian branch is

licensed to carry on insurance business by OSFI and in each province and territory, except for Prince Edward Island.

***Switzerland Insurance Regulation***

In November 2006, Arch Re Bermuda opened a branch office in Zurich, Switzerland named Arch Reinsurance Ltd., Hamilton (Bermuda), European Branch Zurich. The activities of the Arch Re Swiss Branch are limited to reinsurance so it is not required to be licensed by the Swiss insurance regulatory authorities.

***European Union Reinsurance Regulation***

The single system established in the EU for regulation and supervision of the general insurance sector and its single passport regime have until recently applied only to direct insurance, and there has been no common regulation of reinsurance in the EU. On December 9, 2005, the EU published the Reinsurance Directive (the "Directive") as a first step in harmonization of reinsurance regulation in the single market. Member States of the EU and the EEA were required to implement the Directive by December 2007. A number of Member States have implemented the Directive, but some have yet to pass the necessary legislation. Once fully implemented, pure reinsurers established in a Member State of the EU will have freedom to establish branches in and provide services to all EEA states similar to that enjoyed by direct insurers and they will be subject to similar rules in relation to licensing and financial supervision. At present, there are Member States in which this freedom does not apply. Arch-Europe, being established in the U.K. and authorized by the FSA to write reinsurance, is now able, subject to regulatory notifications and there being no objection from the FSA and the Member States concerned, to establish branches and provide reinsurance services in those EEA states which have implemented the Directive. The Directive itself does not prohibit EEA insurers from obtaining reinsurance from reinsurers licensed outside the EEA, such as Arch Re Bermuda. As such, Arch Re Bermuda may do business from Bermuda with EEA Member States but it may not directly operate its reinsurance business within the EEA. Unless agreement is reached between the European Commission and Bermuda to accord Bermuda-based reinsurers market access on the basis of the prudential nature of Bermuda regulation, each individual EEA Member State may impose conditions on reinsurance provided by Bermuda-based reinsurers which could restrict their future provision of reinsurance to the EEA Member State concerned. There are no indications as yet that any EEA Member State will take this course, but Hungary and the Slovak Republic have certain prohibitions on the purchase of insurance from reinsurers not authorized in the EEA. Also, a number of EEA Member States have introduced or are considering legislation that would limit the ability of Bermudian reinsurers to advertise or otherwise market their reinsurance services in those EEA Member States.

**TAX MATTERS**

The following summary of the taxation of ACGL and the taxation of our shareholders is based upon current law and is for general information only. Legislative, judicial or administrative changes may be forthcoming that could affect this summary.

The following legal discussion (including and subject to the matters and qualifications set forth in such summary) of certain tax considerations (a) under " Taxation of ACGL Bermuda" and " Taxation of Shareholders Bermuda Taxation" is based upon the advice of Conyers Dill & Pearman, Hamilton, Bermuda and (b) under " Taxation of ACGL United States," " Taxation of Shareholders United States Taxation," " Taxation of Our U.S. Shareholders" and " United States Taxation of Non-U.S. Shareholders" is based upon the advice of Cahill Gordon & Reindel LLP, New York, New York (the advice of such firms does not include accounting matters, determinations or conclusions relating to the business or activities of ACGL). The summary is based upon current law and is for general information only. The tax treatment of a holder of our shares (common shares, series A non-cumulative preferred shares or series B non-cumulative preferred shares), or of a person treated as a holder of our shares for U.S. federal income, state, local or non-U.S. tax purposes, may vary depending on the holder's particular tax situation. Legislative, judicial or administrative changes or interpretations may be forthcoming that could be retroactive and could affect the tax consequences to us or to holders of our shares.

**Taxation of ACGL**

*Bermuda*

Under current Bermuda law, ACGL is not subject to tax on income or capital gains. ACGL has obtained from the Minister of Finance under the Exempted Undertakings Tax Protection Act 1966 an assurance that, in the event that Bermuda enacts legislation imposing tax computed on profits, income, any capital asset, gain or appreciation, or any tax in the nature of estate duty or inheritance, the imposition of any such tax shall not be applicable to ACGL or to any of our operations or our shares, debentures or other obligations until March 28, 2016. We could be subject to taxes in Bermuda after that date. This assurance will be subject to the proviso that it is not to be construed so as to prevent the application of any tax or duty to such persons as are ordinarily resident in Bermuda (we are not so currently affected) or to prevent the application of any tax payable in accordance with the provisions of the Land Tax Act 1967 or otherwise payable in relation to any property leased to us or our insurance subsidiary. We pay annual Bermuda government fees, and our Bermuda insurance and reinsurance subsidiary pays annual insurance license fees. In addition, all entities employing individuals in Bermuda are required to pay a payroll tax and other sundry taxes payable, directly or indirectly, to the Bermuda government.

*United States*

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 definitive identification of activities which constitute being engaged in a trade or business in the U.S. is not provided by the Internal Revenue Code of 1986, as amended (the "Code"), or regulations or court decisions, there can be no assurance that the U.S. Internal Revenue Service will not contend successfully that ACGL or its non-U.S. subsidiaries are or have been engaged in a trade or business in the United States. A foreign corporation deemed to be so engaged would be subject to U.S. income tax, as well as the branch profits tax, on its income, which is treated as effectively connected with the conduct of that trade or business unless the corporation is entitled to

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relief under the permanent establishment provisions of a tax treaty. Such income tax, if imposed, would be based on effectively connected income computed in a manner generally analogous to that applied to the income of a domestic corporation, except that deductions and credits generally are not permitted unless the foreign corporation has timely filed a U.S. federal income tax return in accordance with applicable regulations. Penalties may be assessed for failure to file tax returns. The 30% branch profits tax is imposed on net income after subtracting the regular corporate tax and making certain other adjustments.

Under the income tax treaty between Bermuda and the United States (the "Treaty"), ACGL's Bermuda insurance subsidiaries will be subject to U.S. income tax on any insurance premium income found to be effectively connected with a U.S. trade or business only if that trade or business is conducted through a permanent establishment in the United States. No regulations interpreting the Treaty have been issued. While there can be no assurances, ACGL does not believe that any of its Bermuda insurance subsidiaries has a permanent establishment in the United States. Such subsidiaries would not be entitled to the benefits of the Treaty if (i) less than 50% of ACGL's shares were beneficially owned, directly or indirectly, by Bermuda residents or U.S. citizens or residents, or (ii) any such subsidiary's income were used in substantial part to make disproportionate distributions to, or to meet certain liabilities to, persons who are not Bermuda residents or U.S. citizens or residents. While there can be no assurances, ACGL believes that its Bermuda insurance subsidiaries are eligible for Treaty benefits.

The Treaty clearly applies to premium income, but may be construed as not protecting investment income. If ACGL's Bermuda insurance subsidiaries were considered to be engaged in a U.S. trade or business and were entitled to the benefits of the Treaty in general, but the Treaty were not found to protect investment income, a portion of such subsidiaries' investment income could be subject to U.S. federal income tax.

Non-U.S. insurance companies carrying on an insurance business within the United States have a certain minimum amount of effectively connected net investment income, determined in accordance with a formula that depends, in part, on the amount of U.S. risk insured or reinsured by such companies. If any of ACGL's non-U.S. insurance subsidiaries is considered to be engaged in the conduct of an insurance business in the United States, a significant portion of such company's investment income could be subject to U.S. income tax.

Non-U.S. corporations not engaged in a trade or business in the United States are nonetheless subject to U.S. income tax on certain "fixed or determinable annual or periodic gains, profits and income" derived from sources within the United States as enumerated in Section 881(a) of the Code (such as dividends and certain interest on investments), subject to exemption under the Code or reduction by applicable treaties.

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 4% for non-life insurance premiums and 1% for life insurance and all reinsurance premiums.

*Personal Holding Company Rules.* A domestic corporation will not be classified as a personal holding company (a "PHC") in a given taxable year unless both (i) at some time during the last half of such taxable year, five or fewer individuals (without regard to their citizenship or residency) own or are deemed to own (pursuant to certain constructive ownership rules) more than 50% of the corporation's shares by value, and (ii) at least 60% of the adjusted ordinary gross income of the corporation for such taxable year consists of PHC income (as defined in Section 543 of the Code). For purposes of the 50% share ownership test, all of our shares owned by an investment partnership will be attributed to each of its partners, if any, who are individuals. As a result of this attribution rule, we believe that currently five or fewer individuals may be treated as owning more than 50% of the value of our shares.



Consequently, one or more of our domestic subsidiaries could be or become PHCs, depending on whether any of our subsidiaries satisfy the PHC gross income test.

We will use commercially reasonable efforts to cause each of our domestic subsidiaries not to satisfy the gross income requirement set forth in Section 542(a) of the Code. If, however, any of our domestic subsidiaries is or were to become a PHC in a given taxable year, such company would be subject to PHC tax (at a 15% rate for taxable years before January 1, 2011, and thereafter at the highest marginal rate on ordinary income applicable to individuals) on its "undistributed PHC income." PHC income generally would not include underwriting income. If any of our subsidiaries is or becomes a PHC, there can be no assurance that the amount of PHC income would be immaterial.

Certain of our U.S. subsidiaries have been PHCs. Such subsidiaries did not have "undistributed personal holding company income" and do not expect to have "undistributed personal holding company income" in 2007.

There can be no assurance that each of our domestic subsidiaries is not or will not become a PHC in the future because of factors including factual uncertainties regarding the application of the PHC rules, the makeup of our shareholder base and other circumstances that affect the application of the PHC rules to our domestic subsidiaries.

#### *United Kingdom*

Our European subsidiaries, Arch-Europe and Arch Capital U.K. Ltd. ("Arch-U.K."), are companies incorporated in the U.K. and are therefore resident in the U.K. for corporation tax purposes and will be subject to U.K. corporate tax on their respective worldwide profits. The current rate of U.K. corporation tax is generally 30% on profits, but this is scheduled to be reduced to 28% for profits accruing from April 1, 2008.

#### *Canada*

In January 2005, Arch Insurance received its federal license to commence underwriting in Canada and began writing business in the first quarter of 2005 through its branch operation. The branch operation is taxed on net business income earned in Canada. The general federal corporate income tax rate in Canada is currently 19.5%. The general federal corporate income tax rate in Canada is legislated to be reduced to 19.0% in 2009, 18.0% in 2010, 16.5% in 2011 and, finally, 15.0% in 2012. Provincial and territorial corporate income tax rates are added to the general federal corporate income tax rate and generally vary between 9.9% and 16.0%. Canadian income taxes are also creditable to the Company's U.S. operations.

#### *Switzerland*

Arch Re Swiss Branch, established as a branch office of Arch Re Bermuda, is subject to Swiss corporation tax on the profit which is allocated to the branch. Under a mixed company ruling, the effective tax rate is expected to be between 11.4% and 12.6%. The annual capital tax on the equity which is allocated to Arch Re Swiss Branch is approximately .035%.

#### *Denmark*

Arch Re Denmark, established as a subsidiary of Arch Re Bermuda, is subject to Danish corporation taxes on its profits at a rate of 28%.

#### **Taxation of Shareholders**

The following summary sets forth certain United States federal income tax considerations related to the purchase, ownership and disposition of our common shares and our series A non-cumulative

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preferred shares and our series B non-cumulative preferred shares (collectively referred to as the "preferred shares"). Unless otherwise stated, this summary deals only with shareholders ("U.S. Holders") that are United States Persons (as defined below) who hold their common shares and preferred shares as capital assets and as beneficial owners. The following discussion is only a general summary of the United States federal income tax matters described herein and does not purport to address all of the United States federal income tax consequences that may be relevant to a particular shareholder in light of such shareholder's specific circumstances. In addition, the following summary does not describe the United States federal income tax consequences that may be relevant to certain types of shareholders, such as banks, insurance companies, regulated investment companies, real estate investment trusts, financial asset securitization investment trusts, dealers in securities or traders that adopt a mark-to-market method of tax accounting, tax exempt organizations, expatriates or persons who hold the common shares or preferred shares as part of a hedging or conversion transaction or as part of a straddle, who may be subject to special rules or treatment under the Code. This discussion is based upon the Code, the Treasury regulations promulgated thereunder and any relevant administrative rulings or pronouncements or judicial decisions, all as in effect on the date of this annual report and as currently interpreted, and does not take into account possible changes in such tax laws or interpretations thereof, which may apply retroactively. This discussion does not include any description of the tax laws of any state or local governments within the United States, or of any foreign government, that may be applicable to our common shares or preferred shares or the shareholders. Persons considering making an investment in the common shares or preferred shares should consult their own tax advisors concerning the application of the United States federal tax laws to their particular situations as well as any tax consequences arising under the laws of any state, local or foreign taxing jurisdiction prior to making such investment.

If a partnership holds our common shares or preferred shares, the tax treatment of a partner will generally depend upon the status of the partner and the activities of the partnership. If you are a partner of a partnership holding our common shares or preferred shares, you should consult your tax advisor.

For purposes of this discussion, the term "United States Person" means:

a citizen or resident of the United States,

a corporation or entity treated as a corporation created or organized in or under the laws of the United States, or any political subdivision thereof,

an estate the income of which is subject to United States federal income taxation regardless of its source,

a trust if either (x) a court within the United States is able to exercise primary supervision over the administration of such trust and one or more United States Persons have the authority to control all substantial decisions of such trust or (y) the trust has a valid election in effect to be treated as a United States Person for U.S. federal income tax purposes or

any other person or entity that is treated for U.S. federal income tax purposes as if it were one of the foregoing.

### ***Bermuda Taxation***

Currently, there is no Bermuda withholding tax on dividends paid by us.

### ***United States Taxation***

*Taxation of Dividends.* The preferred shares should be properly classified as equity rather than debt for U.S. federal income tax purposes. Subject to the discussions below relating to the potential

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application of the CFC and PFIC rules, as defined below, cash distributions, if any, made with respect to our common shares or preferred shares will constitute dividends for U.S. federal income tax purposes to the extent paid out of our current or accumulated earnings and profits (as computed using U.S. tax principles). If a U.S. Holder of our common shares or our preferred shares is an individual or other non-corporate holder, dividends paid, if any, to that holder in taxable years beginning before January 1, 2011 that constitute qualified dividend income will be taxable at the rate applicable for long-term capital gains (generally up to 15%), provided that such person meets a holding period requirement. Generally in order to meet the holding period requirement, the United States Person must hold the common shares for more than 60 days during the 121-day period beginning 60 days before the ex-dividend date and must hold preferred shares for more than 90 days during the 181-day period beginning 90 days before the ex-dividend date. Dividends paid, if any, with respect to common shares or preferred shares generally will be qualified dividend income, provided the common shares or preferred shares are readily tradable on an established securities market in the U.S. in the year in which the shareholder receives the dividend (which should be the case for shares that are listed on the NASDAQ Stock Market or the New York Stock Exchange) and ACGL is not considered to be a passive foreign investment company in either the year of the distribution or the preceding taxable year. No assurance can be given that the preferred shares will be considered readily tradable on an established securities market in the United States. See "Taxation of Our U.S. Shareholders" below. After December 31, 2010, qualified dividend income will no longer be taxed at the rate applicable for long-term capital gains unless Congress enacts legislation providing otherwise.

Distributions with respect to the common shares and the preferred shares will not be eligible for the dividends-received deduction allowed to U.S. corporations under the Code. To the extent distributions on our common shares and preferred shares exceed our earnings and profits, they will be treated first as a return of the U.S. Holder's basis in our common shares and our preferred shares to the extent thereof, and then as gain from the sale of a capital asset.

*Sale, Exchange or Other Disposition.* Subject to the discussions below relating to the potential application of the CFC and PFIC rules, holders of common shares and preferred shares generally will recognize capital gain or loss for U.S. federal income tax purposes on the sale, exchange or disposition of common shares or preferred shares, as applicable.

*Redemption of Preferred Shares.* A redemption of the preferred shares will be treated under section 302 of the Code as a dividend if we have sufficient earnings and profits, unless the redemption satisfies one of the tests set forth in section 302(b) of the Code enabling the redemption to be treated as a sale or exchange, subject to the discussion herein relating to the potential application of the CFC, RPII and PFIC rules. Under the relevant Code section 302(b) tests, the redemption should be treated as a sale or exchange only if it (1) is substantially disproportionate, (2) constitutes a complete termination of the holder's stock interest in us or (3) is "not essentially equivalent to a dividend." In determining whether any of these tests are met, shares considered to be owned by the holder by reason of certain constructive ownership rules set forth in the Code, as well as shares actually owned, must generally be taken into account. It may be more difficult for a United States Person who owns, actually or constructively by operation of the attribution rules, any of our other shares to satisfy any of the above requirements. The determination as to whether any of the alternative tests of section 302(b) of the Code is satisfied with respect to a particular holder of the preference shares depends on the facts and circumstances as of the time the determination is made.

### **Taxation of Our U.S. Shareholders**

#### ***Controlled Foreign Corporation Rules***

Under our bye-laws, the 9.9% voting restriction applicable to the Controlled Shares of a U.S. Person (as defined in our bye-laws) generally does not apply to certain of our investors. As a result of

certain attribution rules, we believe, therefore, that we and our foreign subsidiaries might be controlled foreign corporations ("CFCs"). That status as a CFC would not cause us or any of our subsidiaries to be subject to U.S. federal income tax. Such status also would have no adverse U.S. federal income tax consequences for any U.S. Holder that is considered to own less than 10% of the total combined voting power of our shares or those of our foreign subsidiaries. Only U.S. Holders that are considered to own 10% or more of the total combined voting power of our shares or those of our foreign subsidiaries (taking into account shares actually owned by such U.S. Holder as well as shares attributed to such U.S. Holder under the Code or the regulations thereunder) (a "10% U.S. Voting Shareholder") would be affected by our status as a CFC. The preferred shares generally should not be considered voting stock for purposes of determining whether a United States Person would be a "10% U.S. Voting Shareholder." The shares may, however, become entitled to vote (as a class along with any other class of preferred shares of ACGL then outstanding) for the election of two additional members of the board of directors of ACGL if ACGL does not declare and pay dividends for the equivalent of six or more dividend periods. In such case, the preferred shares should be treated as voting stock for as long as such voting rights continue. Our bye-laws are intended to prevent any U.S. Holder from being considered a 10% U.S. Voting Shareholder by limiting the votes conferred by the Controlled Shares (as defined in our bye-laws) of any U.S. Person to 9.9% of the total voting power of all our shares entitled to vote. However, because under our bye-laws certain funds associated with Warburg Pincus and Hellman & Friedman generally are entitled to vote their directly owned common shares in full, a U.S. Holder that is attributed (under the Code or the regulations thereunder) common shares owned by such funds may be considered a 10% U.S. Voting Shareholder. If you are a direct or indirect investor in a fund associated with Warburg Pincus or Hellman & Friedman, additional common shares could be attributed to you for purposes of determining whether you are considered to be a 10% U.S. Voting Shareholder. If we are a CFC, a U.S. Holder that is considered a 10% U.S. Voting Shareholder would be subject to current U.S. federal income taxation (at ordinary income tax rates) to the extent of all or a portion of the undistributed earnings and profits of ACGL and our subsidiaries attributable to "subpart F income" (including certain insurance premium income and investment income) and may be taxable at ordinary income tax rates on any gain realized on a sale or other disposition (including by way of repurchase or liquidation) of our shares to the extent of the current and accumulated earnings and profits attributable to such shares.

While our bye-laws are intended to prevent any member from being considered a 10% U.S. Voting Shareholder (except as described above), there can be no assurance that a U.S. Holder will not be treated as a 10% U.S. Voting Shareholder, by attribution or otherwise, under the Code or any applicable regulations thereunder. See "Risk Factors Risks Relating to Taxation U.S. persons who hold our common shares or preferred shares may be subject to U.S. income taxation at ordinary income rates on our undistributed earnings and profits."

#### ***Related Person Insurance Income Rules***

Generally, we do not expect the gross "related person insurance income" ("RPII") of any of our non-U.S. subsidiaries to equal or exceed 20% of its gross insurance income in any taxable year for the foreseeable future and do not expect the direct or indirect insureds (and related persons) of any such subsidiary to directly or indirectly own 20% or more of either the voting power or value of our stock. Consequently, we do not expect any U.S. person owning common shares or preferred shares to be required to include in gross income for U.S. federal income tax purposes RPII income, but there can be no assurance that this will be the case.

Section 953(c)(7) of the Code generally provides that Section 1248 of the Code (which generally would require a U.S. Holder to treat certain gains attributable to the sale, exchange or disposition of common shares or preferred shares as a dividend) will apply to the sale or exchange by a U.S. shareholder of shares in a foreign corporation that is characterized as a CFC under the RPII rules if

the foreign corporation would be taxed as an insurance company if it were a domestic corporation, regardless of whether the U.S. shareholder is a 10% U.S. Voting Shareholder or whether the corporation qualifies for either the RPII 20% ownership exception or the RPII 20% gross income exception. Although existing Treasury Department regulations do not address the question, proposed Treasury regulations issued in April 1991 create some ambiguity as to whether Section 1248 and the requirement to file Form 5471 would apply when the foreign corporation has a foreign insurance subsidiary that is a CFC for RPII purposes and that would be taxed as an insurance company if it were a domestic corporation. We believe that Section 1248 and the requirement to file Form 5471 will not apply to a less than 10% U.S. Shareholder because ACGL is not directly engaged in the insurance business. There can be no assurance, however, that the U.S. Internal Revenue Service will interpret the proposed regulations in this manner or that the Treasury Department will not take the position that Section 1248 and the requirement to file Form 5471 will apply to dispositions of our common shares or our preferred shares.

If the U.S. Internal Revenue Service or U.S. Treasury Department were to make Section 1248 and the Form 5471 filing requirement applicable to the sale of our shares, we would notify shareholders that Section 1248 of the Code and the requirement to file Form 5471 will apply to dispositions of our shares. Thereafter, we would send a notice after the end of each calendar year to all persons who were shareholders during the year notifying them that Section 1248 and the requirement to file Form 5471 apply to dispositions of our shares by U.S. Holders. We would attach to this notice a copy of Form 5471 completed with all our information and instructions for completing the shareholder information.

#### ***Tax-Exempt Shareholders***

Tax-exempt entities may be required to treat certain Subpart F insurance income, including RPII, that is includible in income by the tax-exempt entity as unrelated business taxable income. Prospective investors that are tax exempt entities are urged to consult their tax advisors as to the potential impact of the unrelated business taxable income provisions of the Code.

#### ***Passive Foreign Investment Companies***

Sections 1291 through 1298 of the Code contain special rules applicable with respect to foreign corporations that are "passive foreign investment companies" ("PFICs"). In general, a foreign corporation will be a PFIC if 75% or more of its income constitutes "passive income" or 50% or more of its assets produce passive income. If we were to be characterized as a PFIC, U.S. Holders would be subject to a penalty tax at the time of their sale of (or receipt of an "excess distribution" with respect to) their common shares or preferred shares. In general, a shareholder receives an "excess distribution" if the amount of the distribution is more than 125% of the average distribution with respect to the shares during the three preceding taxable years (or shorter period during which the taxpayer held the stock). In general, the penalty tax is equivalent to an interest charge on taxes that are deemed due during the period the shareholder owned the shares, computed by assuming that the excess distribution or gain (in the case of a sale) with respect to the shares was taxable in equal portions throughout the holder's period of ownership. The interest charge is equal to the applicable rate imposed on underpayments of U.S. federal income tax for such period. A U.S. shareholder may avoid some of the adverse tax consequences of owning shares in a PFIC by making a qualified electing fund ("QEF") election. A QEF election is revocable only with the consent of the IRS and has the following consequences to a shareholder:

For any year in which ACGL is not a PFIC, no income tax consequences would result.

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For any year in which ACGL is a PFIC, the shareholder would include in its taxable income a proportionate share of the net ordinary income and net capital gains of ACGL and certain of its non-U.S. subsidiaries.

The PFIC statutory provisions contain an express exception for income "derived in the active conduct of an insurance business by a corporation which is predominantly engaged in an insurance business..." This exception is intended to ensure that income derived by a bona fide insurance company is not treated as passive income, except to the extent such income is attributable to financial reserves in excess of the reasonable needs of the insurance business. The PFIC statutory provisions contain a look-through rule that states that, for purposes of determining whether a foreign corporation is a PFIC, such foreign corporation shall be treated as if it "received directly its proportionate share of the income" and as if it "held its proportionate share of the assets" of any other corporation in which it owns at least 25% of the stock. We believe that we are not a PFIC, and we will use reasonable best efforts to cause us and each of our non-U.S. insurance subsidiaries not to constitute a PFIC.

No regulations interpreting the substantive PFIC provisions have yet been issued. Each U.S. Holder should consult his tax advisor as to the effects of these rules.

### **United States Taxation of Non-U.S. Shareholders**

#### *Taxation of Dividends*

Cash distributions, if any, made with respect to common shares or preferred shares held by shareholders who are not United States Persons ("Non-U.S. holders") generally will not be subject to United States withholding tax.

#### *Sale, Exchange or Other Disposition*

Non-U.S. holders of common shares or preferred shares generally will not be subject to U.S. federal income tax with respect to gain realized upon the sale, exchange or other disposition of such shares unless such gain is effectively connected with a U.S. trade or business of the Non-U.S. holder in the United States or such person is present in the United States for 183 days or more in the taxable year the gain is realized and certain other requirements are satisfied.

#### *Information Reporting and Backup Withholding*

Non-U.S. holders of common shares or preferred shares will not be subject to U.S. information reporting or backup withholding with respect to dispositions of common shares effected through a non-U.S. office of a broker, unless the broker has certain connections to the United States or is a United States person. No U.S. backup withholding will apply to payments of dividends, if any, on our common shares or our preferred shares.

#### *Other Tax Laws*

Shareholders should consult their own tax advisors with respect to the applicability to them of the tax laws of other jurisdictions.

### **ITEM 1A. RISK FACTORS**

Set forth below are risk factors relating to our business. You should also refer to the other information provided in this report, including our "Management's Discussion and Analysis of Financial Condition and Results of Operations" and our accompanying consolidated financial statements, as well as the information under the heading "Cautionary Note Regarding Forward-Looking Statements."

## Risks Relating to Our Industry

*We operate in a highly competitive environment, and we may not be able to compete successfully in our industry.*

The insurance and reinsurance industry is highly competitive. We compete with major U.S. and non-U.S. insurers and reinsurers, many of which have greater financial, marketing and management resources than we do, as well as other potential providers of capital willing to assume insurance and/or reinsurance risk. We also compete with new companies that continue to be formed to enter the insurance and reinsurance markets. In our insurance business, we compete with insurers that provide specialty property and casualty lines of insurance, including ACE Limited, Allied World Assurance Company, Ltd., American International Group, Inc., AXIS Capital Holdings Limited, Berkshire Hathaway, Inc., Chubb Corporation, Endurance Specialty Holdings Ltd., The Hartford Financial Services Group, Inc., HCC Insurance Holdings, Inc., Lloyd's of London, The St. Paul Travelers Companies, W.R. Berkley Corp., XL Capital Ltd. and Zurich Insurance Group. In our reinsurance business, we compete with reinsurers that provide property and casualty lines of reinsurance, including ACE Limited, AXIS Capital Holdings Limited, Berkshire Hathaway, Inc., Endurance Specialty Holdings Ltd., Everest Re Group Ltd., Hannover Rückversicherung AG, Lloyd's of London, Montpelier Re Holdings Ltd., Munich Re Group, PartnerRe Ltd., Platinum Underwriters Holdings, Ltd., RenaissanceRe Holdings Ltd., Swiss Reinsurance Company, Transatlantic Holdings, Inc. and XL Capital Ltd. We do not believe that we have a significant market share in any of our markets.

Financial institutions and other capital markets participants also offer alternative products and services similar to our own or alternative products that compete with insurance and reinsurance products. In addition, we may not be aware of other companies that may be planning to enter the segments of the insurance and reinsurance market in which we operate.

Our competitive position is based on many factors, including our perceived overall financial strength, ratings assigned by independent rating agencies, geographic scope of business, client relationships, premiums charged, contract terms and conditions, products and services offered (including the ability to design customized programs), speed of claims payment, reputation, experience and qualifications of employees and local presence. We may not be successful in competing with others on any of these bases, and the intensity of competition in our industry may erode profitability and result in less favorable policy terms and conditions for insurance and reinsurance companies generally, including us.

*The insurance and reinsurance industry is highly cyclical, and we expect to continue to experience periods characterized by excess underwriting capacity and unfavorable premium rates.*

Historically, insurers and reinsurers have experienced significant fluctuations in operating results due to competition, frequency of occurrence or severity of catastrophic events, levels of capacity, general economic conditions, changes in legislation, case law and prevailing concepts of liability and other factors. In particular, demand for reinsurance is influenced significantly by the underwriting results of primary insurers and prevailing general economic conditions. The supply of insurance and reinsurance is related to prevailing prices and levels of surplus capacity that, in turn, may fluctuate in response to changes in rates of return being realized in the insurance and reinsurance industry. As a result, the insurance and reinsurance business historically has been a cyclical industry characterized by periods of intense price competition due to excessive underwriting capacity as well as periods when shortages of capacity permitted favorable premium levels and changes in terms and conditions. The supply of insurance and reinsurance has increased over the past several years and may increase further, either as a result of capital provided by new entrants or by the commitment of additional capital by existing insurers or reinsurers. Continued increases in the supply of insurance and reinsurance may

have consequences for us, including fewer contracts written, lower premium rates, increased expenses for customer acquisition and retention, and less favorable policy terms and conditions.

*We could face unanticipated losses from war, terrorism and political instability, and these or other unanticipated losses could have a material adverse effect on our financial condition and results of operations.*

We have substantial exposure to unexpected, large losses resulting from future man-made catastrophic events, such as acts of war, acts of terrorism and political instability. These risks are inherently unpredictable, although recent events may lead to increased frequency and severity of losses. It is difficult to predict the timing of such events with statistical certainty or estimate the amount of loss any given occurrence will generate. In certain instances, we specifically insure and reinsure risks resulting from acts of terrorism. Even in cases where we attempt to exclude losses from terrorism and certain other similar risks from some coverages written by us, we may not be successful in doing so. Moreover, irrespective of the clarity and inclusiveness of policy language, there can be no assurance that a court or arbitration panel will not limit enforceability of policy language or otherwise issue a ruling adverse to us. Accordingly, while we believe our reinsurance programs, together with the coverage provided under TRIPRA, are sufficient to reasonably limit our net losses relating to potential future terrorist attacks, we can offer no assurance that our available capital will be adequate to cover losses when they materialize. To the extent that an act of terrorism is certified by the Secretary of the Treasury, our U.S. insurance operations may be covered under TRIPRA for up to 85% of its losses for 2007 and future years, in each case subject to a mandatory deductible of 20% for 2007 through 2014. If an act (or acts) of terrorism result in covered losses exceeding the \$100 billion annual limit, insurers with losses exceeding their deductibles will not be responsible for additional losses. It is not possible to completely eliminate our exposure to unforecasted or unpredictable events, and to the extent that losses from such risks occur, our financial condition and results of operations could be materially adversely affected.

*The insurance and reinsurance industry is subject to regulatory and legislative initiatives or proposals from time to time which could adversely affect our business.*

From time to time, various regulatory and legislative changes have been proposed in the insurance and reinsurance industry. Among the proposals that have in the past been or are at present being considered are the possible introduction of federal regulation in addition to, or in lieu of, the current system of state regulation of insurers. There are a variety of proposals being considered by various state legislatures. We are unable to predict whether any of these laws and regulations will be adopted, the form in which any such laws and regulations would be adopted, or the effect, if any, these developments would have on our operations and financial condition.

*Claims for catastrophic events could cause large losses and substantial volatility in our results of operations, and, as a result, the value of our securities, including our common shares and preferred shares, may fluctuate widely, and could have a material adverse effect on our financial position and results of operations.*

We have large aggregate exposures to natural disasters. Catastrophes can be caused by various events, including hurricanes, floods, windstorms, earthquakes, hailstorms, tornados, explosions, severe winter weather, fires and other natural disasters. Catastrophes can also cause losses in non-property business such as workers' compensation or general liability. In addition to the nature of the property business, we believe that economic and geographic trends affecting insured property, including inflation, property value appreciation and geographic concentration tend to generally increase the size of losses from catastrophic events over time. Our actual losses from catastrophic events which may occur, may vary materially from our current estimates due to the inherent uncertainties in making such determinations resulting from several factors, including the potential inaccuracies and inadequacies in



the data provided by clients, brokers and ceding companies, the modeling techniques and the application of such techniques, the contingent nature of business interruption exposures, the effects of any resultant demand surge on claims activity and attendant coverage issues.

The weather-related catastrophic events that occurred in the second half of 2005 caused significant industry losses, resulted in a substantial improvement in market conditions in property and certain marine lines of business and slowed declines in premium rates in other lines. However, during 2006 and 2007, price erosion occurred in many lines of business as a result of competitive pressures in the insurance market. We increased our writings in property and certain marine lines of business 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 of our results of operations.

In addition, over the past several years, changing weather patterns and climatic conditions, such as global warming, have added to the unpredictability and frequency of natural disasters in certain parts of the world and created additional uncertainty as to future trends and exposures. Claims for catastrophic events could expose us to large losses and cause substantial volatility in our results of operations, which could cause the value of our securities, including our common shares and preferred shares, to fluctuate widely.

*Underwriting claims and reserving for losses are based on probabilities and related modeling, which are subject to inherent uncertainties.*

Our success is dependent upon our ability to assess accurately the risks associated with the businesses that we insure and reinsure. We establish reserves for losses and loss adjustment expenses which represent estimates involving actuarial and statistical projections, at a given point in time, of our expectations of the ultimate settlement and administration costs of losses incurred. We utilize actuarial models as well as available historical insurance industry loss ratio experience and loss development patterns to assist in the establishment of loss reserves. Actual losses and loss adjustment expenses paid will deviate, perhaps substantially, from the reserve estimates reflected in our financial statements.

If our loss reserves are determined to be inadequate, we will be required to increase loss reserves at the time of such determination with a corresponding reduction in our net income in the period in which the deficiency becomes known. It is possible that claims in respect of events that have occurred could exceed our claim reserves and have a material adverse effect on our results of operations, in a particular period, or our financial condition in general. As a compounding factor, although most insurance contracts have policy limits, the nature of property and casualty insurance and reinsurance is such that losses can exceed policy limits for a variety of reasons and could significantly exceed the premiums received on the underlying policies, thereby further adversely affecting our financial condition.

As of December 31, 2007, our reserves for unpaid losses and loss adjustment expenses, net of unpaid losses and loss adjustment expenses recoverable, were approximately \$5.48 billion. Such reserves were established in accordance with applicable insurance laws and GAAP. Loss reserves are inherently subject to uncertainty. In establishing the reserves for losses and loss adjustment expenses, we have made various assumptions relating to the pricing of our reinsurance contracts and insurance policies and have also considered available historical industry experience and current industry conditions. Any estimates and assumptions made as part of the reserving process could prove to be inaccurate due to several factors, including the fact that limited historical information has been reported to us through December 31, 2007.

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*The failure of any of the loss limitation methods we employ could have a material adverse effect on our financial condition or results of operations.*

We have large aggregate exposures to natural and man-made catastrophic events. Catastrophes can be caused by various events, including, but not limited to, hurricanes, floods, windstorms, earthquakes, hailstorms, explosions, severe winter weather and fires. Catastrophes can also cause losses in non-property business such as workers' compensation or general liability. In addition to the nature of property business, we believe that economic and geographic trends affecting insured property, including inflation, property value appreciation and geographic concentration, tend to generally increase the size of losses from catastrophic events over time.

We have substantial exposure to unexpected, large losses resulting from future man-made catastrophic events, such as acts of war, acts of terrorism and political instability. These risks are inherently unpredictable and recent events may lead to increased frequency and severity of losses. It is difficult to predict the timing of such events with statistical certainty or estimate the amount of loss any given occurrence will generate. It is not possible to completely eliminate our exposure to unforecasted or unpredictable events and, to the extent that losses from such risks occur, our financial condition and results of operations could be materially adversely affected. Therefore, claims for natural and man-made catastrophic events could expose us to large losses and cause substantial volatility in our results of operations, which could cause the value of our common shares to fluctuate widely. In certain instances, we specifically insure and reinsure risks resulting from terrorism. Even in cases where we attempt to exclude losses from terrorism and certain other similar risks from some coverages written by us, we may not be successful in doing so. Moreover, irrespective of the clarity and inclusiveness of policy language, there can be no assurance that a court or arbitration panel will limit enforceability of policy language or otherwise issue a ruling adverse to us.

We seek to limit our loss exposure by writing a number of our reinsurance contracts on an excess of loss basis, adhering to maximum limitations on reinsurance written in defined geographical zones, limiting program size for each client and prudent underwriting of each program written. In the case of proportional treaties, we may seek per occurrence limitations or loss ratio caps to limit the impact of losses from any one or series of events. In our insurance operations, we seek to limit our exposure through the purchase of reinsurance. We cannot be certain that any of these loss limitation methods will be effective. We also seek to limit our loss exposure by geographic diversification. Geographic zone limitations involve significant underwriting judgments, including the determination of the area of the zones and the inclusion of a particular policy within a particular zone's limits. There can be no assurance that various provisions of our policies, such as limitations or exclusions from coverage or choice of forum, will be enforceable in the manner we intend. Disputes relating to coverage and choice of legal forum may also arise. Underwriting is inherently a matter of judgment, involving important assumptions about matters that are inherently unpredictable and beyond our control, and for which historical experience and probability analysis may not provide sufficient guidance. One or more catastrophic or other events could result in claims that substantially exceed our expectations, which could have a material adverse effect on our financial condition or our results of operations, possibly to the extent of eliminating our shareholders' equity.

For our natural catastrophe exposed business, we seek to limit the amount of exposure we will assume from any one insured or reinsured and the amount of the exposure to catastrophe losses from a single event in any geographic zone. We monitor our exposure to catastrophic events, including earthquake and wind, and periodically reevaluate the estimated probable maximum pre-tax loss for such exposures. Our estimated probable maximum pre-tax loss is determined through the use of modeling techniques, but such estimate does not represent our total potential loss for such exposures. 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. There can be no assurances that we will not suffer pre-tax losses greater than 25% of our total shareholders' equity from one or more catastrophic events due to several factors, including the inherent uncertainties in estimating the frequency and severity of such events and the margin of error in making such determinations resulting from potential inaccuracies and inadequacies in the data provided by clients and brokers, the modeling techniques and the application of such techniques or as a result of a decision to change the percentage of shareholders' equity exposed to a single catastrophic event. In addition, depending on business opportunities and the mix of business that may comprise our insurance and reinsurance portfolio, we may seek to adjust our self-imposed limitations on probable maximum pre-tax loss for catastrophe exposed business.

*The risk associated with reinsurance underwriting could adversely affect us, and while reinsurance and retrocessional coverage will be used to limit our exposure to risks, the availability of such arrangements may be limited, and counterparty credit and other risks associated with our reinsurance arrangements may result in losses which could adversely affect our financial condition and results of operations.*

Like other reinsurers, our reinsurance group does not separately evaluate each of the individual risks assumed under reinsurance treaties. Therefore, we are largely dependent on the original underwriting decisions made by ceding companies. We are subject to the risk that the ceding companies may not have adequately evaluated the risks to be reinsured and that the premiums ceded may not adequately compensate us for the risks we assume.

For the purposes of managing risk, we use reinsurance and also may use retrocessional arrangements. In the normal course of business, our insurance subsidiaries cede a substantial portion of their premiums through pro rata, excess of loss and facultative reinsurance agreements. Our reinsurance subsidiaries purchase a limited amount of retrocessional coverage as part of their aggregate risk management program. In addition, our 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 our reinsurance subsidiaries, and the ceding company. For 2007, ceded premiums written represented approximately 29.9% of gross premiums written, compared to 29.5% and 21.8%, respectively, for 2006 and 2005.

The availability and cost of reinsurance and retrocessional protection is subject to market conditions, which are beyond our control. As a result of such market conditions and other factors, we may not be able to successfully mitigate risk through reinsurance and retrocessional arrangements. Further, we are subject to credit risk with respect to our reinsurance and retrocessions because the ceding of risk to reinsurers and retrocessionaires does not relieve us of our liability to the clients or companies we insure or reinsure. Our losses for a given event or occurrence may increase if our reinsurers or retrocessionaires dispute or fail to meet their obligations to us or the reinsurance or retrocessional protections purchased by us are exhausted or are otherwise unavailable for any reason. Our failure to establish adequate reinsurance or retrocessional arrangements or the failure of our existing reinsurance or retrocessional arrangements to protect us from overly concentrated risk exposure could adversely affect our financial condition and results of operations. We monitor the financial condition of our reinsurers and attempt to place coverages only with carriers we view as substantial and financially sound. At December 31, 2007 and 2006, approximately 88.5% and 92.3%, respectively, of our reinsurance recoverables on paid and unpaid losses (not including prepaid reinsurance premiums) of \$1.74 billion and \$1.67 billion, respectively, were due from carriers which had an A.M. Best rating of "A-" or better. At December 31, 2007 and 2006, the largest reinsurance recoverables from any one carrier were less than 5.2% and 5.1%, respectively, of our total shareholders' equity. In connection with our acquisition of Arch Specialty in February 2002, the seller,

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Sentry, agreed to reinsure and guarantee all liabilities arising out of Arch Specialty's business prior to the closing of the acquisition. In addition to the guarantee provided by Sentry, substantially all of the recoverable from Sentry is still subject to the original reinsurance agreements inuring to Arch Specialty and, to the extent Sentry fails to comply with its payment obligations to us, we may obtain reimbursement from the third party reinsurers under such agreements.

*Our reliance on brokers subjects us to their credit risk.*

In accordance with industry practice, we generally pay amounts owed on claims under our insurance and reinsurance contracts to brokers, and these brokers, in turn, pay these amounts to the clients that have purchased insurance or reinsurance from us. In some jurisdictions, if a broker fails to make such payment, we may remain liable to the insured or ceding insurer for the deficiency. Likewise, in certain jurisdictions, when the insured or ceding company pays the premiums for these contracts to brokers for payment to us, these premiums are considered to have been paid and the insured or ceding company will no longer be liable to us for those amounts, whether or not we have actually received the premiums from the broker. Consequently, we assume a degree of credit risk associated with our brokers. To date, we have not experienced any losses related to this credit risk.

*We cannot predict the effect that the investigation currently being conducted by the New York Attorney General and others will have on the industry or our business, and the effects of emerging claims and coverage issues and certain proposed legislation are uncertain.*

The New York Attorney General and others are investigating allegations relating to contingent commission payments, bid-rigging and other practices in the insurance industry. We cannot predict the effect that these investigations, and any changes in insurance practice, including future legislation or regulations that may become applicable to us, will have on the insurance industry, the regulatory framework or our business.

The effects of emerging claims and coverage issues are uncertain. The insurance industry is also affected by political, judicial and legal developments which have in the past resulted in new or expanded theories of liability. These or other changes could impose new financial obligations on us by extending coverage beyond our underwriting intent or otherwise require us to make unplanned modifications to the products and services that we provide, or cause the delay or cancellation of products and services that we provide. In some instances, these changes may not become apparent until some time after we have issued insurance or reinsurance contracts that are affected by the changes. As a result, the full extent of liability under our insurance or reinsurance contracts may not be known for many years after a contract is issued. The effects of unforeseen developments or substantial government intervention could adversely impact our ability to achieve our goals.

**Risks Relating to Our Company**

*Our success will depend on our ability to maintain and enhance effective operating procedures and internal controls.*

We continue to enhance our operating procedures and internal controls (including the timely and successful implementation of our information technology initiatives, which include the implementation of improved computerized systems and programs to replace and support manual systems, and including controls over financial reporting) to effectively support our business and our regulatory and reporting requirements. Our management does not expect that our disclosure controls or our internal controls will prevent all errors and all fraud. A control system, no matter how well conceived and operated, can provide only reasonable, not absolute, assurance that the objectives of the control system are met. Further, the design of a control system must reflect the fact that there are resource constraints, and the benefits of controls must be considered relative to their costs. As a result of the inherent limitations in all control systems, no evaluation of controls can provide absolute assurance that all control issues and instances of fraud, if any, within the company have been detected. These inherent limitations include the realities that judgments in decision-making can be faulty, and that breakdowns can occur because of simple error or mistake. Additionally, controls can be circumvented by the individual acts of some persons or by collusion of two or more people. The design of any system of controls also is based in part upon certain assumptions about the likelihood of future events, and there can be no assurance that any design will succeed in achieving its stated goals under all potential future conditions; over time, controls may become inadequate because of changes in conditions, or the degree of compliance with the policies or procedures may deteriorate. As a result of the inherent limitations in a cost-effective control system, misstatement due to error or fraud may occur and not be detected. Accordingly, our disclosure controls and procedures are designed to provide reasonable, not absolute, assurance that the disclosure controls and procedures are met.

*A downgrade in our ratings or our inability to obtain a rating for our operating insurance and reinsurance subsidiaries may adversely affect our relationships with clients and brokers and negatively impact sales of our products.*

Our operating insurance and reinsurance subsidiaries are rated by ratings agencies. Brokers negotiate contracts of reinsurance between a primary insurer and reinsurer, on behalf of the primary insurer. Third-party rating agencies, such as A.M. Best Company, assess and rate the financial strength of insurers and reinsurers based upon criteria established by the rating agencies, which criteria are subject to change. Ratings have become an increasingly important factor in establishing the competitive position of insurance and reinsurance companies. Insurers and intermediaries use these ratings as one measure by which to assess the financial strength and quality of insurers and reinsurers. These ratings are often an important factor in the decision by an insured or intermediary of whether to place business with a particular insurance or reinsurance provider. Our financial strength ratings are subject to periodic review as rating agencies evaluate us to confirm that we continue to meet their criteria for ratings assigned to us by them. Such ratings may be revised downward or revoked at the sole discretion of such ratings agencies in response to a variety of factors, including a minimum capital adequacy ratio, management, earnings, capitalization and risk profile. We can offer no assurances that our ratings will remain at their current levels. A ratings downgrade or the potential for such a downgrade, or failure to obtain a necessary rating, could adversely affect both our relationships with agents, brokers, wholesalers and other distributors of our existing products and services and new sales of our products and services. Any ratings downgrade or failure to obtain a necessary rating could adversely affect our ability to compete in our markets, could cause our premiums and earnings to decrease and have a material adverse impact on our financial condition and results of operations. In addition, a downgrade in ratings of certain of our operating subsidiaries would in certain cases constitute an event of default under our credit facilities. See "Management's Discussion and Analysis of Financial Condition and Results of

Operations Contractual Obligations and Commercial Commitments Letter of Credit and Revolving Credit Facilities" for a discussion of our credit facilities.

*The loss of our key employees or our inability to retain them could negatively impact our business.*

Our success has been, and will continue to be, dependent on our ability to retain the services of our existing key executive officers and to attract and retain additional qualified personnel in the future. The pool of talent from which we actively recruit is limited. Although, to date, we have not experienced difficulties in attracting and retaining key personnel, the inability to attract and retain qualified personnel when available and the loss of services of key personnel could have a material adverse effect on our financial condition and results of operations. In addition, our underwriting staff is critical to our success in the production of business. While we do not consider any of our key executive officers or underwriters to be irreplaceable, the loss of the services of our key executive officers or underwriters or the inability to hire and retain other highly qualified personnel in the future could delay or prevent us from fully implementing our business strategy which could affect our financial performance. We are not aware of any intentions of any of our key personnel that would cause them no longer to provide their professional services to us in the near future.

*The preparation of our financial statements requires us to make many estimates and judgments, which are even more difficult than those made in a mature company since limited historical information has been reported to us through December 31, 2007.*

The preparation of consolidated financial statements requires us to make many estimates and judgments that affect the reported amounts of assets, liabilities (including reserves), revenues and expenses, and related disclosures of contingent liabilities. On an ongoing basis, we evaluate our estimates, including those related to revenue recognition, insurance and other reserves, reinsurance recoverables, investment valuations, intangible assets, bad debts, income taxes, contingencies and litigation. We base our estimates on historical experience, where possible, and on various other assumptions that we believe to be reasonable under the circumstances, which form the basis for our judgments about the carrying values of assets and liabilities that are not readily apparent from other sources. Estimates and judgments for a relatively new insurance and reinsurance company, like our company, are even more difficult to make than those made in a mature company since limited historical information has been reported to us through December 31, 2007. Instead, our current loss reserves are primarily based on estimates involving actuarial and statistical projections of our expectations of the ultimate settlement and administration costs of claims incurred but not yet reported. We utilize actuarial models as well as historical insurance industry loss development patterns to establish loss reserves. Accordingly, actual claims and claim expenses paid may deviate, perhaps substantially, from the reserve estimates reflected in our financial statements.

*The Warburg Pincus funds own approximately 16.3% of our voting shares, and they have the right to have directors on our board; their interests may materially differ from the interests of the holders of our other securities.*

The Warburg Pincus funds own approximately 16.3% of our outstanding voting shares as of December 31, 2007. These shareholders are not subject to the voting limitation contained in our bye-laws. We have agreed (until 2011) not to declare any dividend or make any other distribution on our common shares and not to repurchase any common shares until we have repurchased from the Warburg Pincus funds, pro rata, on the basis of the amount of their investment in us at the time of such repurchase, common shares (which were issued pursuant to the conversion of all of the outstanding preference shares in the 2005 fourth quarter) having an aggregate value of \$250 million, at a per share price acceptable to them. No such shares have yet been repurchased.

In addition, the Warburg Pincus funds are entitled (until 2011) to nominate a prescribed number of directors based on the respective retained percentages of their equity securities purchased in

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November 2001. Currently, our board consists of nine members, which includes three directors nominated by the Warburg Pincus funds. As long as the Warburg Pincus funds retain at least 45% of their original investment they will be entitled to nominate four directors.

By reason of their ownership and the shareholders agreement, the Warburg Pincus funds are able to strongly influence or effectively control certain actions to be taken by us or our shareholders. The interests of these shareholders may differ materially from the interests of the holders of our other securities, and these shareholders could take actions or make decisions that are not in the interests of the holders of our other securities generally.

*The price of our common shares may be volatile.*

There has been significant volatility in the market for equity securities. During 2007 and 2006, the price of our common shares fluctuated from a low of \$63.25 to a high of \$77.30 and from a low of \$52.00 to a high of \$70.59, respectively. On February 15, 2008, our common shares closed at a price of \$70.82. The price of our common shares may not remain at or exceed current levels. The following factors may have an adverse impact on the market price of our common stock:

actual or anticipated variations in our quarterly results of operations, including as a result of catastrophes;

our share repurchase program;

changes in market valuation of companies in the insurance and reinsurance industry;

changes in expectations of future financial performance or changes in estimates of securities analysts;

fluctuations in stock market process and volumes;

issuances or sales of common shares or other securities in the future;

the addition or departure of key personnel; and

announcements by us or our competitors of acquisitions, investments or strategic alliances.

Stock markets in the United States often experience price and volume fluctuations. Market fluctuations, as well as general political and economic conditions such as recession or interest rate or currency rate fluctuations, could adversely affect the market price of our stock.

*Our business is dependent upon insurance and reinsurance brokers, and the loss of important broker relationships could materially adversely affect our ability to market our products and services.*

We market our insurance and reinsurance products primarily through brokers. We derive a significant portion of our business from a limited number of brokers. During 2007, approximately 19.6% and 16.4% of our gross premiums written were generated from or placed by Marsh & McLennan Companies and its subsidiaries and AON Corporation and its subsidiaries, respectively. No other broker and no one insured or reinsured accounted for more than 10% of gross premiums written for 2007. Some of our competitors have had longer term relationships with the brokers we use than we have, and the brokers may promote products offered by companies that may offer a larger variety of products than we do. Loss of all or a substantial portion of the business provided by these brokers could have a material adverse effect on us.

*We could be materially adversely affected to the extent that managing general agents, general agents and other producers in our program business exceed their underwriting authorities or otherwise breach obligations owed to us.*

In program business conducted by our insurance group, following our underwriting, financial, claims and information technology due diligence reviews, we authorize managing general agents,





general agents and other producers to write business on our behalf within underwriting authorities prescribed by us. Once a program incept, we must rely on the underwriting controls of these agents to write business within the underwriting authorities provided by us. Although we monitor our programs on an ongoing basis, our monitoring efforts may not be adequate or our agents may exceed their underwriting authorities or otherwise breach obligations owed to us. We have experienced breaches by certain of our agents, all of which have been resolved favorably for us. To the extent that our agents exceed their authorities or otherwise breach obligations owed to us in the future, our financial condition and results of operations could be materially adversely affected.

*Our investment performance may affect our financial results and ability to conduct business.*

Our operating results depend in part on the performance of our investment portfolio. A significant portion of our cash and invested assets consists of fixed maturities (85% as of December 31, 2007). Although our current investment guidelines and approach stress preservation of capital, market liquidity and diversification of risk, our investments are subject to market-wide risks and fluctuations. In addition, although we did not experience any significant defaults by issuers during 2007, we are subject to risks inherent in particular securities or types of securities, as well as sector concentrations. We may not be able to realize our investment objectives, which could reduce our net income significantly. In the event that we are unsuccessful in correlating our investment portfolio with our expected insurance and reinsurance liabilities, we may be forced to liquidate our investments at times and prices that are not optimal, which could have a material adverse effect on our financial results and ability to conduct our business.

*We may be adversely affected by changes in economic conditions, including interest rate changes.*

Our operating results are affected, in part, by the performance of our investment portfolio. Our investment portfolio contains fixed and floating rate securities and instruments, such as bonds, which may be adversely affected by changes in interest rates. Changes in interest rates could also have an adverse effect on our investment income and results of operations. For example, if interest rates increase, the value of our investment portfolio may decline. Although lower interest rates may increase the value of our portfolio, our investment income might suffer from the lower rates at which new cash could be deployed.

In addition, our investment portfolio includes residential mortgage-backed securities ("RMBS"). As of December 31, 2007, RMBS constituted approximately 12.8% of our cash and invested assets. As with other fixed income investments, the fair value of these securities fluctuates depending on market and other general economic conditions and the interest rate environment. Changes in interest rates can expose us to changes in the prepayment rate on these investments. In periods of declining interest rates, mortgage prepayments generally increase and RMBS are prepaid more quickly, requiring us to reinvest the proceeds at the then current market rates. Conversely, in periods of rising rates, mortgage prepayments generally fall, preventing us from taking full advantage of the higher level of rates.

Interest rates are highly sensitive to many factors, including the fiscal and monetary policies of the U.S. and other major economies, inflation, economic and political conditions and other factors beyond our control. Although we attempt to take measures to manage the risks of investing in changing interest rate environments, we may not be able to mitigate interest rate sensitivity effectively. Despite our mitigation efforts, an increase in interest rates could have a material adverse effect on our book value.

In recent months, delinquencies and losses with respect to residential mortgage loans generally have increased and may continue to increase, particularly in the subprime sector. In addition, in recent months residential property values in many states have declined or remained stable, after extended periods during which those values appreciated. A continued decline or an extended flattening in those values may result in additional increases in delinquencies and losses on residential mortgage loans

generally, especially with respect to second homes and investment properties, and with respect to any residential mortgage loans where the aggregate loan amounts (including any subordinate loans) are close to or greater than the related property values. These developments may have a significant adverse effect on the prices of loans and securities, including those in our investment portfolio. The situation continues to have wide ranging consequences, including downward pressure on economic growth and the potential for increased insurance and reinsurance exposures, which could have an adverse impact on our results of operations, financial condition, business and operations.

*We may require additional capital in the future, which may not be available or only available on unfavorable terms.*

We monitor our capital adequacy on a regular basis. The capital requirements of our business depend on many factors, including our ability to write new business successfully and to establish premium rates and reserves at levels sufficient to cover losses. Our ability to underwrite is largely dependent upon the quality of our claims paying and financial strength ratings as evaluated by independent rating agencies. To the extent that our existing capital is insufficient to fund our future operating requirements and/or cover claim losses, we may need to raise additional funds through financings or limit our growth. Any equity or debt financing, if available at all, may be on terms that are unfavorable to us. In the case of equity financings, dilution to our shareholders could result, and, in any case, such securities may have rights, preferences and privileges that are senior to those of our outstanding securities. If we are not able to obtain adequate capital, our business, results of operations and financial condition could be adversely affected. See "Management's Discussion and Analysis of Financial Condition and Results of Operations Liquidity and Capital Resources."

*We sold our prior reinsurance operations in May 2000 and may have liability to the purchaser and continuing liability from those reinsurance operations if the purchaser should fail to make payments on the reinsurance liabilities it assumed.*

On May 5, 2000, we sold our prior reinsurance operations to Folksamerica. 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 our balance sheet. In addition, in connection with that asset sale, we made extensive representations and warranties about us and our reinsurance operations, some of which survived the closing of the asset sale. Breach of these representations and warranties could result in liability for us. In the event that Folksamerica refuses or is unable to make payment for reserved losses transferred to it by us in the May 2000 sale and the notice given to reinsureds is found not to be an effective release by such reinsureds, we would be liable for such claims. A.M. Best Company has assigned a "A-" (Excellent) financial strength rating to Folksamerica. Folksamerica reported policyholders' surplus of \$1.22 billion at September 30, 2007.

*We sold our non-standard automobile insurance operations and merchant banking operations in 2004 and may have liability to the purchasers.*

In 2004, we sold our non-standard automobile insurance operations and merchant banking operations to third party purchasers. In connection with such sales, we made representations and warranties about us and our transferred businesses, some of which survived the closing of such sales. Breach of these representations and warranties could result in liability to us.

*Any future acquisitions, growth of our operations through the addition of new lines of insurance or reinsurance business through our existing subsidiaries or through the formation of new subsidiaries, expansion into new geographic regions and/or joint ventures or partnerships may expose us to operational risks.*

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We may in the future make strategic acquisitions either of other companies or selected blocks of business, expand our business lines or enter into joint ventures. Any future acquisitions may expose us to operational challenges and risks, including:

integrating financial and operational reporting systems;

establishing satisfactory budgetary and other financial controls;

funding increased capital needs and overhead expenses;

obtaining management personnel required for expanded operations;

funding cash flow shortages that may occur if anticipated sales and revenues are not realized or are delayed, whether by general economic or market conditions or unforeseen internal difficulties;

the value of assets acquired may be lower than expected or may diminish due to credit defaults or changes in interest rates and liabilities assumed may be greater than expected;

the assets and liabilities we may acquire may be subject to foreign currency exchange rate fluctuation; and

financial exposures in the event that the sellers of the entities we acquire are unable or unwilling to meet their indemnification, reinsurance and other obligations to us.

Our failure to manage successfully these operational challenges and risks may impact our results of operations.

*Some of the provisions of our bye-laws and our shareholders agreement may have the effect of hindering, delaying or preventing third party takeovers or changes in management initiated by shareholders. These provisions may also prevent our shareholders from receiving premium prices for their shares in an unsolicited takeover.*

Some provisions of our bye-laws could have the effect of discouraging unsolicited takeover bids from third parties or changes in management initiated by shareholders. These provisions may encourage companies interested in acquiring the Company to negotiate in advance with our board of directors, since the board has the authority to overrule the operation of several of the limitations.

Among other things, our bye-laws provide:

for a classified board of directors, in which the directors of the class elected at each annual general meeting holds office for a term of three years, with the term of each class expiring at successive annual general meetings of shareholders;

that the number of directors is determined by the board from time to time by a vote of the majority of our board;

that directors may only be removed for cause, and cause removal shall be deemed to exist only if the director whose removal is proposed has been convicted of a felony or been found by a court to be liable for gross negligence or misconduct in the performance of his or her duties;

that our board has the right to fill vacancies, including vacancies created by an expansion of the board;

for limitations on shareholders' right to call special general meetings and to raise proposals or nominate directors at general meetings; and

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that shareholders may act by written consent only if such consent is unanimous among all shareholders entitled to vote.

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Our bye-laws provide that certain provisions which may have anti-takeover effects may be repealed or altered only with prior board approval and upon the affirmative vote of holders of shares representing at least 65% of the total voting power of our shares entitled generally to vote at an election of directors.

The bye-laws also contain a provision limiting the rights of any U.S. person (as defined in section 7701(a)(30) of the Internal Revenue Code of 1986, as amended (the "Code")) that owns shares of ACGL, directly, indirectly or constructively (within the meaning of section 958 of the Code), representing more than 9.9% of the voting power of all shares entitled to vote generally at an election of directors. The votes conferred by such shares of such U.S. person will be reduced by whatever amount is necessary so that after any such reduction the votes conferred by the shares of such person will constitute 9.9% of the total voting power of all shares entitled to vote generally at an election of directors. Notwithstanding this provision, the board may make such final adjustments to the aggregate number of votes conferred by the shares of any U.S. person that the board considers fair and reasonable in all circumstances to ensure that such votes represent 9.9% of the aggregate voting power of the votes conferred by all shares of ACGL entitled to vote generally at an election of directors. ACGL will assume that all shareholders (other than the Warburg Pincus funds) are U.S. persons unless we receive assurance satisfactory to us that they are not U.S. persons.

Moreover, most states, including states in which our subsidiaries are domiciled, have laws and regulations that require regulatory approval of a change in control of an insurer or an insurer's holding company. Where such laws apply to us and our subsidiaries, there can be no effective change in our control unless the person seeking to acquire control has filed a statement with the regulators and has obtained prior approval for the proposed change from such regulators. The usual measure for a presumptive change in control pursuant to these laws is the acquisition of 10% or more of the voting power of the insurance company or its parent, although this presumption is rebuttable. Consequently, a person may not acquire 10% or more of our common shares without the prior approval of insurance regulators in the state in which our subsidiaries are domiciled.

The bye-laws also provide that the affirmative vote of 80% of our outstanding shares (including a majority of the outstanding shares held by shareholders other than holders (and such holders' affiliates) of 10% or more ("10% holders") of the outstanding shares) shall be required (the "extraordinary vote") for the following corporate actions:

merger or consolidation of the Company into a 10% holder;

sale of any or all of our assets to a 10% holder;

the issuance of voting securities to a 10% holder; or

amendment of these provisions;

*provided, however*, the extraordinary vote will not apply to any transaction approved by the board, so long as a majority of those board members voting in favor of the transaction were duly elected and acting members of the board prior to the time the 10% holder became a 10% holder.

The provisions described above may have the effect of making more difficult or discouraging unsolicited takeover bids from third parties. To the extent that these effects occur, shareholders could be deprived of opportunities to realize takeover premiums for their shares and the market price of their shares could be depressed. In addition, these provisions could also result in the entrenchment of incumbent management.

*Our operating insurance and reinsurance subsidiaries are subject to regulation in various jurisdictions, and material changes in the regulation of their operations could adversely affect our results of operations.*

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Our insurance and reinsurance subsidiaries are subject to government regulation in each of the jurisdictions in which they are licensed or authorized to do business. Governmental agencies have broad administrative power to regulate many aspects of the insurance business, which may include trade and claim practices, accounting methods, premium rates, marketing practices, claims practices, advertising, policy forms, and capital adequacy. These agencies are concerned primarily with the protection of policyholders rather than shareholders. Moreover, insurance laws and regulations, among other things:

establish solvency requirements, including minimum reserves and capital and surplus requirements;

limit the amount of dividends, tax distributions, intercompany loans and other payments our insurance subsidiaries can make without prior regulatory approval;

impose restrictions on the amount and type of investments we may hold;

require assessments through guaranty funds to pay claims of insolvent insurance companies; and

require participation in state-assigned risk plans which may take the form of reinsuring a portion of a pool of policies or the direct issuance of policies to insureds.

The National Association of Insurance Commissioners ("NAIC") continuously examines existing laws and regulations in the United States. We cannot predict the effect that any NAIC recommendations or proposed or future legislation or rule making in the United States or elsewhere may have on our financial condition or operations.

Our Bermuda insurance and reinsurance subsidiary, Arch Re Bermuda, conducts its business from its offices in Bermuda and is not licensed or admitted to do business in any jurisdiction except Bermuda. Arch Re Swiss Branch conducts only reinsurance activities and is therefore not required to be licensed by the Swiss insurance regulator authorities. We do not believe that Arch Re Bermuda is subject to the insurance laws of any state in the United States; however, recent scrutiny of the insurance and reinsurance industry in the U.S. and other countries could subject Arch Re Bermuda to additional regulation. Our U.S. reinsurance subsidiary, Arch Re U.S., and our U.S. insurance subsidiaries, Arch Insurance, Arch Specialty, Arch E&S and Western Diversified, write reinsurance and insurance in the U.S. These subsidiaries are subject to extensive regulation under state statutes which delegate regulatory, supervisory and administrative powers to state insurance commissioners. Such regulation generally is designed to protect policyholders rather than investors.

Arch-Europe, our European subsidiary, conducts its business from its offices in London, Germany, as well as its other branches in Italy, Spain and, in Denmark, through Arch Re Denmark. It is subject to the insurance regulations of the U.K. and those Member States where it has established branches with respect to the conduct of its business in such Member State, but it remains subject only to the financial and operational supervision by the FSA. Arch-Europe has the freedom to provide insurance services anywhere in the EEA subject to compliance with certain rules governing such provision, including notification to the FSA. Arch-Europe is also approved as an excess and surplus lines insurer in 14 states in the U.S. In addition, the Canadian branch of Arch Insurance writes insurance in Canada and is subject to federal, as well as provincial and territorial, regulation in Canada.

Our U.S., Bermuda and U.K. insurance and reinsurance subsidiaries and the Canadian branch of Arch Insurance are required to maintain minimum capital and surplus as mandated by their respective jurisdictions of incorporation and, in some cases, by the jurisdictions in which those subsidiaries write business. Arch-Europe is required to maintain minimum capital surplus as mandated by the NAIC and certain states where it is approved as an excess and surplus lines insurer. All of our subsidiaries are currently in compliance with these capital and surplus requirements.

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We periodically review our corporate structure in the U.S. so that we can optimally deploy our capital. Changes in that structure require regulatory approval. Delays or failure in obtaining any of these approvals could limit the amount of insurance that we can write in the U.S.

If ACGL or any of our subsidiaries were to become subject to the laws of a new jurisdiction in which such entity is not presently admitted, ACGL or such subsidiary may not be in compliance with the laws of the new jurisdiction. Any failure to comply with applicable laws could result in the imposition of significant restrictions on our ability to do business, and could also result in fines and other sanctions, any or all of which could adversely affect our financial condition and results of operations.

*If our Bermuda operating subsidiary becomes subject to insurance statutes and regulations in jurisdictions other than Bermuda or if there is a change in Bermuda law or regulations or the application of Bermuda law or regulations, there could be a significant and negative impact on our business.*

Arch Re Bermuda, our Bermuda insurance and reinsurance subsidiary, is a registered Bermuda Class 4 insurer. As such, it is subject to regulation and supervision in Bermuda. Bermuda insurance statutes and the regulations and policies of the BMA require Arch Re Bermuda to, among other things:

maintain a minimum level of capital and surplus;

maintain solvency margins and liquidity ratios;

restrict dividends and distributions;

obtain prior approval regarding the ownership and transfer of shares;

maintain a principal office and appoint and maintain a principal representative in Bermuda;

file an annual statutory financial return; and

allow for the performance of certain period examinations of Arch Re Bermuda and its financial condition.

These statutes and regulations may restrict our ability to write insurance and reinsurance policies, distribute funds and pursue our investment strategy.

We do not presently intend for Arch Re Bermuda to be admitted to do business in the U.S., U.K. or any jurisdiction other than Bermuda. However, we cannot assure you that insurance regulators in the U.S., U.K. or elsewhere will not review the activities of Arch Re Bermuda or its subsidiaries or agents and claim that Arch Re Bermuda is subject to such jurisdiction's licensing requirements.

Generally, Bermuda insurance statutes and regulations applicable to Arch Re Bermuda are less restrictive than those that would be applicable if they were governed by the laws of any states in the U.S. If in the future we become subject to any insurance laws of the U.S. or any state thereof or of any other jurisdiction, we cannot assure you that we would be in compliance with such laws or that complying with such laws would not have a significant and negative effect on our business.

The process of obtaining licenses is very time consuming and costly and Arch Re Bermuda may not be able to become licensed in jurisdictions other than Bermuda should we choose to do so. The modification of the conduct of our business that would result if we were required or chose to become licensed in certain jurisdictions could significantly and negatively affect our financial condition and results of operations. In addition, our inability to comply with insurance statutes and regulations could significantly and adversely affect our financial condition and results of operations by limiting our ability to conduct business as well as subject us to penalties and fines.

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Because Arch Re Bermuda is a Bermuda company, it is subject to changes in Bermuda law and regulation that may have an adverse impact on our operations, including through the imposition of tax liability or increased regulatory supervision. In addition, Arch Re Bermuda will be exposed to any changes in the political environment in Bermuda, including, without limitation, changes as a result of the independence issues currently being discussed in Bermuda. The Bermuda insurance and reinsurance regulatory framework recently has become subject to increased scrutiny in many jurisdictions, including the U.K. While we cannot predict the future impact on our operations of changes in the laws and regulation to which we are or may become subject, any such changes could have a material adverse effect on our business, financial condition and results of operations.

As part of the BMA's ongoing review of Bermuda's insurance supervisory framework, the BMA is introducing a new risk-based capital model ("Bermuda Solvency Capital Requirement" or "BSCR") as a tool to assist both in measuring risk and determining appropriate capitalization. It is expected that formal legislation will come into force in 2008 to apply these standards. In addition, the BMA intends to allow insurers to make application to the BMA to use their own internal capital models instead of the BSCR in cases where insurers can establish that their respective internal capital models better reflect their company characteristics. The BMA intends to consult further with insurers on the finer details of these proposals prior to formally implementing them.

*ACGL is a holding company and is dependent on dividends and other payments from its operating subsidiaries, which are subject to dividend restrictions, to make payments, including the payment of debt service obligations and operating expenses we may incur and any payments of dividends, redemption amounts or liquidation amounts with respect to our preferred shares and common shares.*

ACGL is a holding company whose assets primarily consist of the shares in our subsidiaries. Generally, ACGL depends on its available cash resources, liquid investments and dividends or other distributions from subsidiaries to make payments, including the payment of debt service obligations and operating expenses it may incur and any payments of dividends, redemption amounts or liquidation amounts with respect to our preferred shares and common shares. For 2007, 2006 and 2005, ACGL received dividends of \$602.1 million, \$22.1 million and \$22.1 million, respectively, from Arch Re Bermuda. Such amounts were used to fund the share repurchase program, pay interest on ACGL's senior notes and for other corporate expenses.

The ability of our regulated insurance and reinsurance subsidiaries to pay dividends or make distributions is dependent on their ability to meet applicable regulatory standards. Under Bermuda law, Arch Re Bermuda is required to maintain a minimum solvency margin (i.e., the amount by which the value of its general business assets must exceed its general business liabilities) equal to the greatest of (1) \$100 million, (2) 50% of net premiums written (being gross premiums written by us less any premiums ceded by us, but we may not deduct more than 25% of gross premiums when computing net premiums written) and (3) 15% of loss and other insurance reserves. Arch Re Bermuda is prohibited from declaring or paying any dividends during any financial year if it is not in compliance with its minimum solvency margin or minimum liquidity ratio. In addition, Arch Re Bermuda is prohibited from declaring or paying in any financial year dividends of more than 25% of its total statutory capital and surplus (as shown on its previous financial year's statutory balance sheet) unless it files, at least seven days before payment of such dividends, with the BMA an affidavit stating that it will continue to meet the required margins. In addition, Arch Re Bermuda is prohibited, without prior approval of the BMA, from reducing by 15% or more its total statutory capital, as set out in its previous year's statutory financial statements. At December 31, 2007, as determined under Bermuda law, Arch Re Bermuda had statutory capital of \$2.0 billion and statutory capital and surplus of \$3.73 billion. Such amounts include interests in U.S. insurance and reinsurance subsidiaries. Accordingly, Arch Re Bermuda can pay approximately \$933 million to ACGL during 2008 without providing an affidavit to the BMA, as discussed above. Our U.S. insurance and reinsurance subsidiaries can pay approximately



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\$113.9 million in dividends or distributions to Arch-U.S., our U.S. holding company, which is owned by Arch Re Bermuda, during 2008 without prior regulatory approval. Such dividends or distributions may be subject to applicable withholding or other taxes. Arch-Europe can pay approximately £8.4 million, or \$16.7 million, in dividends to ACGL during 2008 without prior notice and approval by the FSA.

In addition, the ability of our insurance and reinsurance subsidiaries to pay dividends could be constrained by our dependence on financial strength ratings from independent rating agencies. Our ratings from these agencies depend to a large extent on the capitalization levels of our insurance and reinsurance subsidiaries.

We believe that ACGL has sufficient cash resources and available dividend capacity to service its indebtedness and other current outstanding obligations.

*If our Bermuda reinsurance subsidiary is unable to provide collateral to ceding companies, its ability to conduct business could be significantly and negatively affected.*

Arch Re Bermuda is a registered Bermuda insurance company and is not licensed or admitted as an insurer in any jurisdiction in the United States. Because insurance regulations in the United States do not permit insurance companies to take credit for reinsurance obtained from unlicensed or non-admitted insurers on their statutory financial statements unless security is posted, Arch Re Bermuda's contracts generally require it to post a letter of credit or provide other security. Although, to date, Arch Re Bermuda has not experienced any difficulties in providing collateral when required, if we are unable to post security in the form of letters of credit or trust funds when required, the operations of Arch Re Bermuda could be significantly and negatively affected.

*We may become subject to taxes in Bermuda after March 28, 2016, which may have a material adverse effect on our results of operations.*

Under current Bermuda law, we are not subject to tax on income or capital gains. Furthermore, we have obtained from the Minister of Finance of Bermuda under the Exempted Undertakings Tax Protection Act, 1966, an assurance that, in the event that Bermuda enacts legislation imposing tax computed on profits, income, any capital asset, gain or appreciation, or any tax in the nature of estate duty or inheritance tax, then the imposition of the tax will not be applicable to us or our operations until March 28, 2016. We could be subject to taxes in Bermuda after that date. This assurance 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.

*Foreign currency exchange rate fluctuation may adversely affect our financial results.*

We write business on a worldwide basis, and our results of operations may be affected by fluctuations in the value of currencies other than the U.S. Dollar. The primary foreign currencies in which we operate are the Euro, the British Pound Sterling and the Canadian Dollar. Changes in foreign currency exchange rates can reduce our revenues and increase our liabilities and costs. We may therefore suffer losses solely as a result of exchange rate fluctuations. In order to mitigate the impact of exchange rate fluctuations, we have invested and expect to continue to invest in securities denominated in currencies other than the U.S. Dollar. Net foreign exchange losses, recorded in the statement of income, for 2007 were \$44.0 million, compared to net foreign exchange losses for the year ended December 31, 2006 of \$23.9 million. We hold investments in foreign currencies which are intended to mitigate our exposure to foreign currency fluctuations in our net insurance liabilities. However, changes in the value of such investments due to foreign currency rate movements are reflected as a direct increase to shareholders' equity and are not included in the statement of income. We have chosen not to hedge the currency risk on the capital contributed to Arch-Europe in May 2004, which is held in British Pounds Sterling. However, we intend to match Arch-Europe's projected liabilities in foreign currencies with investments in the same currencies. There can be no assurances

that such arrangements will mitigate the negative impact of exchange rate fluctuations, and we may suffer losses solely as a result of exchange rate fluctuations. From inception through December 31, 2007, and based on currency spot rates at December 31, 2007, Arch Re Bermuda has recorded net premiums written of approximately \$760 million from Euro-denominated contracts, \$750 million from British Pound Sterling-denominated contracts and \$260 million from Canadian Dollar-denominated contracts. In addition, Arch-Europe writes business in British Pound Sterling and Euros, and the Canadian branch of Arch Insurance writes business in Canadian Dollars.

*Certain employees of our Bermuda operations are required to obtain work permits before engaging in a gainful occupation in Bermuda. Required work permits may not be granted or may not remain in effect.*

Under Bermuda law, only persons who are Bermudians, spouses of Bermudians, holders of a permanent resident's certificate or holders of a working resident's certificate ("exempted persons") may engage in gainful occupation in Bermuda without an appropriate governmental work permit. Our success may depend in part on the continued services of key employees in Bermuda. A work permit may be granted or renewed upon showing that, after proper public advertisement, no exempted person is available who meets the minimum standards reasonably required by the employer. The Bermuda government's policy places a six-year term limit on individuals with work permits, subject to certain exemptions for key employees. A work permit is issued with an expiry date (up to five years) and no assurances can be given that any work permit will be issued or, if issued, renewed upon the expiration of the relevant term. We consider our key officers in Bermuda to be Constantine Iordanou, our President and Chief Executive Officer (work permit expires November 12, 2009), Marc Grandisson, Chairman and Chief Executive Officer of Arch Worldwide Reinsurance Group (work permit expires May 12, 2010), John D. Vollaro, our Executive Vice President and Chief Financial Officer (work permit expires July 25, 2010) and Nicolas Papadopoulos, President and Chief Executive Officer of Arch Re Bermuda (work permit expires March 31, 2010). We also have other key positions in Bermuda held by persons who hold work permits subject to renewal. If work permits are not obtained or renewed for our principal employees, we could lose their services, which could materially affect our business.

*The enforcement of civil liabilities against us may be difficult.*

We are a Bermuda company and in the future some of our officers and directors may be residents of various jurisdictions outside the United States. All or a substantial portion of our assets and the assets of those persons may be located outside the United States. As a result, it may be difficult for you to effect service of process within the United States upon those persons or to enforce in United States courts judgments obtained against those persons.

We have appointed National Registered Agents, Inc., New York, New York, as our agent for service of process with respect to actions based on offers and sales of securities made in the United States. We have been advised by our Bermuda counsel, Conyers Dill & Pearman, that the United States and Bermuda do not currently have a treaty providing for reciprocal recognition and enforcement of judgments of U.S. courts in civil and commercial matters and that a final judgment for the payment of money rendered by a court in the United States based on civil liability, whether or not predicated solely upon the U.S. federal securities laws, would, therefore, not be automatically enforceable in Bermuda. We also have been advised by Conyers Dill & Pearman that a final and conclusive judgment obtained in a court in the United States under which a sum of money is payable as compensatory damages (i.e., not being a sum claimed by a revenue authority for taxes or other charges of a similar nature by a governmental authority, or in respect of a fine or penalty or multiple or punitive damages) may be the subject of an action on a debt in the Supreme Court of Bermuda under the common law doctrine of obligation. Such an action should be successful upon proof that the sum of money is due and payable, and without having to prove the facts supporting the underlying judgment, as long as:

the court which gave the judgment had proper jurisdiction over the parties to such judgment;

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such court did not contravene the rules of natural justice of Bermuda;

such judgment was not obtained by fraud;

the enforcement of the judgment would not be contrary to the public policy of Bermuda;

no new admissible evidence relevant to the action is submitted prior to the rendering of the judgment by the courts of Bermuda; and

there is due compliance with the correct procedures under Bermuda law.

A Bermuda court may impose civil liability on us or our directors or officers in a suit brought in the Supreme Court of Bermuda against us or such persons with respect to a violation of U.S. federal securities laws, provided that the facts surrounding such violation would constitute or give rise to a cause of action under Bermuda law.

### **Risk Relating to our Preferred Shares**

*General market conditions and unpredictable factors could adversely affect market prices for our outstanding preferred shares.*

There can be no assurance about the market prices for any series of our preferred shares. Several factors, many of which are beyond our control, will influence the market value of such series of preferred shares. Factors that might influence the market value of any series of our preferred shares include, but are not limited to:

whether dividends have been declared and are likely to be declared on any series of our preferred shares from time to time;

our creditworthiness, financial condition, performance and prospects;

whether the ratings on any series of our preferred shares provided by any ratings agency have changed;

the market for similar securities; and

economic, financial, geopolitical, regulatory or judicial events that affect us and/or the insurance or financial markets generally.

*Dividends on our preferred shares are non-cumulative.*

Dividends on our preferred shares are non-cumulative and payable only out of lawfully available funds of ACGL under Bermuda law. Consequently, if ACGL's board of directors (or a duly authorized committee of the board) does not authorize and declare a dividend for any dividend period with respect to any series of our preferred shares, holders of such preferred shares would not be entitled to receive any such dividend, and such unpaid dividend will not accrue and will never be payable. ACGL will have no obligation to pay dividends for a dividend period on or after the dividend payment date for such period if its board of directors (or a duly authorized committee of the board) has not declared such dividend before the related dividend payment date; if dividends on any series of our preferred shares are authorized and declared with respect to any subsequent dividend period, ACGL will be free to pay dividends on any other series of preferred shares and/or our common shares. In the past, we have not paid dividends on our common shares.

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*Our preferred shares are equity and are subordinate to our existing and future indebtedness.*

Our preferred shares are equity interests and do not constitute indebtedness. As such, our preferred shares will rank junior to all of our indebtedness and other non-equity claims with respect to assets available to satisfy our claims, including in our liquidation. As of December 31, 2007, our total consolidated long-term debt was \$300.0 million. We may incur additional debt in the future. Our existing and future indebtedness may restrict payments of dividends on our preferred shares. Additionally, unlike indebtedness, where principal and interest would customarily be payable on specified due dates, in the case of preferred shares like our preferred shares, (1) dividends are payable only if declared by the board of directors of ACGL (or a duly authorized committee of the board) and (2) as described above under "Risks Relating to Our Company ACGL is a holding company and is dependent on dividends and other payments from its operating subsidiaries, which are subject to dividend restrictions, to make payments, including the payment of debt service obligations and operating expenses we may incur and any payments of dividends, redemption amounts or liquidation amounts with respect to our preferred shares and common shares," we are subject to certain regulatory and other constraints affecting our ability to pay dividends and make other payments.

*The voting rights of holders of our preferred shares are limited.*

Holders of our preferred shares have no voting rights with respect to matters that generally require the approval of voting shareholders. The limited voting rights of holders of our preferred shares include the right to vote as a class on certain fundamental matters that affect the preference or special rights of our preferred shares as set forth in the certificate of designations relating to each series of preferred shares. In addition, if dividends on any series of our preferred shares have not been declared or paid for the equivalent of six dividend payments, whether or not for consecutive dividend periods, holders of the outstanding preferred shares of any series will be entitled to vote for the election of two additional directors to our board of directors subject to the terms and to the limited extent as set forth in the certificate of designations relating to such series of preferred shares.

*There is no limitation on our issuance of securities that rank equally with or senior to our preferred shares.*

We may issue additional securities that rank equally with or senior to our preferred shares without limitation. The issuance of securities ranking equally with or senior to our preferred shares may reduce the amount available for dividends and the amount recoverable by holders of such series in the event of a liquidation, dissolution or winding-up of ACGL.

*A classification of any series of preferred shares by the NAIC may impact U.S. insurance companies that purchase such series.*

The NAIC, may from time to time, in its discretion, classify securities in insurers' portfolios as either debt, preferred equity or common equity instruments. The NAIC's written guidelines for classifying securities as debt, preferred equity or common equity include subjective factors that require the relevant NAIC examiner to exercise substantial judgment in making a classification. There is therefore a risk that any series of preferred shares may be classified by NAIC as common equity instead of preferred equity. The NAIC classification determines the amount of risk based capital ("RBC") charges incurred by insurance companies in connection with an investment in a security. Securities classified as common equity by the NAIC carry RBC charges that can be significantly higher than the RBC requirement for debt or preferred equity. Therefore, any classification of any series of preferred shares as common equity may adversely affect U.S. insurance companies that hold such series. In addition, a determination by the NAIC to classify such series as common equity may adversely impact the trading of such series in the secondary market.

## Risks Relating to Taxation

*We and our non-U.S. subsidiaries may become subject to U.S. federal income taxation.*

ACGL and its non-U.S. subsidiaries intend to operate their business in a manner that will not cause them to be treated as engaged in a trade or business in the United States and, thus, 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 certain U.S. source investment income) on their income. However, because there is uncertainty as to the activities which constitute being engaged in a trade or business in 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, our shareholders' equity and earnings could be adversely affected. Certain of our U.S. subsidiaries have been personal holding companies, but did not have "undistributed personal holding company income."

Congress has been considering legislation intended to eliminate certain perceived tax advantages of Bermuda insurance companies and U.S. insurance companies having Bermuda affiliates, including perceived tax benefits resulting principally from reinsurance between or among U.S. insurance companies and their Bermuda affiliates. Some U.S. insurance companies have also been lobbying Congress recently to pass such legislation. In this regard, the American Jobs Creation Act of 2004 (the "Jobs Act") permits the United States Internal Revenue Service ("IRS") to re-allocate, re-characterize or adjust items of income, deduction or certain other items related to a reinsurance agreement between related parties to reflect the proper source, character and amount for each item (in contrast to prior law, which only covered source and character). The Jobs Act also eliminated the tax benefits available to a U.S. company that, after March 4, 2003, changed its legal domicile to a non-U.S. jurisdiction, a transaction commonly known as an inversion. We changed our legal domicile from the U.S. to Bermuda, but were not affected by the anti-inversion rule because our change in domicile occurred in November 2000. The American Infrastructure Investment and Improvement Act of 2007 as passed by the Senate Finance Committee would make the Jobs Act anti-inversion rule applicable retroactively to inversions that occurred after March 20, 2002. Although this modification would not affect ACGL, no assurance can be given that the final 2007 bill will not make the Jobs Act anti-inversion rule applicable retroactively to inversions that occurred on an earlier date, in which case ACGL could be adversely affected. Another legislative proposal has been introduced that would treat certain "tax haven CFCs" as U.S. corporations for federal income tax purposes. The term "tax haven CFC" would include a Bermuda corporation that is a controlled foreign corporation, but would exclude corporations that engage in the active conduct of a trade or business in Bermuda. It is not clear how this bill would apply to ACGL, which conducts its insurance and reinsurance businesses through its subsidiaries. Further, it is not clear whether this bill was intended to apply to a publicly traded company such as ACGL. There is no assurance that this legislative proposal, if enacted, would not apply to ACGL or any of its non-U.S. subsidiaries. In addition, Congress has recently conducted hearings relating to the tax treatment of reinsurance between affiliates and is reported to be considering legislation that would adversely affect reinsurance between U.S. and non-U.S. affiliates. One such proposal would increase the excise tax rate on reinsurance premiums paid to affiliated non-U.S. reinsurers; another proposal would limit deductions for premiums ceded to affiliated non-U.S. reinsurers above certain levels. Enactment of some version of such legislation as well as other changes in U.S. tax laws, regulations and interpretations thereof to address these issues could adversely affect us.

*U.S. persons who hold our common shares or preferred shares may be subject to U.S. income taxation at ordinary income rates on our undistributed earnings and profits.*

We believe that we and our non-U.S. subsidiaries currently might be controlled foreign corporations ("CFCs"), although our bye-laws are designed to preclude a U.S. person (other than a U.S. person attributed shares owned by funds associated with the Warburg Pincus funds and

Hellman & Friedman funds) from adverse tax consequences as a result of our CFC status. We do not believe that we are a passive foreign investment company. Since these determinations and beliefs are based upon legal and factual conclusions, no assurances can be given that the U.S. Internal Revenue Service or a court would concur with our conclusions. If they were not to so concur, U.S. persons who hold our common shares or preferred shares may suffer adverse tax consequences.

*Reduced tax rate for qualified dividend income received by individuals and other non-corporate holders may not be available in the future.*

Dividends received by individuals and other non-corporate United States persons on our common shares or preferred shares in taxable years beginning on or before December 31, 2010 may constitute qualified dividend income that is subject to U.S. federal income tax at the rate applicable for long-term capital gains, rather than the higher rates applicable to ordinary income, provided that certain holding period requirements and other conditions are met. For taxable years beginning after December 31, 2010, qualified dividend income will no longer be taxed at the rate applicable for long-term capital gains unless legislation is enacted providing otherwise. In addition, there is proposed legislation before both Houses of Congress that would exclude shareholders of certain foreign corporations from this advantageous tax treatment. If this legislation becomes law, non-corporate U.S. shareholders would no longer qualify for the capital gains tax rate on the dividends paid by us.

*Our non-U.S. companies may be subject to U.K. tax that may have a material adverse effect on our results of operations.*

We intend to operate in such a manner so that none of our companies, other than Arch-Europe and Arch-U.K., should be resident in the U.K. for tax purposes or have a permanent establishment in the U.K. Accordingly, we do not expect that any companies other than Arch-Europe and Arch-U.K. should be subject to U.K. taxation. However, since applicable law and regulations do not conclusively define the activities that constitute conducting business in the U.K. through a permanent establishment, the U.K. Inland Revenue might contend successfully that one or more of our companies, in addition to Arch-Europe and Arch-U.K., is conducting business in the U.K. through a permanent establishment in the U.K. and, therefore, subject to U.K. tax, which could have a material adverse effect on us.

#### **ITEM 1B. UNRESOLVED STAFF COMMENTS**

None.

#### **ITEM 2. PROPERTIES**

Our reinsurance group leases a total of approximately 9,100 square feet in Hamilton, Bermuda under a lease expiring in 2012, and approximately 19,200 square feet in Morristown, New Jersey under a lease expiring in 2011. Our property facultative reinsurance group leases approximately 14,490 square feet for its offices throughout the U.S. and in Toronto.

Our insurance group leases approximately 8,750 square feet in Hamilton, Bermuda for our Bermuda insurance operations. The principal U.S. office of our insurance group is located at One Liberty Plaza, New York, New York where we lease approximately 161,880 square feet. Such lease expires in 2014, with the exception of a portion of that lease for approximately 28,390 square feet that expires in 2010. Our insurance group also leases a total of approximately 211,400 square feet for its other primary U.S. offices and its office in Canada.

Arch-Europe leases approximately 18,900 square feet in London and 1,550 square feet in Germany. Arch Re Denmark, a branch of Arch-Europe, leases less than 1,000 square feet in Denmark. ACGL leases approximately 1,500 square feet in Bermuda. In addition, Arch Capital Services Inc., a subsidiary of ACGL which provides certain financial, legal and other administrative support services for ACGL and its subsidiaries, leases approximately 16,730 square feet in White Plains, New York.

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For 2007, 2006 and 2005, our rental expense, net of income from subleases, was approximately \$14.8 million, \$12.9 million and \$11.1 million, respectively. Our future minimum rental charges for the remaining terms of our existing leases, exclusive of escalation clauses and maintenance costs and net of rental income, will be approximately \$91.2 million. We believe that the above described office space is adequate for our needs. However, as we continue to develop our business, we may open additional office locations during 2008.

### **ITEM 3. LEGAL PROCEEDINGS**

We, in common with the insurance industry in general, are subject to litigation and arbitration in the normal course of our business. As of December 31, 2007, we were not a party to any material litigation or arbitration other than as a part of the ordinary course of business in relation to claims and reinsurance recoverable matters, none of which is expected by management to have a significant adverse effect on our results of operations and financial condition and liquidity.

### **ITEM 4. SUBMISSION OF MATTERS TO A VOTE OF SECURITY HOLDERS**

None.

**PART II****ITEM 5. MARKET FOR REGISTRANT'S COMMON EQUITY, RELATED STOCKHOLDER MATTERS AND ISSUER PURCHASES OF EQUITY SECURITIES****MARKET INFORMATION**

Our common shares are traded on the NASDAQ Stock Market under the symbol "ACGL." For the periods presented below, the high and low sales prices and closing prices for our common shares as reported on the NASDAQ Stock Market were as follows:

	Three Months Ended			
	December 31, 2007	September 30, 2007	June 30, 2007	March 31, 2007
High	\$ 77.30	\$ 75.28	\$ 74.24	\$ 68.58
Low	\$ 66.38	\$ 63.25	\$ 68.04	\$ 63.58
Close	\$ 70.35	\$ 74.41	\$ 72.54	\$ 67.46

	Three Months Ended			
	December 31, 2006	September 30, 2006	June 30, 2006	March 31, 2006
High	\$ 70.59	\$ 63.90	\$ 62.60	\$ 58.07
Low	62.71	56.46	55.42	52.00
Close	67.61	63.49	59.46	57.74

On February 15, 2008 the high and low sales prices and the closing price for our common shares as reported on the NASDAQ Stock Market were \$71.09, \$69.06 and \$70.82, respectively.

**HOLDERS**

As of February 15, 2008, and based on information provided to us by our transfer agent and proxy solicitor, there were 149 holders of record of our common shares and approximately 34,500 beneficial holders of our common shares.

**DIVIDENDS**

Any determination to pay dividends on ACGL's series A and series B non-cumulative preferred shares or common shares will be at the discretion of ACGL's board of directors (or a duly authorized committee of the board of directors) and will be dependent upon its results of operations, financial condition and other factors deemed relevant by ACGL's board of directors. As a holding company, ACGL will depend on future dividends and other permitted payments from its subsidiaries to pay dividends to its shareholders. ACGL's subsidiaries' ability to pay dividends, as well as its ability to pay dividends, is subject to regulatory, contractual, rating agency and other constraints. So long as any series A or series B non-cumulative preferred shares remain outstanding for any dividend period, unless the full dividends for the latest completed dividend period on all outstanding series A and series B non-cumulative preferred shares and parity shares have been declared and paid (or declared and a sum sufficient for the payment thereof has been set aside), (a) no dividend may be paid or declared on ACGL's common shares or any of its other securities ranking junior to the series A and series B non-cumulative preferred shares (other than a dividend payable solely in common shares or in such other junior securities) and (b) no common shares or other junior shares may be purchased, redeemed or otherwise acquired for consideration by ACGL, directly or indirectly (other than (i) as a result of a reclassification of junior shares for or into other junior shares, or the exchange or conversion of one junior share for or into another junior share, (ii) through the use of the proceeds of a substantially contemporaneous sale of junior shares and (iii) as permitted by the bye-laws of ACGL in effect on the date of issuance of the series A and series B non-cumulative preferred shares.



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In addition, pursuant to a shareholders agreement, ACGL has agreed (until 2011) not to declare any dividend or make any other distribution on its common shares, and not to repurchase any common shares, until it has repurchased from the Warburg Pincus funds, pro rata, on the basis of the amount of their investment in us at the time of such repurchase, common shares (which were issued pursuant to the conversion of all outstanding preference shares in the 2005 fourth quarter) having an aggregate value of \$250 million, at a per share price acceptable to them.

### ISSUER PURCHASES OF EQUITY SECURITIES

The following table summarizes our purchases of our common shares for the 2007 fourth quarter:

Issuer Purchases of Equity Securities				
Period	Total Number of Shares Purchased(1)	Average Price Paid per Share	Total Number of Shares Purchased as Part of Publicly Announced Plans or Programs	Approximate Dollar Value of Shares that May Yet be Purchased Under the Plan or Programs(2)
10/1/2007 10/31/2007			196,300	\$ 585,300
11/1/2007 11/30/2007	225	\$ 71.75	734,649	\$ 534,082
12/1/2007 12/31/2007			1,025,647	\$ 462,934
Total	225	\$ 71.75	1,956,596	\$ 462,934

(1) ACGL repurchases shares, from time to time, from employees in order to facilitate the payment of withholding taxes on restricted shares granted. We purchased these shares at their fair market value, as determined by reference to the closing price of our common shares on the day the restricted shares vested.

(2) On February 28, 2007, ACGL's Board of Directors authorized ACGL to invest up to \$1 billion in ACGL's common shares through a share repurchase program. Repurchases under the program may be effected from time to time in open market or privately negotiated transactions through February 2009. 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 and Hellman & Friedman funds waived their rights relating to share repurchases under the shareholders agreement for all repurchases of common shares by ACGL under the repurchase program in open market transactions and certain privately negotiated transactions. In May 2007, the Hellman & Friedman funds ceased to own shares of ACGL and their rights under the shareholders agreement with ACGL terminated.

**PERFORMANCE GRAPH**

The following graph compares the cumulative total shareholder return on our common shares for each of the last five years through December 31, 2007 to the cumulative total return, assuming reinvestment of dividends, of (1) Standard & Poor's ("S&P") 500 Composite Stock Index ("S&P 500 Index") and (2) the S&P 500 Property & Casualty Insurance Index. The share price performance presented below is not necessarily indicative of future results.

**CUMULATIVE TOTAL SHAREHOLDER RETURN (1)(2)(3)**

- 
- (1) Stock price appreciation plus dividends.
  - (2) The above graph assumes that the value of the investment was \$100 on December 31, 2002. The closing price for our common shares on December 31, 2007 (*i.e.*, the last trading day in 2007) was \$70.35.
  - (3) This graph is not "soliciting material," is not deemed filed with the SEC and is not to be incorporated by reference in any filing by us under the Securities Act of 1933, as amended or the Securities and Exchange Act of 1934, whether made before or after the date hereof and irrespective of any general incorporation language in any such filing.

**ITEM 6. SELECTED FINANCIAL DATA**

The following table sets forth summary historical consolidated financial and operating data for the five-year period ended December 31, 2007 and should be read in conjunction with "Management's Discussion and Analysis of Financial Condition and Results of Operations" and our financial statements and the related notes.

(U.S. dollars in thousands except share data)	Years Ended December 31,				
	2007	2006	2005	2004	2003
<b>Statement of Income Data:</b>					
Revenues:					
Net premiums written	\$ 2,901,936	\$ 3,017,418	\$ 3,138,772	\$ 2,980,032	\$ 2,738,415
Net premiums earned	2,944,650	3,081,665	2,977,716	2,915,882	2,212,599
Net investment income	463,070	380,205	232,902	143,705	80,992
Net realized gains (losses)	28,141	(19,437)	(53,456)	30,237	25,317
Total revenues	3,452,445	3,452,678	3,167,529	3,104,050	2,343,737
Income before income taxes and extraordinary item	873,544	739,893	285,435	343,127	306,500
Income before extraordinary item	857,943	713,214	256,486	316,899	279,775
Extraordinary gain excess of fair value of acquired net assets over cost (net of \$0 tax)(1)					816
Net income	857,943	713,214	256,486	316,899	280,591
Preferred dividends	(25,844)	(20,655)			
Net income available to common shareholders	\$ 832,099	\$ 692,559	\$ 256,486	\$ 316,899	\$ 280,591
Weighted average common shares and common share equivalents outstanding:					
Basic(2)	70,995,672	73,212,432	35,342,650	31,560,737	26,264,055
Diluted(2)	73,762,419	76,246,725	74,709,858	72,519,045	67,777,794
Net income (loss) per common share data:					
Basic(2):					
Income before extraordinary item	\$ 11.72	\$ 9.46	\$ 7.26	\$ 10.04	\$ 10.65
Extraordinary gain(1)					0.03
Net income available to common shareholders	\$ 11.72	\$ 9.46	\$ 7.26	\$ 10.04	\$ 10.68
Diluted(2):					
Income before extraordinary item	\$ 11.28	\$ 9.08	\$ 3.43	\$ 4.37	\$ 4.13
Extraordinary gain(1)					0.01
Net income available to common shareholders	\$ 11.28	\$ 9.08	\$ 3.43	\$ 4.37	\$ 4.14
Cash dividends per share					

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<b>Balance Sheet Data:</b>										
Total investments and cash(3)	\$	10,129,663	\$	9,319,148	\$	7,119,450	\$	5,835,515	\$	3,717,147
Premiums receivable		729,628		749,961		672,902		520,781		477,032
Unpaid losses and loss adjustment expenses recoverable		1,609,619		1,552,157		1,389,768		617,607		369,080
Total assets		15,624,267		14,312,467		11,488,436		8,218,754		5,585,321
Reserves for losses and loss adjustment expenses:										
Before unpaid losses and loss adjustment expenses recoverable		7,092,452		6,463,041		5,452,826		3,492,759		1,911,596
Net of unpaid losses and loss adjustment expenses recoverable		5,482,833		4,910,884		4,063,058		2,875,152		1,542,516
Unearned premiums:										
Before prepaid reinsurance premiums		1,765,881		1,791,922		1,699,691		1,518,162		1,378,654
Net of prepaid reinsurance premiums		1,285,419		1,321,784		1,377,256		1,219,795		1,166,937
Senior notes		300,000		300,000		300,000		300,000		
Revolving credit agreement borrowings										200,000
Total liabilities		11,588,456		10,721,848		9,007,909		5,976,848		3,874,592
Common shareholders' equity		3,710,811		3,265,619		2,480,527		2,241,906		1,710,729
Preferred shareholders' equity		325,000		325,000						
Total shareholders' equity		4,035,811		3,590,619		2,480,527		2,241,906		1,710,729
Book value:										
Per common share(4)	\$	55.12	\$	43.97	\$	33.82	\$	41.76	\$	31.74
Diluted(5)	\$	55.12	\$	43.97	\$	33.82	\$	31.03	\$	25.52
Shares outstanding:										
Basic		67,318,466		74,270,466		73,334,870		34,902,923		28,200,372
Diluted(5)		67,318,466		74,270,466		73,334,870		72,251,073		67,045,037

- (1) On November 30, 2002, we acquired The Personal Service Insurance Co. ("PSIC"). In 2003, we recorded an extraordinary gain of \$0.8 million representing an adjustment to the fair value of PSIC due to the recognition of deferred tax assets as part of the acquisition.
- (2) Net income per share is based on the basic and diluted weighted average number of common shares and common share equivalents outstanding.
- (3) In our securities lending transactions, we receive collateral in excess of the fair value of the fixed maturities and short-term investments pledged under securities lending agreements. For purposes of this table, we have excluded \$1.5 billion, \$891.4 million and \$893.4 million, respectively, of collateral received which is reflected as "short-term investment of funds received under securities lending agreements, at fair value" and included \$1.46 billion, \$860.8 million and \$863.9 million, respectively, of "fixed maturities and short-term investments pledged under securities lending agreements, at fair value" at December 31, 2007, 2006 and 2005.
- (4) Book value per common share at December 31, 2004 and 2003 was determined by dividing (i) the difference between total shareholders' equity and the aggregate liquidation preference of the series A convertible preference shares of \$784.3 million and \$815.7 million, respectively, by (ii) the number of common shares outstanding. All outstanding series A convertible preference shares were converted to common shares in 2005.
- (5) Book value per share excludes the effects of stock options and restricted stock units and, in periods prior to 2005, class B warrants.

**ITEM 7. 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 and, therefore, undue reliance should not be placed on them. 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 sections entitled "Cautionary Note Regarding Forward-Looking Statements," and "Risk Factors."

This discussion and analysis should be read in conjunction with our audited consolidated financial statements and notes thereto presented under Item 8.

**General**

*Overview*

Arch Capital Group Ltd. ("ACGL" and, together with its subsidiaries, "we" or "us") is a Bermuda public limited liability company with approximately \$4.34 billion in capital at December 31, 2007 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 11th, as well as the recognition that intense competition in the late 1990s led to inadequate pricing and overly broad terms, conditions and coverages. Such industry developments resulted in poor financial results and erosion of the industry's capital base. Consequently, many established insurers and reinsurers reduced their participation in, or exited from, certain markets and, as a result, premium rates escalated in many lines of business. These developments provided relatively new insurers and reinsurers, like us, with an opportunity to provide needed underwriting capacity. Beginning in late 2003 and continuing through 2005, additional capacity emerged in many classes of business and, consequently, premium rate increases decelerated significantly and, in many classes of business, premium rates decreased. The weather-related catastrophic events that occurred in the second half of 2005 caused significant industry losses and led to a strengthening of rating agency capital requirements for catastrophe-exposed business. The 2005 events also resulted in

substantial improvements in market conditions in property and certain marine lines of business and slowed declines in premium rates in other lines. During 2006 and 2007, excellent industry results led to a significant increase in capacity and, accordingly, competition intensified in 2007 and prices declined generally in all lines of business, including property. This trend is expected to continue 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, even in lines for which rates have fallen. The most attractive area from a pricing point of view remains catastrophe-related property business. We believe that we are still able to write insurance and reinsurance business at what we believe to be acceptable rates. We maintained underwriting discipline during 2007 and, as a result, premiums written by our reinsurance operations were lower than in the 2006 period, while a significant portion of the increase in premiums written by our insurance operations was generated by expansion into the European market with moderate growth in the U.S. and Canadian markets. Such trend may continue as we respond to more challenging market conditions.

### *New Developments*

In January 2007, we entered into a new line of business when we agreed to write excess workers' compensation and employers' liability insurance produced by a managing general agent, Wexford Underwriting Managers, Inc. ("Wexford"). For 2007, Wexford, which primarily serves not-for-profit clients, produced approximately \$35 million of business for our insurance operations. During the 2007 fourth quarter, we completed the acquisition of the operations of Wexford, including the renewal rights of the subject business, through an asset purchase.

In April 2007, we launched a new property facultative reinsurance operation headed by an experienced and well respected industry veteran. This unit is based in Farmington, Connecticut with branch offices across the United States and in Toronto, Canada. We view this business as a long-term opportunity that expands our specialty underwriting platform and will further diversify our book of business over time.

In May 2007, Standard & Poor's Rating Services ("S&P") announced that it had upgraded the financial strength ratings of our principal operating subsidiaries from "A-" (Strong) to "A" (Strong). S&P also upgraded the counterparty credit and senior debt ratings on ACGL to "BBB+" from "BBB". The outlook on all of the ratings is stable.

In January 2008, we announced that Arch Reinsurance Ltd. ("Arch Re Bermuda") finalized a joint venture agreement with Gulf Investment Corporation GSC ("GIC") to establish a new reinsurer to be based in the Dubai International Financial Centre. The joint venture 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. Under the agreement, each of Arch Re Bermuda and GIC will own 50% of the joint venture. 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, which will be provided by Arch Re Bermuda and GIC equally, will consist of \$200 million, plus an additional \$200 million to be funded depending on the joint venture's business needs. The joint venture's underwriting activities are expected to commence during the first half of 2008, subject to approval by the Dubai Financial Services Authority.

### *History*

We commenced operations in September 1995 following the completion of the initial public offering of our predecessor, Arch Capital Group (U.S.) Inc. ("Arch-U.S."). Arch-U.S. is a Delaware company formed in March 1995 under the original name of "Risk Capital Holdings, Inc." From that time until May 2000, we provided reinsurance and other forms of capital to insurance companies. On May 5, 2000, we sold our prior reinsurance book of business to Folksamerica Reinsurance Company ("Folksamerica") in an asset sale, but retained our surplus and our U.S.-licensed reinsurance platform. On November 8, 2000, following shareholder approval, we changed our legal domicile to Bermuda in order to benefit from Bermuda's favorable business, regulatory, tax and financing environment.

During the period from May 2000 through the announcement of our underwriting initiative in October 2001, we built and acquired insurance businesses that were intended to enable us to generate both fee-based revenue (*e.g.*, commissions and advisory and management fees) and risk-based revenue (*i.e.*, insurance premium). As part of this strategy, we built an underwriting platform that was intended to enable us to maximize risk-based revenue during periods in the underwriting cycle when we believed it was more favorable to assume underwriting risk. In October 2001, we concluded that underwriting conditions favored dedicating our attention exclusively to building our insurance and reinsurance business.

In October 2001, we launched an underwriting initiative to meet current and future demand in the global insurance and reinsurance markets that included the recruitment of new insurance and reinsurance management teams and an equity capital infusion of \$763.2 million in the form of convertible preference shares. In April 2002, we completed an offering of common shares and received net proceeds of \$179.2 million and, in September 2002, we received proceeds of \$74.3 million from the exercise of class A warrants by our principal shareholders and certain other investors. In March 2004, we completed a public offering of common shares and received net proceeds of \$179.3 million and, in May 2004, we completed a public offering of \$300 million principal amount of 7.35% senior notes due May 1, 2034 and received net proceeds of \$296.4 million, of which \$200 million of the net proceeds was used to repay all amounts outstanding under our existing credit facility. In 2006, we issued \$325.0 million of non-cumulative preferred shares in public offerings and received net proceeds of \$314.4 million. On February 28, 2007, our Board of Directors authorized us to invest up to \$1 billion in ACGL's common shares through a share repurchase program. Repurchases under the program may be effected from time to time in open market or privately negotiated transactions through February 2009. In 2007, we repurchased approximately 7.8 million common shares for an aggregate purchase price of \$537.1 million.

In the 2005 fourth quarter, all remaining outstanding convertible preference shares were converted to common shares. Since the preference shares were treated as common share equivalents in our reported financial results, the conversion had no impact on diluted earnings per share or diluted book value per share. However, the convertible preference shares were not included in basic calculations prior to their conversion to common shares and, due to the timing of the conversions, basic average shares outstanding and basic earnings per share for 2005 only reflect the impact of the preference share conversion for a small portion of the year. Management does not believe that the comparison of basic earnings per share is meaningful for the 2007, 2006 or 2005 periods presented and such amounts have not been presented or discussed herein.

### *Revenues*

We derive our revenues primarily from the issuance of insurance policies and reinsurance contracts. Insurance and reinsurance premiums are driven by the volume and classes of business of the policies and contracts that we write which, in turn, are related to prevailing market conditions. The premium we charge for the risks assumed is also based on many assumptions. We price these risks well before our ultimate costs are known, which may extend many years into the future. In addition, our

revenues include fee income and income we generate from our investment portfolio. Our investment portfolio is comprised primarily of fixed income investments that are classified as "available for sale." Under accounting principles generally accepted in the United States of America ("GAAP"), these investments are carried at fair value and unrealized gains and losses on the investments are not included in our statement of income. These unrealized gains and losses are included in accumulated other comprehensive income or loss as a separate component of shareholders' equity in our balance sheet.

### *Costs and Expenses*

Our costs and expenses primarily consist of losses and loss adjustment expenses, acquisition expenses and other operating expenses. Losses and loss adjustment expenses include management's best estimate of the ultimate cost of claims incurred during a reporting period. Such costs consist of three components: paid losses, changes in estimated amounts for known losses ("case reserves"), and changes in reserves for incurred but not reported ("IBNR") losses. See "Critical Accounting Policies, Estimates and Recent Accounting Pronouncements Reserves for Losses and Loss Adjustment Expenses" for further discussion. Acquisition expenses, net of ceding commissions received from unaffiliated reinsurers, consist primarily of commissions, brokerage and taxes paid to obtain our business. A significant portion of such costs is paid based on a percentage of the premium written and will vary for each class or type of business that we underwrite. Other operating expenses consist primarily of certain company costs necessary to support our worldwide insurance and reinsurance operations. A large portion of such costs are compensation-related and include share-based compensation.

### **Critical Accounting Policies, Estimates and Recent Accounting Pronouncements**

The preparation of consolidated financial statements in accordance with GAAP requires us to make many estimates and judgments that affect the reported amounts of assets, liabilities (including reserves), revenues and expenses, and related disclosures of contingent liabilities. On an ongoing basis, we evaluate our estimates, including those related to revenue recognition, insurance and other reserves, reinsurance recoverables, allowance for doubtful accounts, investment valuations, intangible assets, bad debts, income taxes, contingencies and litigation. We base our estimates on historical experience, where possible, and on various other assumptions that we believe to be reasonable under the circumstances, which form the basis for our judgments about the carrying values of assets and liabilities that are not readily apparent from other sources. Estimates and judgments for a relatively new insurance and reinsurance company, like our company, are even more difficult to make than those made in a mature company since limited historical information has been reported to us through December 31, 2007. Actual results will differ from these estimates and such differences may be material. We believe that the following critical accounting policies require our more significant judgments and estimates used in the preparation of our consolidated financial statements.

### *Reserves for Losses and Loss Adjustment Expenses*

We are required by applicable insurance laws and regulations and GAAP to establish reserves for losses and loss adjustment expenses ("Loss Reserves") that arise from the business we underwrite. Loss Reserves for our insurance and reinsurance operations are balance sheet liabilities representing estimates of future amounts required to pay losses and loss adjustment expenses for insured or reinsured events which have occurred at or before the balance sheet date. Loss Reserves do not reflect contingency reserve allowances to account for future loss occurrences. Losses arising from future events will be estimated and recognized at the time the losses are incurred and could be substantial.



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At December 31, 2007 and 2006, our Loss Reserves, net of unpaid losses and loss adjustment expenses recoverable, by type and by operating segment were as follows:

(U.S. dollars in thousands)	December 31,	
	2007	2006
<b>Insurance:</b>		
Case reserves.	\$ 811,054	\$ 619,981
IBNR reserves	2,100,696	1,795,510
	\$ 2,911,750	\$ 2,415,491
<b>Reinsurance:</b>		
Case reserves.	\$ 623,419	\$ 605,113
Additional case reserves	80,438	74,181
IBNR reserves	1,867,226	1,816,099
	\$ 2,571,083	\$ 2,495,393
<b>Total:</b>		
Case reserves.	\$ 1,434,473	\$ 1,225,094
Additional case reserves	80,438	74,181
IBNR reserves	3,967,922	3,611,609
	\$ 5,482,833	\$ 4,910,884

### *Insurance Operations*

Loss Reserves for our insurance operations are comprised of (1) case reserves for claims reported and (2) reserves for losses that have occurred but for which claims have not yet been reported, referred to as IBNR reserves. For our insurance operations, generally, claims personnel determine whether to establish a case reserve for the estimated amount of the ultimate settlement of individual claims. The estimate reflects the judgment of claims personnel based on general corporate reserving practices, the experience and knowledge of such personnel regarding the nature and value of the specific type of claim and, where appropriate, advice of counsel. Our insurance operations also contract with a number of outside third party administrators in the claims process who, in certain cases, have limited authority to establish case reserves. The work of such administrators is reviewed and monitored by our claims personnel. Loss Reserves are also established to provide for loss adjustment expenses ("LAE") and represent the estimated expense of settling claims, including legal and other fees and the general expenses of administering the claims adjustment process. Periodically, adjustments to the reported or case reserves may be made as additional information regarding the claims is reported or payments are made. IBNR reserves are established to provide for incurred claims which have not yet been reported to an insurer or reinsurer at the balance sheet date as well as to adjust for any projected variance in case reserving. IBNR reserves are derived by subtracting paid losses and LAE and case reserves from estimates of ultimate losses and loss adjustment expenses. Actuaries estimate ultimate losses and LAE using various generally accepted actuarial methods applied to known losses and other relevant information. Like case reserves, IBNR reserves are adjusted as additional information becomes known or payments are made. The process of estimating reserves involves a considerable degree of judgment by management and, as of any given date, is inherently uncertain.

Ultimate losses and LAE are generally determined by extrapolation of claim emergence and settlement patterns observed in the past that can reasonably be expected to persist into the future. In forecasting ultimate losses and LAE with respect to any line of business, past experience with respect to that line of business is the primary resource, developed through both industry and company experience, but cannot be relied upon in isolation. Uncertainties in estimating ultimate losses and LAE

are magnified by the time lag between when a claim actually occurs and when it is reported and settled. This time lag is sometimes referred to as the "claim-tail". The claim-tail for most property coverages is typically short (usually several months up to a few years). The claim-tail for certain professional liability, executive assurance and healthcare coverages, which are generally written on a claims-made basis, is typically longer than property coverages but shorter than casualty lines. The claim-tail for liability/casualty coverages, such as general liability, products liability, multiple peril coverage, and workers' compensation, may be especially long as claims are often reported and ultimately paid or settled years, even decades, after the related loss events occur. During the long claims reporting and settlement period, additional facts regarding coverages written in prior accident years, as well as about actual claims and trends, may become known and, as a result, our insurance operations may adjust their reserves. If management determines that an adjustment is appropriate, the adjustment is recorded in the accounting period in which such determination is made in accordance with GAAP. Accordingly, should Loss Reserves need to be increased or decreased in the future from amounts currently established, future results of operations would be negatively or positively impacted, respectively.

In determining ultimate losses and LAE, the cost to indemnify claimants, provide needed legal defense and other services for insureds and administer the investigation and adjustment of claims are considered. These claim costs are influenced by many factors that change over time, such as expanded coverage definitions as a result of new court decisions, inflation in costs to repair or replace damaged property, inflation in the cost of medical services and legislated changes in statutory benefits, as well as by the particular, unique facts that pertain to each claim. As a result, the rate at which claims arose in the past and the costs to settle them may not always be representative of what will occur in the future. The factors influencing changes in claim costs are often difficult to isolate or quantify and developments in paid and incurred losses from historical trends are frequently subject to multiple and conflicting interpretations. Changes in coverage terms or claims handling practices may also cause future experience and/or development patterns to vary from the past. A key objective of actuaries in developing estimates of ultimate losses and LAE, and resulting IBNR reserves, is to identify aberrations and systemic changes occurring within historical experience and accurately adjust for them so that the future can be projected reliably. Because of the factors previously discussed, this process requires the substantial use of informed judgment and is inherently uncertain.

At December 31, 2007 and 2006, Loss Reserves for our insurance operations by major line of business, net of unpaid losses and loss adjustment expenses recoverable, were as follows:

	December 31,	
	2007	2006
<b>(U.S. dollars in thousands)</b>		
Casualty	\$ 647,842	\$ 564,959
Construction, surety and national accounts	518,541	385,149
Executive assurance	431,068	344,881
Professional liability	420,083	335,104
Programs	370,852	345,490
Property, marine and aviation.	345,177	304,004
Healthcare	153,018	125,913
Other	25,169	9,991
<b>Total net reserves</b>	<b>\$ 2,911,750</b>	<b>\$ 2,415,491</b>

The reserving method for our insurance operations to date has been, to a large extent, the expected loss method, which is commonly applied when limited loss experience exists. Any estimates and assumptions made as part of the reserving process could prove to be inaccurate due to several factors, including the fact that limited historical information has been reported to our insurance

operations through December 31, 2007. See below for a discussion of the key assumptions in our insurance operations' reserving process.

Although Loss Reserves are initially determined based on underwriting and pricing analysis, our insurance operations apply several generally accepted actuarial methods, as discussed below, on a quarterly basis to evaluate their Loss Reserves, in addition to the expected loss method, in particular for Loss Reserves from more mature accident years (the year in which a loss occurred). As noted below, beginning in 2005, our insurance operations began to give a relatively small amount of weight to their own experience following reviews of open claims on lines of business written on a claims-made basis for which they developed a reasonable level of credible data. Each quarter, as part of the reserving process, actuaries at our insurance operations reaffirm that the assumptions used in the reserving process continue to form a sound basis for the projection of liabilities. If actual loss activity differs substantially from expectations based on historical information, an adjustment to loss reserves may be supported. As time passes, estimated Loss Reserves for a given accident year will be based more on historical loss activity and patterns than on the initial assumptions based on pricing indications. Our insurance operations place more or less reliance on a particular actuarial method based on the facts and circumstances at the time the estimates of Loss Reserves are made. These methods generally fall into one of the following categories or are hybrids of one or more of the following categories:

*Expected loss methods* these methods are based on the assumption that ultimate losses vary proportionately with premiums. Expected loss and LAE ratios are typically developed based upon the information derived by underwriters and actuaries during the initial pricing of the business, supplemented by industry data available from organizations, such as statistical bureaus and consulting firms, where appropriate. These ratios consider, among other things, rate increases and changes in terms and conditions that have been observed in the market. Expected loss methods are useful for estimating ultimate losses and LAE in the early years of long-tailed lines of business, when little or no paid or incurred loss information is available, and is commonly applied when limited loss experience exists for a company.

*Historical incurred loss development methods* these methods assume that the ratio of losses in one period to losses in an earlier period will remain constant in the future. These methods use incurred losses (i.e., the sum of cumulative historical loss payments plus outstanding case reserves) over discrete periods of time to estimate future losses. Historical incurred loss development methods may be preferable to historical paid loss development methods because they explicitly take into account open cases and the claims adjusters' evaluations of the cost to settle all known claims. However, historical incurred loss development methods necessarily assume that case reserving practices are consistently applied over time. Therefore, when there have been significant changes in how case reserves are established, using incurred loss data to project ultimate losses may be less reliable than other methods.

*Historical paid loss development methods* these methods, like historical incurred loss development methods, assume that the ratio of losses in one period to losses in an earlier period will remain constant. These methods use historical loss payments over discrete periods of time to estimate future losses and necessarily assume that factors that have affected paid losses in the past, such as inflation or the effects of litigation, will remain constant in the future. Because historical paid loss development methods do not use incurred losses to estimate ultimate losses, they may be more reliable than the other methods that use incurred losses in situations where there are significant changes in how incurred losses are established by a company's claims adjusters. However, historical paid loss development methods are more leveraged (meaning that small changes in payments have a larger impact on estimates of ultimate losses) than actuarial methods that use incurred losses because cumulative loss payments take much longer to equal the expected ultimate losses than cumulative incurred amounts. In addition, and for similar

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reasons, historical paid loss development methods are often slow to react to situations when new or different factors arise than those that have affected paid losses in the past.

*Adjusted historical paid and incurred loss development methods* these methods take traditional historical paid and incurred loss development methods and adjust them for the estimated impact of changes from the past in factors such as inflation, the speed of claim payments or the adequacy of case reserves. Adjusted historical paid and incurred loss development methods are often more reliable methods of predicting ultimate losses in periods of significant change, provided the actuaries can develop methods to reasonably quantify the impact of changes. As such, these methods utilize more judgment than historical paid and incurred loss development methods.

*Bornhuetter-Ferguson ("B-F") paid and incurred loss methods* these methods utilize actual paid and incurred losses and expected patterns of paid and incurred losses, taking the initial expected ultimate losses into account to determine an estimate of expected ultimate losses. The B-F paid and incurred loss methods are useful when there are few reported claims and a relatively less stable pattern of reported losses.

*Additional analyses* other methodologies are often used in the reserving process for specific types of claims or events, such as catastrophic or other specific major events. These include vendor catastrophe models, which are typically used in the estimation of Loss Reserves at the early stage of known catastrophic events before information has been reported to an insurer or reinsurer, and analyses of specific industry events, such as large lawsuits or claims.

In the initial reserving process for casualty business, primarily consisting of primary and excess exposures written on an occurrence basis, our insurance operations primarily rely on the expected loss method. The development of our insurance operations' casualty business may be unstable due to its long-tail nature and the occurrence of high severity events, as a portion of our insurance operations' casualty business is in high excess layers. As time passes, for a given accident year, additional weight is given to the paid and incurred B-F loss development methods and historical paid and incurred loss development methods in the reserving process. Our insurance operations make a number of key assumptions in reserving for casualty business, including that the pricing loss ratio is the best estimate of the ultimate loss ratio at the time the policy is entered into, that our insurance operations' loss development patterns, which are based on industry loss development patterns and adjusted to reflect differences in our insurance operations' mix of business, are reasonable and that our insurance operations' claims personnel and underwriters analyses of our exposure to major events are assumed to be our best estimate of our exposure to the known claims on those events. As noted earlier, due to the long claims reporting and settlement period for casualty business, additional facts regarding coverages written in prior accident years, as well as about actual claims and trends may become known and, as a result, our insurance operations may be required to adjust their casualty reserves. The expected loss ratios used in the initial reserving process for our insurance operations' casualty business for recent accident years have not varied significantly from earlier accident years due to the long-tail nature of the business written and the limited number of years of historical experience available for use in projecting loss experience using standard actuarial methods. As the credibility of historical experience for earlier accident years increases, the experience from these accident years will be given a greater weighting in the actuarial analysis to determine future accident year expected loss ratios, adjusted for changes in pricing, loss trends, terms and conditions and reinsurance structure.

In the initial reserving process for property, marine and aviation business, which are primarily short-tail exposures, our insurance operations primarily rely on the expected loss method. For catastrophe-exposed business, our insurance operations' reserving process also includes the usage of catastrophe models for known events and a heavy reliance on analysis of individual catastrophic events and management judgment. The development of property losses can be unstable, especially for policies

characterized by high severity, low frequency losses. As time passes, for a given accident year, additional weight is given to the paid and incurred B-F loss development methods and historical paid and incurred loss development methods in the reserving process. Our insurance operations make a number of key assumptions in their reserving process, including that historical paid and reported development patterns are stable, catastrophe models provide useful information about our exposure to catastrophic events that have occurred and our underwriters' judgment as to potential loss exposures can be relied on. The expected loss ratios used in the initial reserving process for our insurance operations' property business have varied over time due to changes in pricing, reinsurance structure, estimates of catastrophe losses, policy changes (such as attachment points, class and limits) and geographical distribution. As a result of the weather-related catastrophic events in the second half of 2005 (and to a lesser extent in 2004), there has been a substantial improvement in rates and market conditions in property lines. As losses in property lines are reported relatively quickly, expected loss ratios are selected for the current accident year based upon actual attritional loss ratios for earlier accident years, adjusted for rate changes, inflation, changes in reinsurance programs and expected attritional losses based on modeling. Due to the short-tail nature of property business, reported loss experience emerges quickly and ultimate losses are known in a reasonably short period of time.

In addition to the assumptions and development characteristics noted above for casualty and property business, our insurance operations authorize managing general agents, general agents and other producers to write program business on their behalf within prescribed underwriting authorities. This adds additional complexity to the reserving process. To monitor adherence to the underwriting guidelines given to such parties, our insurance operations periodically perform claims due diligence reviews. In the initial reserving process for program business, consisting of property and liability exposures which are primarily written on an occurrence basis, our insurance operations primarily rely on the expected loss method. As time passes, for a given accident year, additional weight is given to the paid and incurred B-F loss development methods and historical paid and incurred loss development methods in the reserving process. The expected loss ratios used in the initial reserving process for our insurance operations' program business have varied over time depending on the type of exposures written (casualty or property) and changes in pricing, loss trends, reinsurance structure and changes in the underlying business.

In the initial reserving process for executive assurance, professional liability and healthcare business, primarily consisting of medium-tail exposures written on a claims-made basis, our insurance operations primarily rely on the expected loss method. As time passes, for a given accident year, additional weight is given to the paid and incurred B-F loss development methods and historical paid and incurred loss development methods in the reserving process. Beginning in 2005, our insurance operations began to give a relatively small amount of weight to their own experience following reviews of open claims, in particular for lines of business written on a claims-made basis for which they developed a reasonable level of credible data. In general, the expected loss ratios for executive assurance, professional liability and healthcare business for recent accident years have not varied significantly from earlier accident years since this business is primarily written on a claims-made basis and is subject to high severity, low frequency losses. In addition, only a limited number of years of historical experience is available for use in projecting loss experience using standard actuarial methods. As the credibility of historical experience for earlier accident years increases, the experience from these accident years will be given a greater weighting in the actuarial analysis to determine future accident year expected loss ratios, adjusted for the occurrence or lack of large losses, changes in pricing, loss trends, terms and conditions and reinsurance structure.

In the initial reserving process for construction and surety business, consisting of primary and excess casualty and contract surety coverages written on an occurrence and claims-made basis, our insurance operations primarily rely on the expected loss method. Such business is subject to the assumptions and development characteristics noted above for casualty business. As time passes, for a

given accident year, additional weight is given to the paid and incurred B-F loss development methods and historical paid and incurred loss development methods in the reserving process. The expected loss ratios used in the initial reserving process for our insurance operations' construction and surety business for recent accident years have not varied significantly from earlier accident years due to the medium-tail nature of the business written and the limited number of years of historical experience available for use in actuarial methods. As the credibility of historical experience for earlier accident years increases, the experience from these accident years will be given a greater weighting in the actuarial analysis to determine future accident year expected loss ratios, adjusted for anticipated changes in the regulatory environment, pricing, loss trends, terms and conditions and reinsurance structure.

For the years ended December 31, 2005 to 2007, on average, our insurance segment reported approximately \$16.2 million of estimated net favorable development in prior year Loss Reserves, or approximately 0.9% of average beginning Loss Reserves. Of such amount, approximately \$27.7 million came from long-tail lines, or 3.8% of average beginning Loss Reserves, and \$14.6 million from medium-tail lines, or 1.8% of beginning Loss Reserves, offset partially by adverse development on \$26.1 million from short-tail lines, or 9.2% of average beginning Loss Reserves. The average adverse development on short-tail lines primarily resulted from \$30.8 million of adverse development recorded in 2006 on the 2005 catastrophic events and higher than expected claims development. For the year ended December 31, 2007, estimated net favorable development in prior year Loss Reserves was \$12.7 million, or 0.5% of beginning Loss Reserves. Such amount consisted of approximately \$26.9 million from long-tail lines, or 2.8% of beginning Loss Reserves, and \$19.1 million from medium-tail lines, or 1.8% of beginning Loss Reserves, partially offset by adverse development of \$33.3 million from short-tail lines primarily due to higher than expected claims development, or 8.5% of beginning Loss Reserves. For informational purposes, based on historical results, applying the 0.9% average estimated net favorable development in average beginning Loss Reserves for the years ended December 31, 2005 to 2007 to our insurance segment's net Loss Reserves of \$2.91 billion at December 31, 2007 would result in an increase in income before income taxes of approximately \$25.8 million, or \$0.35 per diluted share, and applying the 0.5% of estimated net favorable development in beginning Loss Reserves for the year ended December 31, 2007 to such Loss Reserves would result in an increase in income before income taxes of approximately \$15.3 million, or \$0.21 per diluted share. The amounts noted above are informational only and should not be considered projections of future events. Future favorable or adverse development in our insurance segment's Loss Reserves is subject to numerous factors, and no assurances can be given that we will experience favorable development in our Loss Reserves or that our ultimate losses will not be significantly different than the amounts shown above, and such differences could directly and significantly impact earnings favorably or unfavorably in the period they are determined. Because of our insurance segment's limited operating history, the sensitivity analysis above is one way to gauge the impact of changes in the assumptions in our reserving process. For another estimate of potential variability in our insurance segment's Loss Reserves, see " Simulation Results." Refer to " Results of Operations" for a discussion on net favorable or adverse development of our insurance operations' prior year Loss Reserves.

### *Reinsurance Operations*

Loss Reserves for our reinsurance operations are comprised of (1) case reserves for claims reported, (2) additional case reserves ("ACRs") and (3) IBNR reserves. Our reinsurance operations receive reports of claims notices from ceding companies and record case reserves based upon the amount of reserves recommended by the ceding company. Case reserves on known events may be supplemented by ACRs, which are often estimated by our reinsurance operations' claims personnel ahead of official notification from the ceding company, or when our reinsurance operations' judgment regarding the size or severity of the known event differs from the ceding company. In certain instances,

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our reinsurance operations establish ACRs even when the ceding company does not report any liability on a known event. In addition, specific claim information reported by ceding companies or obtained through claim audits can alert our reinsurance operations to emerging trends such as changing legal interpretations of coverage and liability, claims from unexpected sources or classes of business, and significant changes in the frequency or severity of individual claims. Such information is often used in the process of estimating IBNR reserves.

The estimation of Loss Reserves for our reinsurance operations is subject to the same risk factors as the estimation of Loss Reserves for our insurance operations. In addition, the inherent uncertainties of estimating such reserves are even greater for reinsurers, due primarily to: (1) the claim-tail for reinsurers is generally longer because claims are first reported to the ceding company and then to the reinsurer through one or more intermediaries, (2) the reliance on premium estimates, where reports have not been received from the ceding company, in the reserving process, (3) the potential for writing a number of reinsurance contracts with different ceding companies with the same exposure to a single loss event, (4) the diversity of loss development patterns among different types of reinsurance treaties or facultative contracts, (5) the necessary reliance on the ceding companies for information regarding reported claims and (6) the differing reserving practices among ceding companies.

As with our insurance operations, the process of estimating Loss Reserves for our reinsurance operations involves a considerable degree of judgment by management and, as of any given date, is inherently uncertain. As discussed above, such uncertainty is greater for reinsurers compared to insurers. As a result, our reinsurance operations obtain information from numerous sources to assist in the process. Pricing actuaries from our reinsurance operations devote considerable effort to understanding and analyzing a ceding company's operations and loss history during the underwriting of the business, using a combination of ceding company and industry statistics. Such statistics normally include historical premium and loss data by class of business, individual claim information for larger claims, distributions of insurance limits provided, loss reporting and payment patterns, and rate change history. This analysis is used to project expected loss ratios for each treaty during the upcoming contract period.

As mentioned above, there can be a considerable time lag from the time a claim is reported to a ceding company to the time it is reported to the reinsurer. The lag can be several years in some cases and may be attributed to a number of reasons, including the time it takes to investigate a claim, delays associated with the litigation process, the deterioration in a claimant's physical condition many years after an accident occurs, the case reserving approach of the ceding company, etc. In the reserving process, our reinsurance operations assume that such lags are predictable, on average, over time and therefore the lags are contemplated in the loss reporting patterns used in their actuarial methods. This means that our reinsurance operations must rely on estimates for a longer period of time than does an insurance company.

Backlogs in the recording of assumed reinsurance can also complicate the accuracy of loss reserve estimation. As of December 31, 2007, there were no significant backlogs related to the processing of assumed reinsurance information at our reinsurance operations.

Our reinsurance operations rely heavily on information reported by ceding companies, as discussed above. In order to determine the accuracy and completeness of such information, underwriters, actuaries, and claims personnel at our reinsurance operations often perform audits of ceding companies and regularly review information received from ceding companies for unusual or unexpected results. Material findings are usually discussed with the ceding companies. Our reinsurance operations sometimes encounter situations where they determine that a claim presentation from a ceding company is not in accordance with contract terms. In these situations, our reinsurance operations attempt to resolve the dispute with the ceding company. Most situations are resolved amicably and without the need for litigation or arbitration. However, in the infrequent situations where a resolution is not possible, our reinsurance operations will vigorously defend their position in such disputes.

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At December 31, 2007 and 2006, Loss Reserves for our reinsurance operations by major line of business, net of unpaid losses and loss adjustment expenses recoverable, were as follows:

	December 31,	
	2007	2006
<b>(U.S. dollars in thousands)</b>		
Casualty	\$ 1,715,712	\$ 1,545,363
Property excluding property catastrophe	295,728	306,990
Other specialty.	212,088	239,132
Marine and aviation	167,290	176,144
Property catastrophe	111,084	147,031
Other	69,181	80,733
	\$ 2,571,083	\$ 2,495,393
	\$ 2,571,083	\$ 2,495,393

The reserving method for our reinsurance operations to date has been, to a large extent, the expected loss method, which is commonly applied when limited loss experience exists. Any estimates and assumptions made as part of the reserving process could prove to be inaccurate due to several factors, including the fact that limited historical information has been reported to our reinsurance operations through December 31, 2007. See below for a discussion of the key assumptions in our reinsurance operations' reserving process.

Although Loss Reserves are initially determined based on underwriting and pricing analysis, our reinsurance operations apply several generally accepted actuarial methods, as discussed above, on a quarterly basis to evaluate their Loss Reserves in addition to the expected loss method, in particular for Loss Reserves from more mature underwriting years (the year in which business is underwritten). Each quarter, as part of the reserving process, actuaries at our reinsurance operations reaffirm that the assumptions used in the reserving process continue to form a sound basis for projection of liabilities. If actual loss activity differs substantially from expectations based on historical information, an adjustment to loss reserves may be supported. As time passes, for a given underwriting year, the reserving process to estimate Loss Reserves will be based more on actual loss activity and historical patterns than on initial assumptions based on pricing indications. Our reinsurance operations place more or less reliance on a particular actuarial method based on the facts and circumstances at the time the estimates of Loss Reserves are made.

In the initial reserving process for medium-tail and long-tail lines, consisting of casualty, other specialty, marine and aviation and other exposures, our reinsurance operations primarily rely on the expected loss method. The development of medium-tail and long-tail business may be unstable, especially if there are high severity major events, with business written on an excess of loss basis typically having a longer tail than business written on a pro rata basis. As time passes, for a given underwriting year, additional weight is given to the paid and incurred B-F loss development methods and historical paid and incurred loss development methods in the reserving process. Our reinsurance operations make a number of key assumptions in reserving for medium-tail and long-tail lines, including that the pricing loss ratio is the best estimate of the ultimate loss ratio at the time the contract is entered into, historical paid and reported development patterns are stable and our reinsurance operations' claims personnel and underwriters analyses of our exposure to major events are assumed to be our best estimate of our exposure to the known claims on those events. The expected loss ratios used in our reinsurance operations' initial reserving process for medium-tail and long-tail contracts have varied over time due to changes in pricing, terms and conditions and reinsurance structure. As the credibility of historical experience for earlier underwriting years increases, the experience from these underwriting years will be used in the actuarial analysis to determine future underwriting year expected loss ratios, adjusted for changes in pricing, loss trends, terms and conditions and reinsurance structure.



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The process of estimating Loss Reserves for our reinsurance operations involves a considerable degree of judgment by management and, as of any given date, is inherently uncertain. The inherent uncertainties of estimating such reserves are even greater for reinsurers than for insurers due to the longer claim-tail for reinsurers, the reliance on premium estimates in the reserving process, the diversity and instability of loss development patterns, the necessary reliance on the ceding companies for information regarding reported claims and the differing reserving practices among ceding companies. In addition, as a result of the start up nature of our reinsurance operations in 2002 and 2003, the assumptions used in the initial loss estimates were subject to greater uncertainty than for an established company, especially for casualty reinsurance exposures (which have a longer claim-tail and involve a higher degree of judgment by management than short-tail lines). In the reserving process in 2002 and 2003, our reinsurance operations recognized that there is a possibility that the assumptions made could prove to be inaccurate due to the factors discussed above related to the start up nature of their operations in both periods.

In response to such factors, and their impact on the credibility of the initial loss estimates for casualty reinsurance exposures, a provision was included in establishing our reinsurance operations' net Loss Reserves in 2002 and 2003 on casualty losses occurring prior to each balance sheet date. As of December 31, 2003, the provision, included in IBNR, was \$49.0 million (or 5.0% of our reinsurance operations' net Loss Reserves). Due to the additional data our reinsurance operations had gained on its existing book of business by the end of 2003, it was determined that it was no longer necessary to continue to include a provision in the reserving process beginning in 2004. Based on the recommendation of an independent actuarial firm, our reinsurance operations adopted a methodology to evaluate the existing provision by comparing actual claims experience to a schedule of expected claims experience prepared by the independent actuarial firm. If the actual claims experience is in line with the expected claims experience, a reduction of the provision is made based on the schedule established in the review. For 2007, 2006 and 2005, following reviews of actual and expected claims experience, our reinsurance operations reduced the provision by \$10.6 million, \$7.7 million and \$12.1 million, respectively. At December 31, 2007, the remaining provision included in our reinsurance operations' Loss Reserves was \$11.3 million (or 0.4% of our reinsurance operations' net Loss Reserves), compared to \$21.9 million (or 0.9% of our reinsurance operations' net Loss Reserves) at December 31, 2006.

In the initial reserving process for short-tail lines, consisting of property excluding property catastrophe and property catastrophe exposures, our reinsurance operations primarily rely on the expected loss method. For known catastrophic events, our reinsurance operations' reserving process also includes the usage of catastrophe models and a heavy reliance on analysis which includes ceding company inquiries and management judgment. The development of property losses may be unstable, especially where there is high catastrophic exposure, may be characterized by high severity, low frequency losses for excess and catastrophe-exposed business and may be highly correlated across contracts. As time passes, for a given underwriting year, additional weight is given to the paid and incurred B-F loss development methods and historical paid and incurred loss development methods in the reserving process. Our reinsurance operations make a number of key assumptions in reserving for short-tail lines, including that historical paid and reported development patterns are stable, catastrophe models provide useful information about our exposure to catastrophic events that have occurred and our underwriters' judgment and guidance received from ceding companies as to potential loss exposures may be relied on. The expected loss ratios used in the initial reserving process for our reinsurance operations' property exposures have varied over time due to changes in pricing, reinsurance structure, estimates of catastrophe losses, terms and conditions and geographical distribution. As losses in property lines are reported relatively quickly, expected loss ratios are selected for the current underwriting year incorporating the experience for earlier underwriting years, adjusted for rate changes, inflation, changes in reinsurance programs, expectations about present and future market conditions and expected attritional losses based on modeling. Due to the short-tail nature of property business,

reported loss experience emerges quickly and ultimate losses are known in a reasonably short period of time.

For the years ended December 31, 2005 to 2007, on average, our reinsurance segment reported approximately \$110.8 million of estimated net favorable development in prior year Loss Reserves, or 5.2% of average beginning Loss Reserves. Of such amount, approximately \$77.7 million came from short-tail lines, or 11.1% of average beginning Loss Reserves, and \$33.1 million came from medium-tail and long-tail lines, or 2.3% of average beginning Loss Reserves. For the year ended December 31, 2007, estimated net favorable development in prior year Loss Reserves was \$172.7 million, or 6.9% of beginning Loss Reserves. Of such amount, approximately \$110.6 million came from short-tail lines, or 15.2% of beginning Loss Reserves, and \$62.1 million came from medium-tail and long-tail lines, or 3.5% of beginning Loss Reserves. For informational purposes, based on our reinsurance segment's historical results, applying the 5.2% average estimated net favorable development in average beginning Loss Reserves for the years ended December 31, 2005 to 2007 to our reinsurance segment's net Loss Reserves of \$2.57 billion at December 31, 2007 would result in an increase in income before income taxes of approximately \$134.5 million, or \$1.82 per diluted share, while using the 6.9% of estimated net favorable development in beginning Loss Reserves for the year ended December 31, 2007 to such Loss Reserves would result in an increase in income before income taxes of approximately \$177.9 million, or \$2.41 per diluted share. The amounts noted above are informational only and should not be considered projections of future events. Future favorable or adverse development in our reinsurance segment's Loss Reserves is subject to numerous factors, and no assurances can be given that we will experience favorable development in our Loss Reserves or that our ultimate losses will not be significantly different than the amounts shown above, and such differences could directly and significantly impact earnings favorably or unfavorably in the period they are determined. Because of our reinsurance segment's limited operating history, the sensitivity analysis above is one way to gauge the impact of changes in the assumptions in our reserving process. For another estimate of potential variability in our reinsurance segment's Loss Reserves, see " Simulation Results." Refer to " Results of Operations" for additional discussion on net favorable or adverse development of our reinsurance operations' prior year Loss Reserves.

#### *Simulation Results*

Generally, due to the insufficient amount of historical loss data for our insurance and reinsurance operations in many lines of business, we do not produce a range of estimates in calculating reserves. As described above, we primarily use the expected loss method to calculate our initial Loss Reserves, and such amounts represent management's best estimate of our ultimate liabilities. As the loss data has developed, other actuarial methods have been given more weight in our reserving process for certain lines of business. In order to illustrate the potential volatility in our reserves for losses and loss adjustment expenses, we used a statistical model to simulate a range of results based on various probabilities. Both the probabilities and related modeling are subject to inherent uncertainties. The simulation relies on a significant number of assumptions, such as the potential for multiple entities to react similarly to external events, and includes other statistical assumptions.

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Our recorded estimate of reserves for losses and loss adjustment expenses, net of unpaid losses and loss adjustment expenses recoverable, by operating segment at December 31, 2007, along with the results of the simulation are as follows:

	December 31, 2007		
	Insurance	Reinsurance	Total
<i>(U.S. dollars in thousands)</i>			
Total net reserves	\$ 2,911,750	\$ 2,571,083	\$ 5,482,833
 Simulation results:			
90th percentile(1)	\$ 3,486,739	\$ 3,341,962	\$ 6,590,695
10th percentile(2)	\$ 2,382,306	\$ 1,903,577	\$ 4,477,747

- (1) Simulation results indicate that a 90% probability exists that the net reserves for losses and loss adjustment expenses will not exceed the indicated amount.
- (2) Simulation results indicate that a 10% probability exists that the net reserves for losses and loss adjustment expenses will be at or below the indicated amount.

The simulation results shown for each segment do not add to the total simulation results, as the individual segment simulation results do not reflect the diversification effects across our segments. For informational purposes, based on the total simulation results, a change in our Loss Reserves to the amount indicated at the 90<sup>th</sup> percentile would result in a decrease in income before income taxes of approximately \$1.11 billion, or \$15.01 per diluted share, while a change in our Loss Reserves to the amount indicated at the 10<sup>th</sup> percentile would result in an increase in income before income taxes of approximately \$1.01 billion, or \$13.63 per diluted share. The simulation results noted above are informational only, and no assurance can be given that our ultimate losses will not be significantly different than the simulation results shown above, and such differences could directly and significantly impact earnings favorably or unfavorably in the period they are determined.

We do not have significant exposure to pre-2002 liabilities, such as asbestos-related illnesses and other long-tail liabilities and, to date, we have experienced a relatively low level of reported claims activity in many lines of business, particularly in longer-tailed lines such as primary and excess casualty and executive assurance, which have longer time periods during which claims are reported and paid. Our limited history does not provide meaningful trend information for such lines of business.

### *Ceded Reinsurance*

In the normal course of business, our insurance operations cede a substantial portion of their premium through pro rata, excess of loss and facultative reinsurance agreements. Our reinsurance operations also obtain reinsurance whereby another reinsurer contractually agrees to indemnify it for all or a portion of the reinsurance risks underwritten by our reinsurance operations. Such arrangements, where one reinsurer provides reinsurance to another reinsurer, are usually referred to as "retrocessional reinsurance" arrangements. In addition, our 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 our reinsurance operations, 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, our insurance or reinsurance operations would be liable for such defaulted amounts.

The availability and cost of reinsurance and retrocessional protection is subject to market conditions, which are beyond our control. Although we believe that our insurance and reinsurance operations have been successful in obtaining reinsurance and retrocessional protection, it is not certain that they will be able to continue to obtain adequate protection at cost effective levels. As a result of

such market conditions and other factors, our insurance and reinsurance operations may not be able to successfully mitigate risk through reinsurance and retrocessional arrangements and may lead to increased volatility in our results of operations in future periods. See "Risk Factors Risks Relating to Our Industry The failure of any of the loss limitation methods we employ could have a material adverse effect on our financial condition or results of operations."

In addition to the use of individual per risk and inuring reinsurance contracts to limit exposure, our insurance operations had in force during 2005 a catastrophe reinsurance program which provides coverage for certain property catastrophe-related losses occurring during the contract period equal to a maximum of 95% of the first \$200 million in excess of a \$50 million retention per occurrence of such losses. Estimated losses related to Hurricane Katrina and Hurricane Wilma have exceeded the per occurrence retention. Based on current estimates, and net of payments to date, our insurance operations has recorded recoverables of approximately \$43.6 million through such coverage for Hurricane Katrina and \$2.6 million for Hurricane Wilma with approximately \$65.8 million of remaining available coverage for Hurricane Katrina and \$187.4 million of remaining available coverage for Hurricane Wilma should the actual amount of losses ultimately attributable to such events exceed current estimates. Amounts shown for Hurricane Katrina are net of reinstatement premiums.

Estimates for our insurance operations related to Hurricanes Katrina, Rita and Wilma and other catastrophic events that occurred in the second half of 2005 are based on currently available information derived from modeling techniques, industry assessments of exposure, claims information obtained from its clients and brokers to date and a review of its in-force contracts. Actual losses from these events may vary materially from the insurance operations' estimates due to the inherent uncertainties in making such determinations resulting from several factors, including the potential inaccuracies and inadequacies in the data provided by clients and brokers, the modeling techniques and the application of such techniques, the contingent nature of business interruption exposures, the effects of any resultant demand surge on claims activity and attendant coverage issues. In addition, actual losses may increase if reinsurers dispute or fail to meet their obligations to our insurance operations or the reinsurance protections purchased by our insurance operations are exhausted or are otherwise unavailable.

Our insurance operations had in effect during 2007 a reinsurance program which provided coverage equal to a maximum of 88% of the first \$325 million in excess of a \$75 million retention per occurrence for certain property catastrophe-related losses occurring during 2007, compared to a reinsurance program in effect during 2006 which provided coverage equal to a maximum of 92% of the first \$325 million in excess of a \$75 million retention per occurrence for certain property catastrophe-related losses occurring during 2006. In the 2008 first quarter, our insurance operations renewed its reinsurance program which provides coverage for certain property-catastrophe related losses occurring during 2008 equal to a maximum of 70% of the first \$275 million in excess of a \$75 million retention per occurrence.

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 "Flatiron 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 Flatiron 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 does not incept beyond September 30, 2006. The ceding percentage for all business bound outside of this period continued to be 45%.

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 with Flatiron Re Ltd. 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 Flatiron 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. Arch Re Bermuda records such profit commission based on underwriting experience recorded each quarter. As a result, 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. On December 31, 2007, the Flatiron Treaty expired by its terms. At December 31, 2007, \$144.9 million of premiums ceded to Flatiron Re Ltd. were unearned. The attendant premiums earned, losses incurred and acquisition expenses will primarily be reflected in the reinsurance segment's results in the first half of 2008.

Our reinsurance operations previously purchased a catastrophe reinsurance program which provides up to \$55 million of coverage in excess of certain deductibles for any one occurrence and \$110 million in the aggregate annually, for certain catastrophe-related losses worldwide occurring during the period from May 2005 through April 2006. Based on current estimates, and net of payments to date, our reinsurance operations have recorded recoverables of approximately \$46.0 million, net of reinstatement premiums, related to the 2005 catastrophic events. The recovery represents full usage of the available coverage under the reinsurance program, and the coverage was not renewed upon expiration. Estimates for our reinsurance operations related to Hurricanes Katrina, Rita and Wilma and other catastrophic events that occurred in the second half of 2005 are based on currently available information derived from modeling techniques, industry assessments of exposure, claims information obtained from its clients and brokers to date and a review of its in-force contracts. Actual losses from these events may vary materially from our reinsurance operations' estimates due to the inherent uncertainties in making such determinations resulting from several factors, including the potential inaccuracies and inadequacies in the data provided by clients and brokers, the modeling techniques and the application of such techniques, the contingent nature of business interruption exposures, the effects of any resultant demand surge on claims activity and attendant coverage issues. In addition, actual losses may increase if reinsurers dispute or fail to meet their obligations to our reinsurance operations or the reinsurance protections purchased by our reinsurance operations are otherwise unavailable. While our reinsurance operations may purchase industry loss warranty contracts and other reinsurance which is intended to limit their exposure, the non-renewal of the catastrophe reinsurance program and the Flatiron Treaty increases the risk retention of our reinsurance operations and, as a result, may increase the volatility in our results of operations in future periods.

#### ***Premium Revenues and Related Expenses***

Insurance premiums written are generally recorded at the policy inception and are primarily earned on a pro rata basis over the terms of the policies for all products, usually 12 months. Premiums written include estimates in most of our insurance operations' lines of business. The amount of such insurance premium estimates included in premiums receivable and other assets at December 31, 2007 and 2006 was \$50.1 million and \$76.4 million, respectively. Such premium estimates are derived from multiple sources which include the historical experience of the underlying business, similar business and available industry information. Unearned premium reserves represent the portion of premiums written that relates to the unexpired terms of in-force insurance policies.

Reinsurance premiums written include amounts reported by brokers and ceding companies, supplemented by our own estimates of premiums where reports have not been received or in cases where the amounts reported by brokers and ceding companies are adjusted to reflect management's best judgments and expectations. Premium estimates are derived from multiple sources which include our underwriters, the historical experience of the underlying business, similar business and available industry information. Premiums written are recorded based on the type of contracts we write. Premiums

on our excess of loss and pro rata reinsurance contracts are estimated when the business is underwritten. For excess of loss contracts, the minimum premium, as defined in the contract, is generally recorded as an estimate of premiums written as of the inception date of the treaty. Estimates of premiums written under pro rata contracts are recorded in the period in which the underlying risks incept and are based on information provided by the brokers and the ceding companies. For multi-year reinsurance treaties which are payable in annual installments, generally, only the initial annual installment is included as premiums written at policy inception due to the ability of the reinsured to commute or cancel coverage during the term of the policy. The remaining annual installments are included as premiums written at each successive anniversary date within the multi-year term.

Reinstatement premiums for our insurance and reinsurance operations are recognized at the time a loss event occurs, where coverage limits for the remaining life of the contract are reinstated under pre-defined contract terms. Reinstatement premiums, if obligatory, are fully earned when recognized. The accrual of reinstatement premiums is based on an estimate of losses and loss adjustment expenses, which reflects management's judgment, as described above in "Reserves for Losses and Loss Adjustment Expenses."

The amount of reinsurance premium estimates included in premiums receivable and the amount of related acquisition expenses by type of business were as follows at December 31, 2007 and 2006:

(U.S. dollars in thousands)	December 31,					
	2007			2006		
	Gross Amount	Acquisition Expenses	Net Amount	Gross Amount	Acquisition Expenses	Net Amount
Casualty.	\$ 171,876	(\$ 47,127)	\$ 124,749	\$ 191,842	(\$ 52,382)	\$ 139,460
Property excluding property catastrophe	94,892	(23,918)	70,974	110,996	(26,653)	84,343
Marine and aviation	81,672	(22,492)	59,180	76,167	(19,440)	56,727
Other specialty	47,161	(11,185)	35,976	85,886	(26,166)	59,720
Property catastrophe	25,677	(4,346)	21,331	23,079	(3,694)	19,385
Other	1,157	(57)	1,100	1,554	(101)	1,453
<b>Total</b>	<b>\$ 422,435</b>	<b>(\$ 109,125)</b>	<b>\$ 313,310</b>	<b>\$ 489,524</b>	<b>(\$ 128,436)</b>	<b>\$ 361,088</b>

Premium estimates are reviewed by management at least quarterly. Such review includes a comparison of actual reported premiums to expected ultimate premiums along with a review of the aging and collection of premium estimates. Based on management's review, the appropriateness of the premium estimates is evaluated, and any adjustment to these estimates is recorded in the period in which it becomes known. Adjustments to premium estimates could be material and such adjustments could directly and significantly impact earnings favorably or unfavorably in the period they are determined because the estimated premium may be fully or substantially earned.

A significant portion of amounts included as premiums receivable, which represent estimated premiums written, net of commissions, are not currently due based on the terms of the underlying contracts. Based on currently available information, management believes that the premium estimates included in premiums receivable will be collectible and, therefore, no provision for doubtful accounts has been recorded on the premium estimates at December 31, 2007.

Reinsurance premiums assumed, irrespective of the class of business, are generally earned on a pro rata basis over the terms of the underlying policies or reinsurance contracts. Contracts and policies written on a "losses occurring" basis cover claims that may occur during the term of the contract or policy, which is typically 12 months. Accordingly, the premium is earned evenly over the term. Contracts which are written on a "risks attaching" basis cover claims which attach to the underlying insurance policies written during the terms of such contracts. Premiums earned on such contracts

usually extend beyond the original term of the reinsurance contract, typically resulting in recognition of premiums earned over a 24-month period.

Certain of our reinsurance contracts include provisions that adjust premiums or acquisition expenses based upon the experience under the contracts. Premiums written and earned, as well as related acquisition expenses, are recorded based upon the projected experience under such contracts.

Retroactive reinsurance reimburses a ceding company for liabilities incurred as a result of past insurable events covered by the underlying policies reinsured. In certain instances, reinsurance contracts cover losses both on a prospective basis and on a retroactive basis and, accordingly, we bifurcate the prospective and retrospective elements of these reinsurance contracts and account for each element separately. Underwriting income generated in connection with retroactive reinsurance contracts is deferred and amortized into income over the settlement period while losses are charged to income immediately. Subsequent changes in estimated or actual cash flows under such retroactive reinsurance contracts are accounted for by adjusting the previously deferred amount to the balance that would have existed had the revised estimate been available at the inception of the reinsurance transaction, with a corresponding charge or credit to income.

Acquisition expenses and other expenses that vary with, and are directly related to, the acquisition of business in our underwriting operations are deferred and amortized over the period in which the related premiums are earned. Acquisition expenses, net of ceding commissions received from unaffiliated reinsurers, consist primarily of commissions, brokerage and taxes paid to obtain our business. Other operating expenses also include expenses that vary with, and are directly related to, the acquisition of business. Deferred acquisition costs, which are based on the related unearned premiums, are carried at their estimated realizable value and take into account anticipated losses and loss adjustment expenses, based on historical and current experience, and anticipated investment income.

#### ***Collection of Insurance-Related Balances and Provision for Doubtful Accounts***

For purposes of managing risk, we reinsure a portion of our exposures, paying to reinsurers a part of the premiums received on the policies we write, and we may also use retrocessional protection. Ceded premiums written represented approximately 29.9% of gross premiums written for 2007, compared to 29.5% for 2006 and 21.8% for 2005.

The availability and cost of reinsurance and retrocessional protection is subject to market conditions, which are beyond our control. Although we believe that our insurance subsidiaries have been successful in obtaining reinsurance protection, it is not certain that we will be able to obtain adequate protection at cost effective levels. As a result of such market conditions and other factors, we may not be able to successfully mitigate risk through reinsurance and retrocessional arrangements. Further, we are subject to credit risk with respect to our reinsurers and retrocessionaires because the ceding of risk to reinsurers and retrocessionaires does not relieve us of our liability to the clients or companies we insure or reinsure. We are also subject to risks based upon the possibility that loss payments could occur earlier than the receipt of related reinsurance recoverables. Our failure to establish adequate reinsurance or retrocessional arrangements or the failure of our existing reinsurance or retrocessional arrangements to protect us from overly concentrated risk exposure could adversely affect our financial condition and results of operations.

We monitor the financial condition of our reinsurers and attempt to place coverages only with substantial, financially sound carriers. At December 31, 2007 and 2006, approximately 88.5% and 92.3%, respectively, of our reinsurance recoverables on paid and unpaid losses (not including prepaid reinsurance premiums) of \$1.74 billion and \$1.67 billion, respectively, were due from carriers which had an A.M. Best rating of "A-" or better. At December 31, 2007 and 2006, the largest reinsurance recoverables from any one carrier were less than 5.2% and 5.1%, respectively, of our total shareholders' equity.

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The following table details our reinsurance recoverables at December 31, 2007:

	<u>% of Total</u>	<u>A.M. Best Rating(1)</u>
Everest Reinsurance Company	12.1%	A+
Flatiron Re Ltd.(2)	8.8%	NR
Munich Reinsurance America, Inc.	6.9%	A+
Lloyd's of London syndicates(3)	6.7%	A
Allied World Assurance Company Ltd.	5.8%	A
Odyssey America Reinsurance Corporation(4)	5.1%	A
Swiss Reinsurance America Corporation	5.0%	A+
Federal Insurance Company	4.1%	A++
ACE Property & Casualty Insurance Company	3.4%	A+
Transatlantic Reinsurance Company	3.3%	A+
Platinum Underwriters Reinsurance Inc.	2.9%	A
GE Frankona Reinsurance Ltd.	2.7%	A
Sentry Insurance a Mutual Company(5)	2.3%	A+
All other(6)	30.9%	
<b>Total</b>	<b>100.0%</b>	

(1)

The financial strength ratings are as of February 8, 2008 and were assigned by A.M. Best based on its opinion of the insurer's financial strength as of such date. An explanation of the ratings listed in the table follows: the ratings of "A++" and "A+" are designated "Superior"; and the "A" and "A-" ratings are designated "Excellent." Additionally, A.M. Best has five classifications within the "Not Rated" or "NR" category. Reasons for an "NR" rating being assigned by A.M. Best include insufficient data, size or operating experience, companies which are in run-off with no active business writings or are dormant, companies which disagree with their rating and request that a rating not be published or insurers that request not to be formally evaluated for the purposes of assigning a rating opinion.

(2)

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 December 31, 2007. See note 11, "Commitments and Contingencies," of the notes accompanying our consolidated financial statements for further details on the Flatiron Treaty.

(3)

The A.M. Best group rating of "A" (Excellent) has been applied to all Lloyd's of London syndicates.

(4)

A significant portion of amounts due from Odyssey America Reinsurance Corporation is collateralized through reinsurance trusts.

(5)

In connection with our acquisition of Arch Specialty in February 2002, the seller, Sentry, agreed to reinsure and guarantee all liabilities arising out of Arch Specialty's business prior to the closing of the acquisition. In addition to the guarantee provided by Sentry, substantially all of the recoverable from Sentry is still subject to the original reinsurance agreements inuring to Arch Specialty and, to the extent Sentry fails to comply with its payment obligations to us, we may seek reimbursement from the third party reinsurers under such agreements.



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(6)

The following table provides a breakdown of the "All other" category by A.M. Best rating:

Companies rated "A-" or better	28.2%
Companies not rated(7)	2.7%
<hr/>	
Total	30.9%
<hr/>	

(7)

A substantial portion of such amount is collateralized through reinsurance trusts or letters of credit.

If the financial condition of our reinsurers or retrocessionaires deteriorates, resulting in an impairment of their ability to make payments, we will provide for probable losses resulting from our inability to collect amounts due from such parties, as appropriate. We evaluate the credit worthiness of all the reinsurers to which we cede business. If our analysis indicates that there is significant uncertainty regarding the collectibility of amounts due from reinsurers, managing general agents, brokers and other clients, we will record a provision for doubtful accounts.

At December 31, 2007, approximately 78.8% of premiums receivable of \$729.6 million represented amounts not yet due, while amounts in excess of 90 days overdue were 2.9% of the total. At December 31, 2006, approximately 83.5% of premiums receivable of \$750.0 million represented amounts not yet due, while amounts in excess of 90 days overdue were 1.9% of the total. Approximately 37.4% of the \$132.3 million of paid losses and loss adjustment expenses recoverable were in excess of 90 days overdue at December 31, 2007 (a significant portion of such overdue amounts were collected in February 2008), compared to 19.6% of the \$122.1 million of paid losses and loss adjustment expenses recoverable at December 31, 2006. At December 31, 2007 and 2006, our reserves for doubtful accounts were approximately \$10.5 million and \$12.0 million, respectively.

We are also subject to credit risk from our alternative market products, such as rent-a-captive risk-sharing programs, which allow a client to retain a significant portion of its loss exposure without the administrative costs and capital commitment required to establish and operate its own captive. In certain of these programs, we participate in the operating results by providing excess reinsurance coverage and earn commissions and management fees. In addition, we write program business on a risk-sharing basis with managing general agents or brokers, which may be structured with commissions which are contingent on the underwriting results of the program. While we attempt to obtain collateral from such parties in an amount sufficient to guarantee their projected financial obligations to us, there is no guarantee that such collateral will be sufficient to secure their actual ultimate obligations.

### *Income Taxes*

Deferred income taxes reflect the expected future tax consequences of temporary differences between the carrying amounts of assets and liabilities for financial reporting purposes and amounts used for income tax purposes. A valuation allowance is recorded if it is more likely than not that some or all of a deferred income tax asset may not be realized. We consider future taxable income and feasible tax planning strategies in assessing the need for a valuation allowance. In the event we determine that we will not be able to realize all or part of our deferred income tax assets in the future, an adjustment to the deferred income tax assets would be charged to income in the period in which such determination is made. In addition, if we subsequently assess that the valuation allowance is no longer needed, a benefit would be recorded to income in the period in which such determination is made.

We recognize a tax benefit where we conclude that it is more likely than not that the tax benefit will be sustained on audit by the taxing authority based solely on the technical merits of the associated tax position. If the recognition threshold is met, we recognize a tax benefit measured at the largest

amount of the tax benefit that, in our judgment, is greater than 50% likely to be realized. We record interest and penalties related to unrecognized tax benefits in the provision for income taxes.

### *Investments*

We currently classify all of our fixed maturity investments, short-term investments and other investments as "available for sale" and, accordingly, they are carried at estimated fair value. The fair value of fixed maturity securities is generally determined from quotations received from nationally recognized pricing services, or when such prices are not available, by reference to broker or underwriter bid indications. Short-term investments comprise securities due to mature within one year of the date of issue. Short-term investments include certain cash equivalents which are part of our investment portfolios under the management of external and internal investment managers. Other investments are carried at estimated fair value. Fair value is initially considered to be equal to the cost of such investment until the investment is revalued based on substantive events or other factors which could indicate a diminution or appreciation in value.

Other investments are classified as "available for sale" and include alternative investments, which are funds with underlying ownership structures that may be limited partnerships ("LPs") or limited liability companies ("LLCs"), equity securities such as investments in mutual funds and privately held securities. For those investments in which the underlying ownership structure is an LP or an LLC (*i.e.*, when the LLC meets specific criteria requiring it to be treated similar to an LP) we use the equity method to account for such investments. Under the equity method, investments are initially recorded at cost and are subsequently adjusted for changes in our proportionate share of net income or loss or other changes in capital of the investee. Changes in the carrying value of such investments are recorded in net investment income or other income. Investments in equity securities are carried at estimated fair value in accordance with SFAS No. 115. The estimated fair value of investments in privately held securities, other than those carried under the equity method, is initially equal to the cost of such investments until the investments are revalued based principally on substantive events or other factors which could indicate a diminution or appreciation in value, such as an arm's-length third party transaction justifying an increased valuation or adverse development of a significant nature requiring a write-down.

In accordance with SFAS No. 115, "Accounting for Certain Investments in Debt and Equity Securities," FASB Staff Position Nos. FAS 115-1 and FAS 124-1, "The Meaning of Other-Than-Temporary Impairment and Its Application to Certain Investments" and Securities and Exchange Commission Staff Accounting Bulletin No. 59, "Other-Than-Temporary Impairment of Certain Investments in Debt and Equity Securities," we review our investments each quarter to determine whether a decline in fair value below the amortized cost basis is other-than-temporary. Our 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) our intent and ability to hold the investment for a sufficient period of time for the value to recover. Where our analysis of the above factors results in the conclusion that declines in fair values are other-than-temporary, the cost of the securities is written down to fair value and is reflected as a realized loss. In periods subsequent to the recognition of an other-than-temporary impairment on fixed maturities, we account for such securities as if they had been purchased on the measurement date of the other-than-temporary impairment and the provision for other-than-temporary impairment (reflected as a discount or reduced premium based on the new cost basis) is amortized into net investment income over the remaining life of the fixed maturities, or until such securities are sold.

With respect to securities where the decline in value is determined to be temporary because we concluded that the investment was impaired for a minor length of time or to a minor extent and the security's value is not written down, a subsequent decision may be made to sell that security and realize a loss. Such sale would not contradict our determination that the decline was temporary because subsequent decisions to sell a security are made within the context of overall risk management, new information and the assessment of such security's value relative to comparable securities. While our internal and external investment managers may, at a given point in time, believe the preferred course of action is to hold securities until such losses are recovered, the dynamic nature of portfolio management may result in a subsequent decision by us to sell the security and realize the loss, based upon a change in market and other factors discussed above. We believe these subsequent decisions are consistent with the classification of our investment portfolio as "available for sale." See note 7, "Investment Information," of the notes accompanying our consolidated financial statements.

Under SFAS No. 133, "Accounting for Derivative Instruments and Hedging Activities" ("SFAS No. 133"), as amended on January 1, 2001, all derivative financial instruments, including embedded derivative instruments, are required to be recognized as either assets or liabilities in the consolidated balance sheets and measured at fair value. The accounting for gains and losses associated with changes in the fair value of a derivative and the effect on the consolidated financial statements depends on whether it has been designated and qualifies as part of a hedging relationship and whether the hedge is highly effective in achieving offsetting changes in the fair value of the asset or liability hedged.

Our investment strategy allows for the use of derivative instruments. We utilize various derivative instruments such as futures contracts to enhance investment performance, replicate investment positions or manage market exposures and duration risk that would be allowed under our investment guidelines if implemented in other ways. Pursuant to SFAS No. 133, these instruments, which have no hedging designation, are recognized as assets and liabilities in our balance sheet at fair value and changes in fair value are included in net realized gains and losses in our results of operations. See note 7, "Investment Information Investment-Related Derivatives," of the notes accompanying our consolidated financial statements for more information about our use of derivative instruments.

#### ***Share-Based Compensation***

On January 1, 2006, we adopted the fair value method of accounting for share-based awards using the modified prospective method of transition as described in Financial Accounting Standards Board ("FASB") Statement No. 123 (revised 2004), "Share-Based Payment" ("SFAS No. 123(R)"). Under SFAS No.123(R), the estimated grant date fair value adjusted for assumed forfeitures of share-based compensation related to stock option awards is recognized as compensation expense over the requisite service period of the grant. Under the fair value method of accounting pursuant to SFAS No. 123(R), the fair value of restricted share and unit awards is measured by the grant date price of our shares. No value is attributed to awards that employees forfeit because they fail to satisfy vesting conditions. As such, the number of shares granted is reduced by assumed forfeitures and adjusted based on actual forfeitures until vesting. Such expense is amortized over the requisite service period of the related awards. For awards granted to retirement-eligible employees where no service is required for the employee to retain the award, the grant date fair value is immediately recognized as compensation cost at the grant date because the employee is able to retain the award without continuing to provide service. For employees near retirement eligibility, attribution of compensation cost is over the period from the grant date to the retirement eligibility date. The share-based compensation expense associated with awards that have graded vesting features and vest based on service conditions only (i) granted after the effective date of adoption is calculated on a straight-line basis over the requisite service periods of the related awards and (ii) granted prior to the effective date of adoption and that remain unvested as of the date of adoption is calculated on a graded-vesting basis as prescribed under FASB Interpretation No. 28, "Accounting for Stock Appreciation Rights and Other Variable Stock Option or

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Award Plans an interpretation of APB Opinions No. 15 and 25," over the remaining requisite service periods of the related awards.

Under the modified prospective method of transition, compensation expense is recognized beginning with the effective date of adoption for all share-based payments (i) granted after the effective date of adoption and (ii) granted prior to the effective date of adoption and that remain unvested on the date of adoption. Under the modified prospective method of transition, we are not required to restate our prior period financial statements to reflect expensing of share-based compensation under SFAS No.123(R). Therefore, the results for 2007 and 2006 are not comparable to results for 2005 period.

Under SFAS No. 123(R), we use the Black-Scholes option pricing model to estimate the fair value of the share-based option awards as of the grant date. The Black-Scholes model, by its design, is highly complex, and requires judgment in determining key data inputs including estimating the risk free interest rate, expected life of the option and expected volatility rate. In addition, judgment is also required in estimating the amount of share-based awards that are expected to be forfeited. The primary data inputs with the greatest degree of judgment are the estimated lives of the share-based awards and the estimated volatility of our stock price. The Black-Scholes model is highly sensitive to changes in these two data inputs. In our process for estimating the fair value of stock options granted, we believe that we have made a good faith fair value estimate in accordance with the provisions of SFAS No. 123(R) as well as guidance from the SEC as contained in Staff Accounting Bulletin No. 107 in a way that is designed to take into account the assumptions that underlie the instrument's value that marketplace participants would reasonably make. If actual results differ significantly from these estimates, share-based compensation expense and our results of operations could be materially impacted.

See note 2(l), "Significant Accounting Policies Share-Based Compensation," of the notes accompanying our consolidated financial statements for more information about the adoption of SFAS No. 123(R).

### *Reclassifications*

We have reclassified the presentation of certain prior year information to conform to the current presentation. Such reclassifications had no effect on our net income, shareholders' equity or cash flows.

### *Recent Accounting Pronouncements*

See note 2(p), "Significant Accounting Policies Recent Accounting Pronouncements," of the notes accompanying our consolidated financial statements.

## Results of Operations

### *Comparison of Years Ended December 31, 2007 and 2006*

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

	Years Ended December 31,	
	2007	2006
(U.S. dollars in thousands, except share data)		
Net income available to common shareholders	\$ 832,099	\$ 692,559
Diluted net income per common share	\$ 11.28	\$ 9.08
Diluted weighted average common shares and common share equivalents outstanding	73,762,419	76,246,725

Net income available to common shareholders was \$832.1 million for 2007, compared to \$692.6 million for 2006. The improvement in our results of operations was primarily due to growth in

investment income and a low level of catastrophic activity, as discussed in "Segment Information" below. Our net income available to common shareholders for 2007 represented a 23.9% annualized return on average common equity, compared to 24.1% for 2006.

The decrease in diluted average shares outstanding from 2006 to 2007 was primarily due to the weighted impact of share repurchases during 2007, partially offset by increases in the dilutive effects of stock options and nonvested restricted stock calculated using the treasury stock method and the exercise of stock options. Under the treasury stock method, the dilutive impact of options and nonvested stock on diluted weighted average shares outstanding increases as the market price of our common shares increases.

**Segment Information**

We determined our reportable operating segments using the management approach described in SFAS No. 131 "Disclosures about Segments of an Enterprise and Related Information," as further detailed in note 3, "Segment Information," of the notes accompanying our consolidated financial statements. Management measures segment performance based on underwriting income or loss, which includes the excess or deficiency of net premiums earned for each reporting period over the combined total of expenses and losses incurred during the same period.

*Insurance Segment*

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

	Years Ended December 31,	
	2007	2006
<b>(U.S. dollars in thousands)</b>		
Gross premiums written	\$ 2,660,302	\$ 2,624,757
Net premiums written	1,717,548	1,652,056
Net premiums earned	\$ 1,702,343	\$ 1,600,854
Fee income	5,063	5,085
Losses and loss adjustment expenses	(1,077,769)	(1,017,263)
Acquisition expenses, net	(201,703)	(175,740)
Other operating expenses	(276,388)	(249,637)
Underwriting income	\$ 151,546	\$ 163,299
<b>Underwriting Ratios</b>		
Loss ratio	63.3%	63.5%
Acquisition expense ratio(1)	11.7%	10.8%
Other operating expense ratio	16.2%	15.6%
Combined ratio	91.2%	89.9%

(1)

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

*Underwriting Income.* The insurance segment's underwriting income was \$151.5 million for 2007, compared to \$163.3 million for 2006. The combined ratio for the insurance segment was 91.2% for 2007, compared to 89.9% for 2006. The components of the insurance segment's underwriting income are discussed below.

*Premiums Written.* Gross premiums written by the insurance segment were \$2.66 billion for 2007, compared to \$2.62 billion for 2006, and ceded premiums written were 35.4% of gross premiums written for 2007, compared to 37.1% for 2006. Net premiums written by the insurance segment were \$1.72 billion for 2007, compared to \$1.65 billion for 2006. Contributing to the higher level of net



premiums written in 2007 were increases in professional liability business, as a result of growth in policies written, a higher level of travel and accident business and a decrease in the usage of reinsurance, national accounts casualty business and excess workers' compensation and employers' liability business produced by Wexford (included in 'other'). During the 2007 fourth quarter, we completed the acquisition of the operations of Wexford, including the renewal rights of the subject business, through an asset purchase. This growth was partially offset by a continued reduction in U.S. primary casualty business and surety business in response to increasing competition and market conditions. For information regarding net premiums written by major line of business and geographic location, refer to note 3, "Segment Information," of the notes accompanying our consolidated financial statements.

*Net Premiums Earned.* Net premiums earned for the insurance segment were \$1.7 billion for 2007, compared to \$1.6 billion for 2006, and generally reflect changes in net premiums written over the previous five quarters, including the mix and type of business written.

*Losses and Loss Adjustment Expenses.* Insurance segment losses and loss adjustment expenses incurred for 2007 were \$1.08 billion, or 63.3% of net premiums earned, compared to \$1.02 billion, or 63.5% of net premiums earned, for 2006. The 2007 loss ratio reflected a 0.7 point reduction related to estimated net favorable development in prior year loss reserves, compared to a 0.5 point reduction in 2006. Prior to 2005, the insurance segment's reserving method relied heavily on industry data. In 2005, the insurance segment began to give a relatively small amount of weight to its own experience. As a result, the insurance segment reduced loss selections for some lines, in particular those written on a claims-made basis and for which it now believes it has a reasonable level of credible data. The insurance segment's net favorable development in 2007 and 2006 was primarily due to reductions in reserves in medium-tailed and long-tailed lines of business resulting from such changes, partially offset by adverse development of \$33.3 million from short-tail lines which primarily resulted from higher than expected claims development. The net favorable development was partially offset by an increase in acquisition expenses of \$9.5 million, primarily due to sliding scale arrangements on certain policies..

For a discussion of the reserves for losses and loss adjustment expenses, please refer to the section above entitled "Critical Accounting Policies, Estimates and Recent Accounting Pronouncements Reserves for Losses and Loss Adjustment Expenses."

*Underwriting Expenses.* The underwriting expense ratio for the insurance segment was 27.9% in 2007, compared to 26.4% for 2006. The acquisition expense ratio is influenced by, among other things, (1) the amount of ceding commissions received from unaffiliated reinsurers, (2) the amount of business written on a surplus lines (non-admitted) basis and (3) mix of business. The acquisition expense ratio was 11.7% for 2007, compared to 10.8% for 2006. The acquisition expense ratio in 2007 reflects changes in the form of reinsurance ceded and the mix of business and also included 0.5 points related to favorable prior year loss development, while the 2006 period included a decrease in surety profit commissions which increased the 2006 acquisition expense ratio by 0.5 points. The insurance segment's other operating expense ratio was 16.2% for 2007, compared to 15.6% for 2006. The higher operating expense ratio in 2007 compared to 2006 was primarily due to growth in compensation-related expenses without an attendant growth in net premiums earned.

*Reinsurance Segment*

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

	Years Ended December 31,	
	2007	2006
<b>(U.S. dollars in thousands)</b>		
Gross premiums written	\$ 1,517,645	\$ 1,703,796
Net premiums written	1,184,388	1,365,362
Net premiums earned	\$ 1,242,307	\$ 1,480,811
Fee income	2,473	4,729
Losses and loss adjustment expenses	(566,401)	(773,286)
Acquisition expenses, net	(278,828)	(368,171)
Other operating expenses	(81,059)	(53,533)
Underwriting income	\$ 318,492	\$ 290,550
<b>Underwriting Ratios</b>		
Loss ratio	45.6%	52.2%
Acquisition expense ratio	22.4%	24.9%
Other operating expense ratio	6.5%	3.6%
Combined ratio	74.5%	80.7%

*Underwriting Income.* The reinsurance segment's underwriting income was \$318.5 million for 2007, compared to \$290.6 million for 2006. The combined ratio for the reinsurance segment was 74.5% for 2007, compared to 80.7% for 2006. The components of the reinsurance segment's underwriting income are discussed below.

*Premiums Written.* Gross premiums written by the reinsurance segment were \$1.52 billion in 2007, compared to \$1.7 billion for 2006. Gross premiums written for 2007 reflects a lower level of casualty, other specialty and non-catastrophe exposed property business which was in response to continued competition and resulted in either non-renewals or lower shares written by the reinsurance segment. Such reductions were partially offset by continued growth in international property and marine lines, due to higher rates and an increase in exposure. Catastrophe-exposed property and marine lines have continued to provide attractive opportunities in the wake of the 2005 storms.

Ceded premiums written by the reinsurance segment were 22.0% of gross premiums written for 2007, compared to 19.9% for 2006. The higher ceded percentage in 2007 primarily resulted from the \$311.3 million of premiums written ceded by Arch Re Bermuda to Flatiron Re Ltd. (\$282.2 million on an earned basis), compared to \$273.2 million in 2006 (\$157.4 million on an earned basis). At December 31, 2007, \$144.9 million of premiums ceded to Flatiron Re Ltd. were unearned. The attendant premiums earned, losses incurred and acquisition expenses will primarily be reflected in the reinsurance segment's results in the first half of 2008.

Net premiums written by the reinsurance segment were \$1.18 billion for 2007, compared to \$1.37 billion for 2006. Net premiums written for 2007 reflects the lower level of international casualty business noted above, which more than offset growth in international property and marine lines, net of the amounts ceded to Flatiron Re Ltd. For information regarding net premiums written by major line and type of business and geographic location, refer to note 3, "Segment Information," of the notes accompanying our consolidated financial statements.

*Net Premiums Earned.* Net premiums earned for our reinsurance segment were \$1.24 billion for 2007, compared to \$1.48 billion for 2006, and generally reflect changes in net premiums written over the previous five quarters, including the mix and type of business written.



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*Losses and Loss Adjustment Expenses.* Reinsurance segment losses and loss adjustment expenses incurred for 2007 were \$566.4 million, or 45.6% of net premiums earned, compared to \$773.3 million, or 52.2% of net premiums earned, for 2006. The 2007 loss ratio reflected a 13.9 point reduction related to estimated net favorable development in prior year loss reserves, compared to a 4.6 point reduction in 2006. Of the 2007 net favorable development in the reinsurance segment, a significant portion came from short-tail lines and resulted from better than anticipated loss emergence. In addition, the reinsurance segment's 2007 results included approximately 4.3 points related to 2007 catastrophe losses, while the 2006 results included 3.1 points related to 2006 catastrophe losses. The reinsurance segment's 2007 loss ratio also reflects an increase in expected loss ratios across a number of lines of business, primarily due to premium rate decreases and loss cost trends, and changes in the mix of business.

In its reserving process in 2002 and 2003, the reinsurance segment recognized that there is a possibility that the assumptions made could prove to be inaccurate due to several factors primarily related to the start up nature of its operations. Due to the availability of additional data, and based on reserve analyses, it was determined that it was no longer necessary to continue to include such factors in the reserving process in 2004. Following reserve reviews, and based on the level of claims activity reported to date, the reinsurance segment has reduced the amount it had recorded in 2002 and 2003 by \$10.6 million in 2007 and \$7.7 million in 2006. Such amounts are reflected in the prior year development indicated above.

The net favorable development on prior year loss reserves in both periods was partially offset by increased acquisition expenses, primarily as a result of the commutation of certain treaties. Such activity resulted in an increase to the acquisition expense ratio of approximately 1.5 points in 2007, compared to 0.5 points in 2006. The remainder of the change in the loss ratio for 2007, compared to 2006, resulted from better results recorded in the reinsurance segment's property lines of business and changes in their mix of business.

For a discussion of the reserves for losses and loss adjustment expenses, please refer to the section above entitled "Critical Accounting Policies, Estimates and Recent Accounting Pronouncements Reserves for Losses and Loss Adjustment Expenses."

*Underwriting Expenses.* The underwriting expense ratio for the reinsurance segment was 28.9% for 2007, compared to 28.5% for 2006. The acquisition expense ratio for 2007 was 22.4%, compared to 24.9% for 2006. The acquisition expense ratio is influenced by, among other things, the mix and type of business written and earned and the level of ceding commission income. The acquisition expense ratio for 2007 included 1.5 points related to favorable prior year loss development, compared to 0.5 points in 2006. In addition, the reinsurance segment's results included commission income (in excess of the reimbursement of direct acquisition expenses) on the quota-share reinsurance treaty with Flatiron Re Ltd., which reduced the acquisition expense ratio by 3.1 points in 2007, compared to 1.6 points in 2006. The reinsurance segment's other operating expense ratio was 6.5% for 2007, compared to 3.6% for 2006. The higher ratio in 2007 primarily resulted from expenses related to the reinsurance segment's property facultative reinsurance operation, which commenced operations during the 2007 second quarter, and a lower level of net premiums earned.

### ***Net Investment Income***

Net investment income was \$463.1 million for 2007, compared to \$380.2 million for 2006. The increase in net investment income in 2007 resulted from a higher level of average invested assets primarily generated by cash flows from operations. In addition, an increase in the pre-tax investment income yield to 4.88% for 2007 from 4.71% for 2006 contributed to the growth in net investment income. These yields were calculated based on amortized cost. The increase in the pre-tax investment yield primarily resulted from higher interest rates embedded in the investment portfolio as the portfolio's average credit quality remained near the AAA level and the effective duration only

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increased marginally. Yields on future investment income may vary based on financial market conditions, investment allocation decisions and other factors.

### *Net Realized Gains or Losses*

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

(U.S. dollars in thousands)	Years Ended December 31,	
	2007	2006
Fixed maturities	\$ 38,611	(\$ 27,379)
Other investments	847	4,186
Other	(11,317)	3,756
Total	\$ 28,141	(\$ 19,437)

Total return on our portfolio under management for 2007 was 6.52%, compared to 5.24% for 2006. Total return is calculated on a pre-tax basis and before investment expenses. The higher total return in 2007 compared to 2006 was primarily due to movements in interest rates and foreign exchange rates during the periods. For 2007, net realized gains on our fixed maturities of \$38.6 million included a provision of \$28.1 million for declines in the fair value of investments held in our available for sale portfolio which were considered to be other-than-temporary, based on reviews performed during 2007. For 2006, net realized losses on our fixed maturities of \$27.4 million included a provision of \$31.6 million for declines in the fair value of investments held in our available for sale portfolio which were considered to be other-than-temporary, based on reviews performed during 2006. In periods subsequent to the recognition of an other-than-temporary impairment on fixed maturities, we account for such securities as if they had been purchased on the measurement date of the other-than-temporary impairment and the provision for the other-than-temporary impairment (reflected as a discount or reduced premium based on the new cost basis) is amortized into net investment income over the remaining life of the fixed maturities, or until such securities are sold. The declines in fair value on such securities were primarily due to the prevailing interest rate, credit and foreign exchange environments. The balance of net realized gains on our fixed maturities in 2007 and 2006 resulted from the sale of securities. For the 2007 and 2006 periods, net realized gains or losses from the sale of fixed maturities primarily resulted from our decisions to reduce credit exposure, changes in duration targets, relative value determinations and sales related to rebalancing the portfolio.

### *Other Expenses*

Other expenses, which are included in our other operating expenses and part of our corporate and other segment (non-underwriting), were \$30.7 million for 2007, compared to \$29.1 million for 2006. Such amounts primarily represent certain holding company costs necessary to support our worldwide insurance and reinsurance operations, share based compensation expense and costs associated with operating as a publicly traded company.

As required by the provisions of SFAS 123(R), we recorded pre-tax share-based compensation expense related to stock options of \$9.0 million in 2007, compared to \$9.2 million in 2006. See note 13, "Share Capital," of the notes accompanying our consolidated financial statements and "Critical Accounting Policies, Estimates and Recent Accounting Policies Share-Based Compensation" for more information about the adoption of SFAS No. 123(R).

### *Net Foreign Exchange Gains or Losses*

Net foreign exchange losses for 2007 of \$44.0 million consisted of net unrealized losses of \$48.8 million and net realized gains of \$4.8 million, compared to net foreign exchange losses of

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\$23.9 million for 2006, which consisted of net unrealized losses of \$27.3 million and net realized gains of \$3.4 million. For the 2007 and 2006 periods, the net unrealized foreign exchange gains or losses recorded were largely offset by changes in the value of our investments held in foreign currencies. Net unrealized foreign exchange gains or losses result from the effects of revaluing our net insurance liabilities required to be settled in foreign currencies at each balance sheet date. The net foreign exchange losses in 2007 and 2006 primarily resulted from a weakening of the U.S. Dollar. We hold investments in foreign currencies which are intended to mitigate its exposure to foreign currency fluctuations in its net insurance liabilities. However, changes in the value of such investments due to foreign currency rate movements are reflected as a direct increase or decrease to shareholders' equity and are not included in the statement of income. For the 2007 and 2006 periods, the net unrealized foreign exchange gains or losses recorded by us were largely offset by changes in the value of our investments held in foreign currencies.

### *Income Taxes*

ACGL changed its legal domicile from the United States to Bermuda in November 2000. Under current Bermuda law, we are not obligated to pay any taxes in Bermuda based upon income or capital gains. We have received a written undertaking from the Minister of Finance in Bermuda under the Exempted Undertakings Tax Protection Act of 1966 that in the event legislation is enacted in Bermuda imposing tax computed on profits, income, gain or appreciation on any capital asset, or tax in the nature of estate duty or inheritance tax, such tax will not be applicable to us or our operations until March 28, 2016.

ACGL will be subject to U.S. federal income tax only to the extent that it derives 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. ACGL will be subject to a withholding tax on dividends from U.S. investments and interest from certain U.S. taxpayers. ACGL does not consider itself to be engaged in a trade or business within the U.S. and, consequently, does not expect to be subject to direct U.S. income taxation. 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. See "Risk Factors Risks Relating to Taxation" and "Business Tax Matters."

The income tax provision on income before income taxes resulted in an effective tax rate of 1.8% for 2007, compared to 3.6% for 2006. Our effective tax rate fluctuates from year to year consistent with the relative mix of income reported by jurisdiction due primarily to the varying tax rates in each jurisdiction. A significant portion of our catastrophe-exposed property business is written by a Bermuda-based subsidiary. As a result, on a relative basis, our effective tax rate is likely to be favorably affected in periods that have a low level of catastrophic losses incurred and adversely impacted in periods with significant catastrophic claims activity. We currently estimate that our comparable income tax provision in 2008 will result in an effective tax rate of approximately 2.0% to 4.0%, although no assurances can be given to that effect. See note 9, "Income Taxes," of the notes accompanying our consolidated financial statements for a reconciliation of the difference between the provision for income taxes and the expected tax provision at the weighted average statutory tax rate for 2007, 2006 and 2005, along with a description of net operating loss carryforwards and other tax items.

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*Comparison of Years Ended December 31, 2006 and 2005*

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

	Years Ended December 31,	
	2006	2005
<b>(U.S. dollars in thousands, except share data)</b>		
Net income available to common shareholders	\$ 692,559	\$ 256,486
Diluted net income per common share	\$ 9.08	\$ 3.43
Diluted weighted average common shares and common share equivalents outstanding	76,246,725	74,709,858

Net income available to common shareholders was \$692.6 million for 2006, compared to \$256.5 million for 2005. The improvement in our results of operations was primarily due to a lower level of catastrophic activity in 2006, as discussed in " Segment Information" below, and growth in investment income. Our net income available to common shareholders for 2006 represented a 24.1% annualized return on average common equity, compared to 10.9% for 2005.

The increase in diluted average shares outstanding from 2005 to 2006 was due, in part, to increases in the dilutive effects of stock options and nonvested restricted stock calculated using the treasury stock method and the exercise of stock options. Under the treasury stock method, the dilutive impact of options and nonvested stock on diluted weighted average shares outstanding increases as the market price of our common shares increases.

**Segment Information**

*Insurance Segment*

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

	Years Ended December 31,	
	2006	2005
<b>(U.S. dollars in thousands)</b>		
Gross premiums written	\$ 2,624,757	\$ 2,325,632
Net premiums written	1,652,056	1,481,300
Net premiums earned	\$ 1,600,854	\$ 1,392,114
Fee income	5,085	5,332
Losses and loss adjustment expenses	(1,017,263)	(949,996)
Acquisition expenses, net	(175,740)	(137,804)
Other operating expenses	(249,637)	(221,934)
Underwriting income	\$ 163,299	\$ 87,712
<b>Underwriting Ratios</b>		
Loss ratio	63.5%	68.2%
Acquisition expense ratio(1)	10.8%	9.7%
Other operating expense ratio	15.6%	15.9%
Combined ratio	89.9%	93.8%

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(1)

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

*Underwriting Income.* The insurance segment's underwriting income was \$163.3 million for 2006, compared to \$87.7 million for 2005. The combined ratio for the insurance segment was 89.9% for 2006,

compared to 93.8% for 2005. The components of the insurance segment's underwriting income are discussed below.

*Premiums Written.* Gross premiums written by the insurance segment were \$2.62 billion for 2006, compared to \$2.33 billion for 2005, and ceded premiums written were 37.1% of gross premiums written for 2006, compared to 36.3% for 2005. Net premiums written by the insurance segment were \$1.65 billion for 2006, compared to \$1.48 billion for 2005. Roughly half of the increase was in worldwide property business, primarily as a result of rate increases which were tempered by higher reinsurance costs. The balance of the growth was generated from increases in professional liability business, as a result of growth in policies written and a decrease in the usage of reinsurance in 2006 business, construction business, primarily due to growth in large deductible construction accounts, surety business, and in executive assurance business. This growth was partially offset by a reduction in U.S. primary casualty business in response to increasing competition. For information regarding net premiums written by major line of business and geographic location, refer to note 3, "Segment Information," of the notes accompanying our consolidated financial statements.

*Net Premiums Earned.* Net premiums earned for the insurance segment were \$1.6 billion for 2006, compared to \$1.39 billion for 2005, and generally reflect changes in net premiums written over the previous five quarters, including the mix and type of business written.

*Losses and Loss Adjustment Expenses.* Insurance segment losses and loss adjustment expenses incurred for 2006 were \$1.02 billion, or 63.5% of net premiums earned, compared to \$950.0 million, or 68.2% of net premiums earned, for 2005. The insurance segment's results for 2006 included several large individual risk losses in the 2006 fourth quarter totaling \$36.6 million, or 2.3 points, while 2005 included \$119.8 million, or 8.6 points, related to Hurricanes Dennis, Emily, Katrina, Rita and Wilma and the European Floods. In addition, the 2006 loss ratio reflected a 0.5 point reduction related to estimated net favorable development in prior year loss reserves, compared to a 2.0 point reduction in 2005. Prior to 2005, the insurance segment's reserving method relied heavily on industry data. In 2005, the insurance segment began to give a relatively small amount of weight to its own experience. As a result, the insurance segment reduced loss selections for some lines, in particular those written on a claims-made basis and for which it now believes it has a reasonable level of credible data. The insurance segment's net favorable development in 2006 and 2005 was primarily due to reductions in reserves in medium-tailed and long-tailed lines of business resulting from such changes, partially offset by adverse development from short-tail lines which was primarily resulted from development on the 2005 catastrophic events.

For a discussion of the reserves for losses and loss adjustment expenses, please refer to the section above entitled "Critical Accounting Policies, Estimates and Recent Accounting Pronouncements Reserves for Losses and Loss Adjustment Expenses."

*Underwriting Expenses.* The underwriting expense ratio for the insurance segment was 26.4% in 2006, compared to 25.6% for 2005. The acquisition expense ratio was 10.8% for 2006, compared to 9.7% for 2005. As a result of the large individual risk losses noted above, the insurance segment reduced profit commissions that it had recorded previously by \$7.7 million, or 0.5 points of the acquisition expense ratio. The remainder of the increase in the acquisition expense ratio was primarily due to changes in the mix of business. The insurance segment's other operating expense ratio was 15.6% for 2006, compared to 15.9% for 2005.

*Reinsurance Segment*

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

	Years Ended December 31,	
	2006	2005
<b>(U.S. dollars in thousands)</b>		
Gross premiums written	\$ 1,703,796	\$ 1,750,839
Net premiums written	1,365,362	1,657,472
Net premiums earned	\$ 1,480,811	\$ 1,585,602
Fee income	4,729	5,035
Losses and loss adjustment expenses	(773,286)	(1,051,953)
Acquisition expenses, net	(368,171)	(442,116)
Other operating expenses	(53,533)	(52,192)
Underwriting income	\$ 290,550	\$ 44,376
<b>Underwriting Ratios</b>		
Loss ratio	52.2%	66.3%
Acquisition expense ratio	24.9%	27.9%
Other operating expense ratio	3.6%	3.3%
Combined ratio	80.7%	97.5%

*Underwriting Income.* The reinsurance segment's underwriting income was \$290.6 million for 2006, compared to \$44.4 million for 2005. The combined ratio for the reinsurance segment was 80.7% for 2006, compared to 97.5% for 2005. The components of the reinsurance segment's underwriting income are discussed below.

*Premiums Written.* Gross premiums written by the reinsurance segment were \$1.7 billion in 2006, compared to \$1.75 billion for 2005. Gross premiums written for 2006 reflects a lower level of international casualty business in response to actual and anticipated market conditions, partially offset by growth in international property and marine lines, due to higher rates and an increase in exposure. Catastrophe-exposed property and marine lines have continued to provide attractive opportunities in the wake of the 2005 storms. As a result of the significant catastrophic activity in 2005 and the impact of such events on the insurance market, the reinsurance segment was able to write certain property (both catastrophe and non-catastrophe) and marine business in the 2005 fourth quarter, which resulted in approximately \$109.2 million of gross premiums written (\$100.2 million on a net basis). Such business did not contribute to the reinsurance segment's 2006 premiums written.

Ceded premiums written by the reinsurance segment were 19.9% of gross premiums written for 2006, compared to 5.3% for 2005. The higher ceded percentage in 2006 primarily resulted from the \$273.2 million of premiums written ceded by Arch Re Bermuda to Flatiron Re Ltd. (\$157.4 million on an earned basis) under a quota-share reinsurance treaty, as previously disclosed.

Net premiums written by the reinsurance segment were \$1.37 billion for 2006, compared to \$1.66 billion for 2005. Net premiums written for 2006 reflects the lower level of international casualty business noted above, which more than offset growth in international property and marine lines, net of the amounts ceded to Flatiron Re Ltd. In addition, net premiums written in 2005 included \$100.2 million of non-recurring business, as noted above. For information regarding net premiums written by major line and type of business and geographic location, refer to note 3, "Segment Information," of the notes accompanying our consolidated financial statements.

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*Net Premiums Earned.* Net premiums earned for our reinsurance segment were \$1.48 billion for 2006, compared to \$1.59 billion for 2005, and generally reflect changes in net premiums written over the previous five quarters, including the mix and type of business written.

*Fee Income.* The reinsurance segment recorded \$4.7 million of fee income for 2006, compared to \$5.0 million for 2005. The 2006 amount related to certain assumed reinsurance contracts which were deemed, under GAAP, not to transfer insurance risk, and are accounted for using the deposit method of accounting. Of the 2005 amount, \$4.5 million related to an industry loss warranty contract. Under this contract, we received payment when industry-wide losses from certain natural perils exceeded a specified amount.

*Losses and Loss Adjustment Expenses.* Reinsurance segment losses and loss adjustment expenses incurred for 2006 were \$773.3 million, or 52.2% of net premiums earned, compared to \$1.05 billion, or 66.3% of net premiums earned, for 2005. The reinsurance segment's 2006 results included approximately \$45.9 million, or 3.1 points, related to 2006 catastrophe losses, while the 2005 results included \$208.5 million, or 13.1 points, related to Hurricanes Dennis, Emily, Katrina, Rita and Wilma and the European Floods and \$24.0 million, or 1.5 points, of other catastrophe losses. In addition, the 2006 loss ratio reflected a 4.6 point reduction related to estimated net favorable development in prior year loss reserves, compared to a 5.8 point reduction in 2005.

In its reserving process in 2002 and 2003, the reinsurance segment recognized that there is a possibility that the assumptions made could prove to be inaccurate due to several factors primarily related to the start up nature of its operations. Due to the availability of additional data, and based on reserve analyses, it was determined that it was no longer necessary to continue to include such factors in the reserving process in 2004. Following reserve reviews, and based on the level of claims activity reported to date, the reinsurance segment has reduced the amount it had recorded in 2002 and 2003 by \$7.7 million in 2006 and \$12.1 million in 2005. Such amounts are reflected in the prior year development shown above.

The net favorable development on prior year loss reserves in both periods was partially offset by increased acquisition expenses, primarily as a result of the commutation of certain treaties. Such activity resulted in an increase to the acquisition expense ratio of approximately 0.5 points in 2006, compared to 0.6 points in 2005. The remainder of the change in the loss ratio for 2006, compared to 2005, resulted from better results recorded in the reinsurance segment's property lines of business and changes in their mix of business.

For a discussion of the reserves for losses and loss adjustment expenses, please refer to the section above entitled "Critical Accounting Policies, Estimates and Recent Accounting Pronouncements Reserves for Losses and Loss Adjustment Expenses."

*Underwriting Expenses.* The underwriting expense ratio for the reinsurance segment was 28.5% for 2006, compared to 31.2% for 2005. The acquisition expense ratio for 2006 was 24.9%, compared to 27.9% for 2005. The reinsurance segment's 2006 results included commission income (in excess of the reimbursement of direct acquisition expenses) on the quota-share reinsurance treaty with Flatiron Re Ltd., which reduced the acquisition expense ratio by 1.6 points in 2006. The 2005 results included \$13.3 million of assessments incurred as a result of the 2005 hurricane activity, which added 0.8 points to the 2005 acquisition expense ratio. The reinsurance segment's other operating expense ratio was 3.6% for 2006, compared to 3.3% for 2005.

### ***Net Investment Income***

Net investment income was \$380.2 million for 2006, compared to \$232.9 million for 2005. The increase in net investment income in 2006 resulted from a higher level of average invested assets primarily generated by cash flows from operations. In addition, an increase in the pre-tax investment



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income yield to 4.71% for 2006 from 3.68% for 2005 contributed to the growth in net investment income. These yields were calculated based on amortized cost. Yields on future investment income may vary based on financial market conditions, investment allocation decisions and other factors.

### *Net Realized Gains or Losses*

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

(U.S. dollars in thousands)	Years Ended December 31,	
	2006	2005
Fixed maturities	(\$ 27,379)	(\$ 56,770)
Other investments	4,186	1,016
Other	3,756	2,298
Total	(\$ 19,437)	(\$ 53,456)

Total return on our portfolio under management for 2006 was 5.24%, compared to 2.09% for 2005. Total return is calculated on a pre-tax basis and before investment expenses. The higher total return in 2006 compared to 2005 was primarily due to movements in interest rates during the periods. The increase in interest rates in 2005 was greater than the increase in 2006 and resulted in a lower relative return compared to 2006. For 2006, net realized losses on our fixed maturities of \$27.4 million included a provision of \$31.6 million for declines in the fair value of investments held in our available for sale portfolio which were considered to be other-than-temporary, based on a review performed during 2006. For 2005, net realized losses on our fixed maturities of \$56.8 million included a provision of \$25.7 million for declines in the fair value of investments held in our available for sale portfolio which were considered to be other-than-temporary, based on a review performed during 2005. In periods subsequent to the recognition of an other-than-temporary impairment on fixed maturities, we account for such securities as if they had been purchased on the measurement date of the other-than-temporary impairment and the provision for the other-than-temporary impairment (reflected as a discount or reduced premium based on the new cost basis) is amortized into net investment income over the remaining life of the fixed maturities, or until such securities are sold. The declines in fair value on such securities were primarily due to the current interest rate environment. The balance of \$4.2 million in net realized gains on our fixed maturities in 2006 resulted from the sale of securities, compared to net realized losses from the sale of fixed maturities of \$31.1 million for 2005. For the 2006 and 2005 periods, net realized gains or losses from the sale of fixed maturities resulted from our decisions to reduce credit exposure, changes in duration targets, relative value determinations and sales related to rebalancing the portfolio.

### *Other Expenses*

Other expenses, which are included in our other operating expenses and part of our corporate and other segment (non-underwriting), were \$29.1 million for 2006, compared to \$25.8 million for 2005. Such amounts primarily represent certain holding company costs necessary to support our worldwide insurance and reinsurance operations, share based compensation expense and costs associated with operating as a publicly traded company. Other expenses for 2005 included approximately \$1.9 million of costs related to an agreement entered into with Robert Clements, former Chairman of our board of directors, and approximately \$4.9 million of costs related to an agreement entered into with Dwight Evans, former Chairman and Chief Executive Officer of Arch Worldwide Reinsurance Group. See note 10, "Transactions with Related Parties," of the notes accompanying our consolidated financial statements.

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As required by the provisions of SFAS 123(R), we recorded pre-tax share-based compensation expense related to stock options of \$9.2 million in 2006. Under the modified prospective method of transition, no expense related to stock options was recorded in 2005. Therefore, results for 2006 are not comparable to 2005. See note 13, "Share Capital," of the notes accompanying our consolidated financial statements and "Critical Accounting Policies, Estimates and Recent Accounting Policies Share-Based Compensation" for more information about the adoption of SFAS No. 123(R).

### ***Interest Expense***

Interest expense was \$22.1 million for 2006, compared to \$22.5 million for 2005. Such amounts primarily relate to the \$300 million in 7.35% senior notes outstanding in both periods.

### ***Net Foreign Exchange Gains or Losses***

Net foreign exchange losses for 2006 of \$23.9 million consisted of net unrealized losses of \$27.3 million and net realized gains of \$3.4 million, compared to net foreign exchange gains of \$22.2 million for 2005, which consisted of net unrealized gains of \$23.3 million and net realized losses of \$1.1 million. For the 2006 and 2005 periods, the net unrealized foreign exchange gains or losses recorded were largely offset by changes in the value of our investments held in foreign currencies.

### ***Income Taxes***

The income tax provision on income before income taxes resulted in an effective tax rate of 3.6% for 2006, compared to 10.1% for 2005. Our effective tax rate fluctuates from year to year consistent with the relative mix of income reported by jurisdiction due primarily to the varying tax rates in each jurisdiction. A significant portion of our catastrophe-exposed property business is written by a Bermuda-based subsidiary. As a result, on a relative basis, our effective tax rate is likely to be favorably affected in periods that have a low level of catastrophic losses incurred and adversely impacted in periods with significant catastrophic claims activity.

### **Liquidity and Capital Resources**

ACGL is a holding company whose assets primarily consist of the shares in its subsidiaries. Generally, ACGL depends on its available cash resources, liquid investments and dividends or other distributions from its subsidiaries to make payments, including the payment of debt service obligations and operating expenses it may incur and any dividends or liquidation amounts with respect to the series A non-cumulative and series B non-cumulative preferred shares and common shares.

On a consolidated basis, our aggregate cash and invested assets totaled \$10.13 billion at December 31, 2007, compared to \$9.32 billion at December 31, 2006. ACGL's readily available cash, short-term investments and marketable securities, excluding amounts held by our regulated insurance and reinsurance subsidiaries, totaled \$36.3 million at December 31, 2007, compared to \$14.2 million at December 31, 2006. For 2007, 2006 and 2005, ACGL received dividends of \$602.1 million, \$22.1 million and \$22.1 million from Arch Re Bermuda which were used to fund the share repurchase program described below along with the payment of preferred dividends, interest expense and other corporate expenses.

The ability of our regulated insurance and reinsurance subsidiaries to pay dividends or make distributions or other payments to us is dependent on their ability to meet applicable regulatory standards. Under Bermuda law, Arch Re Bermuda is required to maintain a minimum solvency margin (*i.e.*, the amount by which the value of its general business assets must exceed its general business liabilities) equal to the greatest of (1) \$100 million, (2) 50% of net premiums written (being gross premiums written by us less any premiums ceded by us, but we may not deduct more than 25% of gross premiums when computing net premiums written) and (3) 15% of loss and other insurance

reserves. Arch Re Bermuda is prohibited from declaring or paying any dividends during any financial year if it is not in compliance with its minimum solvency margin or minimum liquidity ratio. In addition, Arch Re Bermuda is prohibited from declaring or paying in any financial year dividends of more than 25% of its total statutory capital and surplus (as shown on its previous financial year's statutory balance sheet) unless it files, at least seven days before payment of such dividends, with the Bermuda Monetary Authority an affidavit stating that it will continue to meet the required margins. In addition, Arch Re Bermuda is prohibited, without prior approval of the Bermuda Monetary Authority, from reducing by 15% or more its total statutory capital, as set out in its previous year's statutory financial statements. At December 31, 2007, as determined under Bermuda law, Arch Re Bermuda had statutory capital of \$2.0 billion and statutory capital and surplus of \$3.73 billion. Such amounts include ownership interests in U.S. insurance and reinsurance subsidiaries. Accordingly, Arch Re Bermuda can pay approximately \$933 million to ACGL during 2008 without providing an affidavit to the Bermuda Monetary Authority, as discussed above. Our U.S. insurance and reinsurance subsidiaries can pay approximately \$113.9 million in dividends or distributions to Arch-U.S., our U.S. holding company, which is owned by Arch Re Bermuda, during 2008 without prior regulatory approval. Such dividends or distributions may be subject to applicable withholding or other taxes. Arch-Europe can pay approximately £8.4 million, or \$16.7 million, in dividends to ACGL during 2008 without prior notice and approval by the FSA. In addition, the ability of our insurance and reinsurance subsidiaries to pay dividends is also constrained by our dependence on the financial strength ratings of our insurance and reinsurance subsidiaries from independent rating agencies. The ratings from these agencies depend to a large extent on the capitalization levels of our insurance and reinsurance subsidiaries. We believe that ACGL has sufficient cash resources and available dividend capacity to service its indebtedness and other current outstanding obligations.

Our insurance and reinsurance subsidiaries are required to maintain assets on deposit, which primarily consist of fixed maturities, with various regulatory authorities to support their operations. The assets on deposit are available to settle insurance and reinsurance liabilities to third parties. Our insurance and reinsurance subsidiaries also have investments in segregated portfolios primarily to provide collateral or guarantees for letters of credit to third parties. At December 31, 2007 and 2006, such amounts approximated \$1.17 billion and \$1.16 billion, respectively. In addition, certain of our operating subsidiaries maintain assets in trust accounts as collateral for insurance and reinsurance transactions with affiliated companies. At December 31, 2007 and 2006, such amounts approximated \$3.8 billion and \$3.61 billion, respectively.

ACGL, through its subsidiaries, provides financial support to certain of its insurance subsidiaries and affiliates, through certain reinsurance arrangements essential to the ratings of such subsidiaries. Except as described in the preceding sentence, or where express reinsurance, guarantee or other financial support contractual arrangements are in place, each of ACGL's subsidiaries or affiliates is solely responsible for its own liabilities and commitments (and no other ACGL subsidiary or affiliate is so responsible). Any reinsurance arrangements, guarantees or other financial support contractual arrangements that are in place are solely for the benefit of the ACGL subsidiary or affiliate involved and third parties (creditors or insureds of such entity) are not express beneficiaries of such arrangements.

Our insurance and reinsurance operations provide liquidity in that premiums are received in advance, sometimes substantially in advance, of the time losses are paid. The period of time from the occurrence of a claim through the settlement of the liability may extend many years into the future. Sources of liquidity include cash flows from operations, financing arrangements or routine sales of investments.

As part of our investment strategy, we seek to establish a level of cash and highly liquid short-term and intermediate-term securities which, combined with expected cash flow, is believed by us to be adequate to meet our foreseeable payment obligations. However, due to the nature of our operations,

cash flows are affected by claim payments that may comprise large payments on a limited number of claims and which can fluctuate from year to year. We believe that our liquid investments and cash flow will provide us with sufficient liquidity in order to meet our claim payment obligations. However, the timing and amounts of actual claim payments related to recorded Loss Reserves vary based on many factors, including large individual losses, changes in the legal environment, as well as general market conditions. The ultimate amount of the claim payments could differ materially from our estimated amounts. Certain lines of business written by us, such as excess casualty, have loss experience characterized as low frequency and high severity. The foregoing may result in significant variability in loss payment patterns. The impact of this variability can be exacerbated by the fact that the timing of the receipt of reinsurance recoverables owed to us may be slower than anticipated by us. Therefore, the irregular timing of claim payments can create significant variations in cash flows from operations between periods and may require us to utilize other sources of liquidity to make these payments, which may include the sale of investments or utilization of existing or new credit facilities or capital market transactions. If the source of liquidity is the sale of investments, we may be forced to sell such investments at a loss, which may be material.

Consolidated cash provided by operating activities was \$1.44 billion for 2007, compared to \$1.61 billion for 2006. The lower level of operating cash flows for 2007 primarily resulted from an increase in paid losses as our insurance and reinsurance loss reserves continue to mature, along with a lower level of premiums written and collected. Cash flow from operating activities are provided by premiums collected, fee income, investment income and collected reinsurance recoverables, offset by losses and loss adjustment expense payments, reinsurance premiums paid, operating costs and current taxes paid.

We expect that our operational needs, including our anticipated insurance obligations and operating and capital expenditure needs, for the next twelve months, at a minimum, will be met by our balance of cash, short-term investments and our credit facilities, as well as by funds generated from underwriting activities and investment income and proceeds on the sale or maturity of our investments. See " Contractual Obligations and Commercial Commitments Contractual Obligations" for an analysis of our contractual commitments at December 31, 2007.

We monitor our capital adequacy on a regular basis and will seek to adjust our capital base (up or down) according to the needs of our business. The future capital requirements of our business will depend on many factors, including our ability to write new business successfully and to establish premium rates and reserves at levels sufficient to cover losses. Our ability to underwrite is largely dependent upon the quality of our claims paying and financial strength ratings as evaluated by independent rating agencies. In particular, we require (1) sufficient capital to maintain our financial strength ratings, as issued by several ratings agencies, at a level considered necessary by management to enable our key operating subsidiaries to compete; (2) sufficient capital to enable our underwriting subsidiaries to meet the capital adequacy tests performed by statutory agencies in the U.S. and other key markets; and (3) letters of credit and other forms of collateral that are necessary for our non-U.S. operating companies because they are "non-admitted" under U.S. state insurance regulations.

As part of our capital management program, we may seek to raise additional capital or may seek to return capital to our shareholders through share repurchases, cash dividends or other methods (or a combination of such methods). Any such determination will be at the discretion of our board of directors and will be dependent upon our profits, financial requirements and other factors, including legal restrictions, rating agency requirements and such other factors as our board of directors deems relevant.

On February 28, 2007, our Board of Directors authorized us to invest up to \$1 billion in ACGL's common shares through a share repurchase program. Repurchases under the program may be effected from time to time in open market or privately negotiated transactions through February 2009. In 2007,

we repurchased approximately 7.8 million common shares for an aggregate purchase price of \$537.1 million. As a result of share repurchase transactions, book value per common share at December 31, 2007 was reduced by \$1.45 per share and weighted average shares outstanding were reduced by 3.3 million. In 2008 (through February 25), approximately 2.1 million common shares were repurchased for an aggregate purchase price of \$144.8 million. The timing and amount of the repurchase transactions under this program will depend on a variety of factors, including market conditions and corporate and regulatory considerations. In connection with the repurchase program, the Warburg Pincus funds and the Hellman & Friedman funds waived their rights relating to share repurchases under the shareholders agreement for all repurchases of common shares by ACGL under the repurchase program in open market transactions and certain privately negotiated transactions. In May 2007, the Hellman & Friedman funds ceased to own shares of ACGL and their rights under the shareholders agreement with ACGL terminated. See "Market for Registrant's Common Equity, Related Stockholder Matters and Issuer Purchases of Equity Securities Issuer Purchases of Equity Securities."

To the extent that our existing capital is insufficient to fund our future operating requirements or maintain such ratings, we may need to raise additional funds through financings or limit our growth. If we are not able to obtain adequate capital, our business, results of operations and financial condition could be adversely affected, which could include, among other things, the following possible outcomes: (1) potential downgrades in the financial strength ratings assigned by ratings agencies to our operating subsidiaries, which could place those operating subsidiaries at a competitive disadvantage compared to higher-rated competitors; (2) reductions in the amount of business that our operating subsidiaries are able to write in order to meet capital adequacy-based tests enforced by statutory agencies; and (3) any resultant ratings downgrades could, among other things, affect our ability to write business and increase the cost of bank credit and letters of credit.

In addition to common share capital, we depend on external sources of finance to support our underwriting activities, which can be in the form (or any combination) of debt securities, preference shares, common equity and bank credit facilities providing loans and/or letters of credit. Any equity or debt financing, if available at all, may be on terms that are unfavorable to us. In the case of equity financings, dilution to our shareholders could result, and, in any case, such securities may have rights, preferences and privileges that are senior to those of our outstanding securities.

In June 2006, ACGL and Arch-U.S. filed a universal shelf registration statement with the SEC. This registration statement allows for the possible future offer and sale by us of various types of securities, including unsecured debt securities, preference shares, common shares, warrants, share purchase contracts and units and depositary shares. The shelf registration statement enables us to efficiently access the public debt and/or equity capital markets in order to meet our future capital needs. The shelf registration statement also allows selling shareholders to resell common shares that they own in one or more offerings from time to time. We will not receive any proceeds from any shares offered by the selling shareholders. This report is not an offer to sell or the solicitation of an offer to buy nor shall there be any sale of these securities in any state in which such offer, solicitation or sale would be unlawful prior to registration or qualification under the securities laws of any such state.

In August 2006, we entered into a five-year agreement for a \$300 million unsecured revolving loan and letter of credit facility and a \$1.0 billion secured letter of credit facility. The \$300 million unsecured loan and letter of credit facility is also available for the issuance of unsecured letters of credit up to \$100 million for our U.S.-based reinsurance operation.

During 2006, ACGL completed two public offerings of non-cumulative preferred shares. On February 1, 2006, \$200.0 million principal amount of 8.0% series A non-cumulative preferred shares ("series A preferred shares") were issued with net proceeds of \$193.5 million and, on May 24, 2006, \$125.0 million principal amount of 7.875% series B non-cumulative preferred shares ("series B preferred shares" and together with the series A preferred shares, the "preferred shares") were issued

with net proceeds of \$120.9 million. The net proceeds of the offerings were used to support the underwriting activities of ACGL's insurance and reinsurance subsidiaries. ACGL has the right to redeem all or a portion of each series of preferred shares at a redemption price of \$25.00 per share on or after (1) February 1, 2011 for the series A preferred shares and (2) May 15, 2011 for the series B preferred shares. Dividends on the preferred shares are non-cumulative. Consequently, in the event dividends are not declared on the preferred shares for any dividend period, holders of preferred shares will not be entitled to receive a dividend for such period, and such undeclared dividend will not accrue and will not be payable. Holders of preferred shares will be entitled to receive dividend payments only when, as and if declared by ACGL's board of directors or a duly authorized committee of 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. For 2007 and 2006, we paid \$25.8 million and \$17.4 million, respectively, to holders of the preferred shares and, at December 31, 2007, had declared an aggregate of \$3.3 million of dividends to be paid to holders of the preferred shares.

At December 31, 2007, ACGL's capital of \$4.34 billion consisted of \$300.0 million of senior notes, representing 6.9% of the total, \$325.0 million of preferred shares, representing 7.5% of the total, and common shareholders' equity of \$3.71 billion, representing the balance. At December 31, 2006, ACGL's capital of \$3.89 billion consisted of \$300.0 million of senior notes, representing 7.7% of the total, \$325.0 million of preferred shares, representing 8.4% of the total, and common shareholders' equity of \$3.27 billion, representing the balance. The increase in capital during 2007 of \$445.2 million was primarily attributable to net income for 2007 and an after-tax increase in the fair value of our investment portfolio, partially offset by \$537.1 million of share repurchases during the period. The increase in the fair value of our investment portfolio primarily resulted from changes in the level of interest rates in the second half of 2007.

#### **Natural and Man-Made Catastrophic Events**

We have large aggregate exposures to natural and man-made catastrophic events. Catastrophes can be caused by various events, including, but not limited to, hurricanes, floods, windstorms, earthquakes, hailstorms, explosions, severe winter weather and fires. Catastrophes can also cause losses in non-property business such as workers' compensation or general liability. In addition to the nature of property business, we believe that economic and geographic trends affecting insured property, including inflation, property value appreciation and geographic concentration, tend to generally increase the size of losses from catastrophic events over time.

We have substantial exposure to unexpected, large losses resulting from future man-made catastrophic events, such as acts of war, acts of terrorism and political instability. These risks are inherently unpredictable and recent events may lead to increased frequency and severity of losses. It is difficult to predict the timing of such events with statistical certainty or estimate the amount of loss any given occurrence will generate. It is not possible to completely eliminate our exposure to unforecasted or unpredictable events and, to the extent that losses from such risks occur, our financial condition and results of operations could be materially adversely affected. Therefore, claims for natural and man-made catastrophic events could expose us to large losses and cause substantial volatility in our results of operations, which could cause the value of our common shares to fluctuate widely. In certain instances, we specifically insure and reinsure risks resulting from terrorism. Even in cases where we attempt to exclude losses from terrorism and certain other similar risks from some coverages written by us, we may not be successful in doing so. Moreover, irrespective of the clarity and inclusiveness of policy language, there can be no assurance that a court or arbitration panel will limit enforceability of policy language or otherwise issue a ruling adverse to us.

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We seek to limit our loss exposure by writing a number of our reinsurance contracts on an excess of loss basis, adhering to maximum limitations on reinsurance written in defined geographical zones, limiting program size for each client and prudent underwriting of each program written. In the case of proportional treaties, we may seek per occurrence limitations or loss ratio caps to limit the impact of losses from any one or series of events. In our insurance operations, we seek to limit our exposure through the purchase of reinsurance. We cannot be certain that any of these loss limitation methods will be effective. We also seek to limit our loss exposure by geographic diversification. Geographic zone limitations involve significant underwriting judgments, including the determination of the area of the zones and the inclusion of a particular policy within a particular zone's limits. There can be no assurance that various provisions of our policies, such as limitations or exclusions from coverage or choice of forum, will be enforceable in the manner we intend. Disputes relating to coverage and choice of legal forum may also arise. Underwriting is inherently a matter of judgment, involving important assumptions about matters that are inherently unpredictable and beyond our control, and for which historical experience and probability analysis may not provide sufficient guidance. One or more catastrophic or other events could result in claims that substantially exceed our expectations, which could have a material adverse effect on our financial condition or our results of operations, possibly to the extent of eliminating our shareholders' equity.

For our natural catastrophe exposed business, we seek to limit the amount of exposure we will assume from any one insured or reinsured and the amount of the exposure to catastrophe losses from a single event in any geographic zone. We monitor our exposure to catastrophic events, including earthquake and wind and periodically reevaluate the estimated probable maximum pre-tax loss for such exposures. Our estimated probable maximum pre-tax loss is determined through the use of modeling techniques, but such estimate does not represent our total potential loss for such exposures. 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. There can be no assurances that we will not suffer pre-tax losses greater than 25% of our total shareholders' equity from one or more catastrophic events due to several factors, including the inherent uncertainties in estimating the frequency and severity of such events and the margin of error in making such determinations resulting from potential inaccuracies and inadequacies in the data provided by clients and brokers, the modeling techniques and the application of such techniques or as a result of a decision to change the percentage of shareholders' equity exposed to a single catastrophic event. In addition, depending on business opportunities and the mix of business that may comprise our insurance and reinsurance portfolio, we may seek to adjust our self-imposed limitations on probable maximum pre-tax loss for catastrophe exposed business. See " Critical Accounting Policies, Estimates and Recent Accounting Pronouncements Ceded Reinsurance" for a discussion of our catastrophe reinsurance programs.

### **Contractual Obligations and Commercial Commitments**

#### *Letter of Credit and Revolving Credit Facilities*

As of December 31, 2007, we had access to 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 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 our option. Secured letters of credit are available for issuance on behalf of our insurance and reinsurance subsidiaries. Issuance of letters of credit and borrowings under the Credit Agreement are subject to our compliance with certain covenants and conditions, including absence of a material adverse change. These covenants require,

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among other things, that we 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 our principal insurance and reinsurance subsidiaries maintain at least a "B++" rating from A.M. Best. In addition, certain of our subsidiaries which are party to the Credit Agreement are required to maintain minimum shareholders' equity levels. We were in compliance with all covenants contained in the Credit Agreement at December 31, 2007. The Credit Agreement expires on August 30, 2011.

Issuance of letters of credit and borrowings under the Credit Agreement are subject to our compliance with certain covenants and conditions, including absence of a material adverse change. These covenants require, among other things, that we 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 our principal insurance and reinsurance subsidiaries maintain at least a "B++" rating from A.M. Best. In addition, certain of our subsidiaries which are party to the Credit Agreement are required to maintain minimum shareholders' equity levels.

Including the secured letter of credit portion of the Credit Agreement and another letter of credit facility (together, the "LOC Facilities"), we have access to letter of credit facilities for up to a total of \$1.45 billion. 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 we have entered into reinsurance arrangements to ensure that such counterparties are permitted to take credit for reinsurance obtained from our 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 our business and the loss experience of such business. When issued, certain letters of credit are secured by a portion of our investment portfolio. In addition, the LOC Facilities also require the maintenance of certain covenants, which we were in compliance with at December 31, 2007. At such date, we had approximately \$612.4 million in outstanding letters of credit under the LOC Facilities, which were secured by investments totaling \$652.8 million. The other letter of credit facility was replaced on substantially the same terms in December 2007. 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 we utilize. In addition to letters of credit, we have established and may establish additional insurance trust accounts in the U.S. and Canada to secure our reinsurance amounts payable as required. See note 7, "Investment Information," of the notes accompanying our consolidated financial statements.

### *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 2007, 2006 and 2005, interest expense on the Senior Notes was approximately \$22.1 million. The market value of the Senior Notes at December 31, 2007 and 2006 was \$325.4 million and \$332.0 million, respectively.



**Contractual Obligations**

The following table provides an analysis of our contractual commitments at December 31, 2007:

(U.S. dollars in thousands)	Payment due by period				
	Total	Less than 1 year	1 - 3 years	4 - 5 years	More than 5 years
Long-term debt obligations	\$ 300,000				\$ 300,000
Interest expense on long-term debt obligations	584,325	22,050	44,100	44,100	474,075
Operating lease obligations	91,204	14,346	31,614	26,568	18,676
Purchase obligations	22,013	10,119	11,894		
Reserves for losses and loss adjustment expenses, gross(1)	7,092,452	2,073,060	2,383,358	1,091,084	1,544,950
Deposit accounting liabilities(2)	43,506	2,523	6,141	8,850	25,992
Securities lending collateral(3)	1,503,723	1,503,723			
Unfunded investment commitments	150,180	150,180			
<b>Total</b>	<b>\$ 9,787,403</b>	<b>\$ 3,776,001</b>	<b>\$ 2,477,107</b>	<b>\$ 1,170,602</b>	<b>\$ 2,363,693</b>

- (1) The estimated expected contractual commitments related to the reserves for losses and loss adjustment expenses are presented on a gross basis. It should be noted that until a claim has been presented to us, determined to be valid, quantified and settled, there is no known obligation on an individual transaction basis, and while estimable in the aggregate, the timing and amount contain significant uncertainty. Approximately 72.4% of our net reserves were incurred but not reported at December 31, 2007.
- (2) The estimated expected contractual commitments related to deposit accounting liabilities have been estimated using projected cash flows from the underlying contracts. It should be noted that, due to the nature of such liabilities, the timing and amount contain significant uncertainty.
- (3) As part of our securities lending program, we loan certain fixed income securities to third parties and receive collateral, primarily in the form of cash. The collateral received is reinvested and is reflected as "short-term investment of funds received under securities lending agreements, at fair value." Such collateral is due back to the third parties at the close of the securities lending transaction.

**Off-Balance Sheet Arrangements**

We are not party to any transaction, agreement or other contractual arrangement to which an entity unconsolidated with us is a party that management believes is reasonably likely to have a current or future effect on our financial condition, revenues or expenses, results of operations, liquidity, capital expenditures or capital resources that is material to investors. We concluded that, under FASB Interpretation No. 46R, "Consolidation of Variable Interest Entities," which was issued and became effective for us during the 2004 first quarter, we are required to consolidate the assets, liabilities and results of operations (if any) of a certain managing general agency in which one of our subsidiaries has an investment. Such agency ceased producing business in 1999 and is currently running-off its operations. Based on current information, there are no assets or liabilities of such agency required to be reflected on the face of our consolidated financial statements that are not, or have not been previously, otherwise reflected therein.

On December 29, 2005, Arch Re Bermuda entered into a quota share reinsurance treaty with Flatiron Re Ltd. pursuant to which Flatiron Re Ltd. assumed a 45% quota share (the "Flatiron 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 Flatiron 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 Flatiron Treaty expired by its terms. As a result of the terms of the Flatiron Treaty, we 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, we are not required to consolidate the assets, liabilities and results of operations of Flatiron Re Ltd. per FIN 46R. See note 11, "Commitments and Contingencies," of the notes accompanying our consolidated financial statements for further details on the Flatiron Treaty.

## Investments

The finance and investment committee of our board of directors establishes our investment policies and creates guidelines for our investment managers. The finance and investment committee reviews the implementation of the investment strategy on a regular basis. Our current approach stresses preservation of capital, market liquidity and diversification of risk.

Our cash and invested assets were as follows at December 31, 2007 and 2006:

(U.S. dollars in thousands)	December 31,	
	2007	2006
Fixed maturities available for sale, at fair value	\$ 7,137,998	\$ 6,876,548
Fixed maturities pledged under securities lending agreements, at fair value(1)	1,462,826	860,803
<b>Total fixed maturities</b>	<b>8,600,824</b>	<b>7,737,351</b>
Short-term investments available for sale, at fair value	699,036	957,698
Short-term investments pledged under securities lending agreements, at fair value(1)	219	
Cash	239,915	317,017
Other investments, at fair value	589,669	307,082
<b>Total cash and invested assets(1)(2)</b>	<b>\$ 10,129,663</b>	<b>\$ 9,319,148</b>

(1) In our securities lending transactions, we receive collateral in excess of the fair value of the fixed maturities and short-term investments pledged under securities lending agreements. For purposes of this table, we have excluded \$1.5 billion and \$891.4 million, respectively, of collateral received which is reflected as "short-term investment of funds received under securities lending agreements, at fair value" and included \$1.46 billion and \$860.8 million, respectively, of "fixed maturities and short-term investments pledged under securities lending agreements, at fair value" at December 31, 2007 and 2006.

(2) Includes certain securities transactions entered into but not settled at the balance sheet date. Net of such amounts, total cash and investments were approximately \$10.1 billion at December 31, 2007 and \$9.09 billion at December 31, 2006.

At December 31, 2007, our fixed income portfolio, which includes fixed maturity securities and short-term investments, had a "AA+" average credit quality rating, an average effective duration of 3.29 years, and an average yield to maturity (imbedded book yield), before investment expenses, of 5.03%. At December 31, 2006, our fixed income portfolio, which includes fixed maturity securities and short-term investments, had a "AAA" average credit quality rating, an average effective duration of 3.23 years, and an average yield to maturity (imbedded book yield), before investment expenses, of 4.97%.

Our portfolio includes investments, such as mortgage-backed securities, which are subject to prepayment risk. At December 31, 2007, our investments in mortgage-backed securities, excluding commercial mortgage-backed securities, amounted to approximately \$1.23 billion, or 12.2% of total investments and cash, compared to \$1.18 billion, or 12.7%, at December 31, 2006. Such amounts are classified as "available for sale" and are not held for trading purposes. In addition, our fixed maturities at December 31, 2007 include exposures to certain corporate sectors, such as the financial sector (11% of total investments and cash) and the industrial sector (7% of total investments and cash).



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

Our Chief Investment Officer administers the investment portfolio, oversees our investment managers, formulates investment strategy in conjunction with our finance and investment committee and directly manages certain portions of our fixed income portfolio. At December 31, 2007, approximately \$4.61 billion, or 45.5%, of our total investments and cash was internally managed, compared to \$3.9 billion, or 41.8%, at December 31, 2006. While maintaining our emphasis on preservation of capital and liquidity, we expect our portfolio to become more diversified and, as a result, we may expand into areas which are not currently part of our investment strategy.

We participate in a securities lending program under which certain of our 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." We maintain control over the securities we lend, retain the earnings and cash flows associated with the loaned securities and receive a fee from the borrower for the temporary use of the securities. Collateral received, primarily in the form of cash, is required at a rate of 102% of the fair value of the loaned securities (or 105% of the fair 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 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. At December 31, 2006, the fair value and amortized cost of fixed maturities and short-term investments pledged under securities lending agreements were \$860.8 million and \$854.8 million, respectively, while collateral received totaled \$891.4 million at fair value and amortized cost.

As part of our investment strategy, we seek to establish a level of cash and highly liquid short-term and intermediate-term securities which, combined with expected cash flow, is believed by us to be adequate to meet our foreseeable payment obligations. Our 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 our investment guidelines if implemented in other ways. The fair values of those derivatives are based on quoted market prices. At December 31, 2007 and 2006, the notional value of the net long position for equity futures was \$91.2 million and \$78.6 million, respectively. At December 31, 2007, the notional value of the net long position for Treasury note futures was \$61.7 million, compared to a net short position of \$35.2 million at December 31, 2006. For 2007, we recorded net realized losses of \$2.0 million related to changes in the fair value of all futures contracts, compared to net realized gains of \$2.1 million for 2006. At December 31, 2007, the carrying value and fair value of all futures contracts was \$0.8 million, compared to \$0.3 million at December 31, 2006.

Our portfolio also includes investments in other asset sectors, such as alternative investment funds that primarily include funds that invest in investment grade and non-investment grade fixed income

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securities; equity securities which include certain investments in mutual funds and other preferred stocks; and privately held securities which include our investment in Aeolus LP. In future periods, we may allocate substantial additional funds to alternate investments in order to increase the diversification of our portfolio and to maximize returns within a defined level of risk over a longer period of time. Certain of these alternative investments may be accounted for under the equity method, which could increase the volatility of our reported earnings. See note 10, "Transactions with Related Parties," of the notes accompanying our consolidated financial statements for further details on the Company's investment in Aeolus, L.P. Our unfunded investment commitments related to other investments totaled approximately \$150.2 million at December 31, 2007. The commitments were primarily to alternative investment funds that invest in investment grade and non-investment grade fixed income securities.

### Calculation of Book Value Per Common Share

The following table presents the calculation of book value per common share and the impact of transactions under the share repurchase program on book value per common share at December 31, 2007 and 2006:

(U.S. dollars in thousands, except share data)	December 31,	
	2007	2006
<b>Calculation of book value per common share:</b>		
Total shareholders' equity	\$ 4,035,811	\$ 3,590,619
Less preferred shareholders' equity	(325,000)	(325,000)
	3,710,811	3,265,619
Common shareholders' equity	3,710,811	3,265,619
Common shares outstanding(1)	67,318,466	74,270,466
	55.12	43.97
Book value per common share	\$ 55.12	\$ 43.97
<b>Effect of share repurchases during period:</b>		
Aggregate purchase price of shares repurchased	\$ 537,066	
Shares repurchased	7,769,039	
	69.13	
Average price per share repurchased	\$ 69.13	
Estimated dilutive impact on ending book value per common share(2)	\$ (1.45)	

(1) Excludes the effects of 5,486,033 and 5,669,994 stock options and 116,453 and 91,514 restricted stock units outstanding at December 31, 2007 and 2006, respectively.

(2) As the average price per share repurchased during the period exceeded the book value per common share at December 31, 2007, the repurchase of shares during the period reduced book value per common share at that date.

### Market Sensitive Instruments and Risk Management

Our investment results are subject to a variety of risks, including risks related to changes in the business, financial condition or results of operations of the entities in which we invest, as well as changes in general economic conditions and overall market conditions. We are also exposed to potential loss from various market risks, including changes in equity prices, interest rates and foreign currency exchange rates.

In accordance with the SEC's Financial Reporting Release No. 48, we performed a sensitivity analysis to determine the effects that market risk exposures could have on the future earnings, fair values or cash flows of our financial instruments as of December 31, 2007. Market risk represents the risk of changes in the fair value of a financial instrument and consists of several components, including liquidity, basis and price risks.

The sensitivity analysis performed as of December 31, 2007 presents hypothetical losses in cash flows, earnings and fair values of market sensitive instruments which were held by us on December 31, 2007 and are sensitive to changes in interest rates and equity security prices. This

risk management

discussion and the estimated amounts generated from the following sensitivity analysis represent forward-looking statements of market risk assuming certain adverse market conditions occur. Actual results in the future may differ materially from these projected results due to actual developments in the global financial markets. The analysis methods used by us to assess and mitigate risk should not be considered projections of future events or losses.

The focus of the SEC's market risk rules is on price risk. For purposes of specific risk analysis, we employ sensitivity analysis to determine the effects that market risk exposures could have on the future earnings, fair values or cash flows of our financial instruments. The financial instruments included in the following sensitivity analysis consist of all of our investments and cash.

### ***Investment Market Risk***

**Fixed Income Securities.** We invest in interest rate sensitive securities, primarily debt securities. We consider the effect of interest rate movements on the market value of our fixed maturities, fixed maturities pledged under securities lending agreements, short-term investments and certain of our other investments which invest in fixed income securities and the corresponding change in unrealized appreciation. As interest rates rise, the market value of our interest rate sensitive securities falls, and the converse is also true. The following table summarizes the effect that an immediate, parallel shift in the interest rate yield curve would have had on the portfolio at December 31, 2007 and 2006. Based on historical observations, there is a low probability that all interest rate yield curves would shift in the same direction at the same time and, accordingly, the actual effect of interest rate movements may differ materially from the amounts set forth below. For further discussion on investment activity, please refer to "Investments."

(U.S. dollars in millions)	Interest Rate Shift in Basis Points				
	-100	-50	0	50	100
<b>December 31, 2007:</b>					
Total market value	\$ 10,048.9	\$ 9,885.3	\$ 9,725.0	\$ 9,565.4	\$ 9,409.6
Market value change from base	3.33%	1.65%		(1.64)%	(3.24)%
Change in unrealized value	\$ 323.9	\$ 160.3		\$ (159.6)	\$ (315.4)
<b>December 31, 2006:</b>					
Total market value	\$ 9,153.8	\$ 9,007.0	\$ 8,862.5	\$ 8,720.5	\$ 8,581.2
Market value change from base	3.29%	1.63%		(1.60)%	(3.17)%
Change in unrealized value	\$ 291.3	\$ 144.5		\$ (142.0)	\$ (281.3)

Another method that attempts to measure portfolio risk is Value-at-Risk ("VaR"). VaR attempts to take into account a broad cross-section of risks facing a portfolio by utilizing relevant securities volatility data skewed towards the most recent months and quarters. VaR measures the amount of a portfolio at risk for outcomes 1.65 standard deviations from the mean based on normal market conditions over a one year time horizon and is expressed as a percentage of the portfolio's initial value. In other words, 95% of the time, should the risks taken into account in the VaR model perform per their historical tendencies, the portfolio's loss in any one year period is expected to be less than or equal to the calculated VaR, stated as a percentage of the measured portfolio's initial value. As of December 31, 2007, our portfolio's VaR was estimated to be 3.73%, compared to an estimated 3.66% at December 31, 2006.

**Equities and Privately Held Securities.** Our investment portfolio includes an allocation to other investments which include investments in certain stock index funds, other preferred stocks and privately held securities. At December 31, 2007 and 2006, the fair value of our investments in equities and privately held securities totaled \$164.8 million and \$139.6 million, respectively. These securities are exposed to price risk, which is the potential loss arising from decreases in the market value of equities. An immediate hypothetical 10% depreciation in the value of each equity position would reduce the fair value of such investments by approximately \$16.5 million and \$14.0 million at December 31, 2007 and 2006, respectively, and would have decreased book value per common share by approximately \$0.24 and \$0.19, respectively.



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*Investment-Related Derivatives.* We began to invest in certain derivative instruments in 2006 to replicate investment positions and to manage market exposures and duration risk. At December 31, 2007 and 2006, the notional value of the net long position for equity futures was \$91.2 million and \$78.6 million, respectively. At December 31, 2007, the notional value of the net long position for Treasury note futures was \$61.7 million, compared to a net short position of \$35.2 million at December 31, 2006. A 10% depreciation of the underlying exposure to these derivative instruments at December 31, 2007 and 2006 would have resulted in a reduction in net income of approximately \$15.3 million and \$11.4 million, respectively, and would have decreased book value per common share by \$0.23 and \$0.15, respectively.

### **Foreign Currency Exchange Risk**

Foreign currency rate risk is the potential change in value, income and cash flow arising from adverse changes in foreign currency exchange rates. A 10% depreciation of the U.S. Dollar against other currencies under our outstanding contracts at December 31, 2007 and 2006, net of unrealized appreciation on our securities denominated in currencies other than the U.S. Dollar, would have resulted in unrealized gains of approximately \$12.9 million and \$14.8 million, respectively, and would have increased book value per common share by approximately \$0.19 and \$0.20, respectively. A 10% appreciation of the U.S. Dollar against other currencies under our outstanding contracts at December 31, 2007 and 2006, net of unrealized depreciation on our securities denominated in currencies other than the U.S. Dollar, would have resulted in unrealized losses of approximately \$12.9 million and \$14.8 million, respectively, and would have decreased book value per common share by approximately \$0.19 and \$0.20, respectively. Historical observations indicate a low probability that all foreign currency exchange rates would shift against the U.S. Dollar in the same direction and at the same time and, accordingly, the actual effect of foreign currency rate movements may differ materially from the amounts set forth above. For further discussion on foreign exchange activity, please refer to " Results of Operations."

### **Effects of Inflation**

We do not believe that inflation has had a material effect on our consolidated results of operations, except insofar as inflation may affect our reserves for losses and loss adjustment expenses and interest rates. The potential exists, after a catastrophe loss, for the development of inflationary pressures in a local economy. The anticipated effects of inflation on us are considered in our catastrophe loss models. The actual effects of inflation on our results cannot be accurately known until claims are ultimately settled.

### **ITEM 7A. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK**

Reference is made to the information appearing above under the subheading "Market Sensitive Instruments and Risk Management" under the caption "Management's Discussion and Analysis of Financial Condition and Results of Operation," which information is hereby incorporated by reference.

### **ITEM 8. FINANCIAL STATEMENTS AND SUPPLEMENTARY DATA**

See our consolidated financial statements and notes thereto and required financial statement schedules commencing on page F-1.

### **ITEM 9. CHANGES IN AND DISAGREEMENTS WITH ACCOUNTANTS ON ACCOUNTING AND FINANCIAL DISCLOSURE**

None.

### **ITEM 9A. CONTROLS AND PROCEDURES**

#### **Evaluation of Disclosure Controls and Procedures**

In connection with the filing of this Form 10-K, our management, including the Chief Executive Officer and Chief Financial Officer, conducted an evaluation, as of December 31, 2007, for the

purposes set forth in the applicable rules under the Securities and Exchange Act of 1934, as amended (the "Exchange Act"). Based on that evaluation, the Chief Executive Officer and Chief Financial Officer concluded that the disclosure controls and procedures are effective.

We continue to enhance our operating procedures and internal controls (including the timely and successful implementation of our information technology initiatives, which include the implementation of improved computerized systems and programs to replace and support manual systems, and including controls over financial reporting) to effectively support our business and our regulatory and reporting requirements. Our management does not expect that our disclosure controls or our internal controls will prevent all errors and all fraud. A control system, no matter how well conceived and operated, can provide only reasonable, not absolute, assurance that the objectives of the control system are met. Further, the design of a control system must reflect the fact that there are resource constraints, and the benefits of controls must be considered relative to their costs. As a result of the inherent limitations in all control systems, no evaluation of controls can provide absolute assurance that all control issues and instances of fraud, if any, within the company have been detected. These inherent limitations include the realities that judgments in decision-making can be faulty, and that breakdowns can occur because of simple error or mistake. Additionally, controls can be circumvented by the individual acts of some persons or by collusion of two or more people. The design of any system of controls also is based in part upon certain assumptions about the likelihood of future events, and there can be no assurance that any design will succeed in achieving its stated goals under all potential future conditions; over time, controls may become inadequate because of changes in conditions, or the degree of compliance with the policies or procedures may deteriorate. As a result of the inherent limitations in a cost-effective control system, misstatement due to error or fraud may occur and not be detected. Accordingly, our disclosure controls and procedures are designed to provide reasonable, not absolute, assurance that the disclosure controls and procedures are met.

#### **Management's Annual Report on Internal Control Over Financial Reporting**

Our management is responsible for establishing and maintaining adequate internal control over financial reporting, as defined in Rules 13a-15(f) and 15d-15(f) under the Exchange Act. Our management assessed the effectiveness of our internal control over financial reporting as of December 31, 2007. In making this assessment, management used the criteria set forth by the Committee of Sponsoring Organizations (COSO) of the Treadway Commission in *Internal Control-Integrated Framework*.

Based on our assessment, management determined that, as of December 31, 2007, our internal control over financial reporting was effective. The effectiveness of our internal control over financial reporting as of December 31, 2007 has been audited by PricewaterhouseCoopers LLP, an independent registered public accounting firm, as stated in their report which appears on page F-2.

#### **Changes in Internal Controls Over Financial Reporting**

There have been no changes in internal control over financial reporting that occurred in connection with the Company's evaluation required pursuant to Rules 13a-15 and 15d-15 under the Exchange Act during the fiscal quarter ended December 31, 2007 that have materially affected, or are reasonably likely to materially affect, internal control over financial reporting.

#### **ITEM 9B. OTHER INFORMATION**

None.

**PART III**

**ITEM 10. DIRECTORS, EXECUTIVE OFFICERS AND CORPORATE GOVERNANCE**

The information required by this item is incorporated by reference from the information to be included in our definitive proxy statement ("Proxy Statement") for our annual meeting of shareholders to be held in 2008, which we intend to file with the SEC pursuant to Regulation 14A. Copies of our code of ethics applicable to our chief executive officer, chief financial officer and principal accounting officer or controller are available free of charge to investors upon written request addressed to the attention of ACGL's corporate secretary, Wessex House, 45 Reid Street, Hamilton HM 12, Bermuda. In addition, our code of ethics and certain other basic corporate documents, including the charters of our audit committee, compensation committee and nominating committee are posted on our website. If any substantive amendments are made to the code of ethics or if there is a grant of a waiver, including any implicit waiver, we will disclose the nature of such amendment or waiver on our website or in a report on Form 8-K, to the extent required by applicable law or the rules and regulations of any exchange applicable to us. Our website address is intended to be an inactive, textual reference only and none of the material on our website is incorporated by reference into this report.

**ITEM 11. EXECUTIVE COMPENSATION**

The information required by this item is incorporated by reference from the information to be included in the Proxy Statement to be filed pursuant to Regulation 14A with the SEC before April 30, 2008, which Proxy Statement is incorporated by reference.

**ITEM 12. SECURITY OWNERSHIP OF CERTAIN BENEFICIAL OWNERS AND MANAGEMENT AND RELATED STOCKHOLDER MATTERS**

Other than the information set forth below, the information required by this item is incorporated by reference from the information to be included in the Proxy Statement to be filed pursuant to Regulation 14A with the SEC before April 30, 2008, which Proxy Statement is incorporated by reference.

**SECURITIES AUTHORIZED FOR ISSUANCE UNDER EQUITY COMPENSATION PLANS**

In October 2001, we adopted the Long Term Incentive Plan for New Employees ("New Employee Plan") to provide incentives to attract and motivate new hires in connection with the launch of our underwriting initiative. A total of 3,634,170 of such share awards were granted under the New Employee Plan. The New Employee Plan was not approved by our shareholders and was subsequently terminated in 2002, although a total of 1,671,880 share awards remain outstanding under the New Employee Plan as of December 31, 2007. For information about our equity compensation plans, see note 13, "Share Capital," of the notes accompanying our consolidated financial statements.

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The following information is as of December 31, 2007:

<b>Plan category</b>	<b>Number of securities to be issued upon exercise of outstanding options(1), warrants and rights (a)</b>	<b>Weighted-average exercise price of outstanding options(1), warrants and rights (b)</b>	<b>Number of securities remaining available for future issuance under equity compensation plans (excluding securities reflected in column(a)) (c)</b>
Equity compensation plans approved by security holders	3,814,153	\$ 38.22	3,379,175
Equity compensation plans not approved by security holders	1,671,880	\$ 22.57	
<b>Total</b>	<b>5,486,033</b>	<b>\$ 33.45</b>	<b>3,379,175</b>

(1) Includes all vested and unvested options.

### ITEM 13. CERTAIN RELATIONSHIPS AND RELATED TRANSACTIONS, AND DIRECTOR INDEPENDENCE

The information required by this item is incorporated by reference from the information to be included in the Proxy Statement to be filed pursuant to Regulation 14A with the SEC before April 30, 2008, which Proxy Statement is incorporated by reference.

### ITEM 14. PRINCIPAL ACCOUNTANT FEES AND SERVICES

The information required by this item is incorporated by reference from the information to be included in our Proxy Statement to be filed pursuant to Regulation 14A with the SEC before April 30, 2008, which Proxy Statement is incorporated by reference.

## PART IV

### ITEM 15. EXHIBITS AND FINANCIAL STATEMENT SCHEDULES

#### FINANCIAL STATEMENT SCHEDULES

Financial statement schedules listed in the accompanying index to our financial statements schedules on page F-1 are filed as part of this report, and are included in Item 8.

#### EXHIBITS

The exhibits listed in the accompanying exhibit index on page E-1 are filed as part of this report.

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**SIGNATURES**

Pursuant to the requirements of Section 13 or 15(d) of the Securities Exchange Act of 1934, the Registrant has duly caused this report to be signed on its behalf by the undersigned, thereunto duly authorized.

**ARCH CAPITAL GROUP LTD.**  
(Registrant)

By: /s/ CONSTANTINE IORDANOU

Name: Constantine Iordanou  
Title: *President & Chief Executive Officer*

February 29, 2008

Pursuant to the requirements of the Securities Exchange Act of 1934, this report has been signed below by the following persons on behalf of the Registrant and in the capacities and on the dates indicated.

<u>Name</u>	<u>Title</u>	<u>Date</u>
<u>/s/ CONSTANTINE IORDANOU</u> Constantine Iordanou	President and Chief Executive Officer (Principal Executive Officer) and Director	February 29, 2008
<u>/s/ JOHN D. VOLLARO</u> John D. Vollaro	Executive Vice President, Chief Financial Officer and Treasurer (Principal Financial and Principal Accounting Officer)	February 29, 2008
<u>*</u> Paul B. Ingrey	Chairman and Director	February 29, 2008
<u>*</u> Wolfe "Bill" H. Bragin	Director	February 29, 2008
<u>*</u> John L. Bunce, Jr.	Director	February 29, 2008
<u>*</u> Sean D. Carney	Director	February 29, 2008

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Kewsong Lee                      Director                      February 29, 2008

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James J. Meenaghan                      Director                      February 29, 2008

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John M. Pasquesi                      Director                      February 29, 2008

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Robert F. Works                      Director                      February 29, 2008

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\*  
By John D. Vollaro, as attorney-in-fact and agent, pursuant to a power of attorney, a copy of which has been filed with the Securities and Exchange Commission as Exhibit 24 to this report.

/s/ JOHN D. VOLLARO

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Name: John D. Vollaro  
*Attorney-in-Fact*

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## INDEX TO FINANCIAL STATEMENTS AND SCHEDULES

<b>Arch Capital Group Ltd. and Subsidiaries</b>	<b>Pages</b>
Report of Independent Registered Public Accounting Firm	F-2
Consolidated Balance Sheets at December 31, 2007 and 2006	F-4
Consolidated Statements of Income for the years ended December 31, 2007, 2006 and 2005	F-5
Consolidated Statements of Changes in Shareholders' Equity for the years ended December 31, 2007, 2006 and 2005	F-6
Consolidated Statements of Comprehensive Income for the years ended December 31, 2007, 2006 and 2005	F-7
Consolidated Statements of Cash Flows for the years ended December 31, 2007, 2006 and 2005	F-8
Notes to Consolidated Financial Statements	F-9
 <b>Schedules</b>	
I. Summary of Investments Other Than Investments in Related Parties at December 31, 2007	S-1
II. Condensed Financial Information of Registrant	S-2
III. Supplementary Insurance Information for the years ended December 31, 2007, 2006 and 2005	S-5
IV. Reinsurance for the years ended December 31, 2007, 2006 and 2005	S-6
VI. Supplementary Information for Property and Casualty Underwriters	S-7

Schedules other than those listed above are omitted for the reason that they are not applicable.

**Report of Independent Registered Public Accounting Firm**

To the Board of Directors and Shareholders of  
Arch Capital Group Ltd.:

In our opinion, the accompanying consolidated balance sheets and the related consolidated statements of income, changes in shareholders' equity, comprehensive income, and cash flows present fairly, in all material respects, the financial position of Arch Capital Group Ltd. and its subsidiaries (the "Company") at December 31, 2007 and December 31, 2006, and the results of their operations and their cash flows for each of the three years in the period ended December 31, 2007 in conformity with accounting principles generally accepted in the United States of America. In addition, in our opinion, the financial statement schedules listed in the accompanying index present fairly, in all material respects, the information set forth therein when read in conjunction with the related consolidated financial statements. Also in our opinion, the Company maintained, in all material respects, effective internal control over financial reporting as of December 31, 2007, based on criteria established in *Internal Control - Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO). The Company's management is responsible for these financial statements and financial statement schedules, for maintaining effective internal control over financial reporting and for its assessment of the effectiveness of internal control over financial reporting, included in Management's Annual Report on Internal Control over Financial Reporting appearing under Item 9A. Our responsibility is to express opinions on these financial statements, on the financial statement schedules and on the Company's internal control over financial reporting based on our integrated audits. We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audits to obtain reasonable assurance about whether the financial statements are free of material misstatement and whether effective internal control over financial reporting was maintained in all material respects. Our audits of the financial statements included examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, and evaluating the overall financial statement presentation. Our audit of internal control over financial reporting included obtaining an understanding of internal control over financial reporting, assessing the risk that a material weakness exists, and testing and evaluating the design and operating effectiveness of internal control based on the assessed risk. Our audits also included performing such other procedures as we considered necessary in the circumstances. We believe that our audits provide a reasonable basis for our opinions.

As discussed in Note 2 to the consolidated financial statements, the Company changed the manner in which it accounts for share-based compensation in 2006.

A company's internal control over financial reporting is a process designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles. A company's internal control over financial reporting includes those policies and procedures that (i) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the company; (ii) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the company are being made only in accordance with authorizations of management and directors of the company; and (iii) provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use, or disposition of the company's assets that could have a material effect on the financial statements.



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Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements. Also, projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

/s/ PricewaterhouseCoopers LLP  
New York, New York  
February 28, 2008

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**ARCH CAPITAL GROUP LTD. AND SUBSIDIARIES**  
**CONSOLIDATED BALANCE SHEETS**

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

	December 31,	
	2007	2006
<b>Assets</b>		
Investments:		
Fixed maturities available for sale, at fair value (amortized cost: 2007, \$7,037,272; 2006, \$6,858,970)	\$ 7,137,998	\$ 6,876,548
Short-term investments available for sale, at fair value (amortized cost: 2007, \$700,262; 2006, \$956,926)	699,036	957,698
Short-term investment of funds received under securities lending agreements, at fair value	1,503,723	891,376
Other investments (cost: 2007, \$559,925; 2006, \$282,923)	589,669	307,082
	9,930,426	9,032,704
Cash	239,915	317,017
Accrued investment income	73,862	68,440
Fixed maturities and short-term investments pledged under securities lending agreements, at fair value	1,463,045	860,803
Premiums receivable	729,628	749,961
Funds held by reinsureds	74,752	82,385
Unpaid losses and loss adjustment expenses recoverable	1,609,619	1,552,157
Paid losses and loss adjustment expenses recoverable	132,289	122,149
Prepaid reinsurance premiums	480,462	470,138
Deferred income tax assets, net	57,051	63,606
Deferred acquisition costs, net	290,059	290,999
Receivable for securities sold	17,359	190,168
Other assets	525,800	511,940
	15,624,267	14,312,467
<b>Total Assets</b>	<b>\$ 15,624,267</b>	<b>\$ 14,312,467</b>
<b>Liabilities</b>		
Reserve for losses and loss adjustment expenses	\$ 7,092,452	\$ 6,463,041
Unearned premiums	1,765,881	1,791,922
Reinsurance balances payable	301,309	301,679
Senior notes	300,000	300,000
Deposit accounting liabilities	43,506	45,107
Securities lending collateral	1,503,723	891,376
Payable for securities purchased	23,155	418,109
Other liabilities	558,430	510,614
	11,588,456	10,721,848
<b>Total Liabilities</b>	<b>11,588,456</b>	<b>10,721,848</b>
<b>Commitments and Contingencies</b>		
<b>Shareholders' Equity</b>		
Non-cumulative preferred shares (\$0.01 par value, 50,000,000 shares authorized)		
Series A (issued: 2007 and 2006, 8,000,000)	80	80
Series B (issued: 2007 and 2006, 5,000,000)	50	50
	673	743

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	December 31,	
	<u>                    </u>	<u>                    </u>
Common shares (\$0.01 par value, 200,000,000 shares authorized, issued: 2007, 67,318,466; 2006, 74,270,466)		
Additional paid-in capital	1,451,667	1,944,304
Retained earnings	2,428,117	1,593,907
Accumulated other comprehensive income, net of deferred income tax	155,224	51,535
	<u>                    </u>	<u>                    </u>
<b>Total Shareholders' Equity</b>	4,035,811	3,590,619
	<u>                    </u>	<u>                    </u>
<b>Total Liabilities and Shareholders' Equity</b>	\$ 15,624,267	\$ 14,312,467
	<u>                    </u>	<u>                    </u>

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)

	Years Ended December 31,		
	2007	2006	2005
<b>Revenues</b>			
Net premiums written	\$ 2,901,936	\$ 3,017,418	\$ 3,138,772
Decrease (increase) in unearned premiums	42,714	64,247	(161,056)
	2,944,650	3,081,665	2,977,716
Net premiums earned	2,944,650	3,081,665	2,977,716
Net investment income	463,070	380,205	232,902
Net realized gains (losses)	28,141	(19,437)	(53,456)
Fee income	7,536	9,814	10,367
Other income	9,048	431	
	3,452,445	3,452,678	3,167,529
<b>Total revenues</b>	<b>3,452,445</b>	<b>3,452,678</b>	<b>3,167,529</b>
<b>Expenses</b>			
Losses and loss adjustment expenses	1,644,170	1,790,549	2,001,949
Acquisition expenses	480,531	543,911	579,920
Other operating expenses	388,138	332,302	299,901
Interest expense	22,093	22,090	22,504
Net foreign exchange losses (gains)	43,969	23,933	(22,180)
	2,578,901	2,712,785	2,882,094
<b>Total expenses</b>	<b>2,578,901</b>	<b>2,712,785</b>	<b>2,882,094</b>
<b>Income before income taxes</b>	<b>873,544</b>	<b>739,893</b>	<b>285,435</b>
Income taxes:			
Current tax expense	(21,002)	(18,405)	(38,024)
Deferred tax benefit (expense)	5,401	(8,274)	9,075
	(15,601)	(26,679)	(28,949)
<b>Income tax expense</b>	<b>(15,601)</b>	<b>(26,679)</b>	<b>(28,949)</b>
<b>Net income</b>	<b>857,943</b>	<b>713,214</b>	<b>256,486</b>
Preferred dividends	(25,844)	(20,655)	
	832,099	692,559	256,486
<b>Net income available to common shareholders</b>	<b>\$ 832,099</b>	<b>\$ 692,559</b>	<b>\$ 256,486</b>
<b>Net income per common share data</b>			
Basic	\$ 11.72	\$ 9.46	\$ 7.26
Diluted	\$ 11.28	\$ 9.08	\$ 3.43
<b>Weighted average common shares and common share equivalents outstanding</b>			
Basic	70,995,672	73,212,432	35,342,650
Diluted	73,762,419	76,246,725	74,709,858

See Notes to Consolidated Financial Statements

**ARCH CAPITAL GROUP LTD. AND SUBSIDIARIES**  
**CONSOLIDATED STATEMENTS OF CHANGES IN SHAREHOLDERS' EQUITY**

(U.S. dollars in thousands)

	Years Ended December 31,		
	2007	2006	2005
<b>Series A Convertible Preference Shares</b>			
Balance at beginning of year	\$	\$	\$ 373
Converted to common shares			(373)
<b>Balance at end of year</b>			
<b>Non-Cumulative Preferred Shares</b>			
Balance at beginning of year	130		
Series A preferred shares issued		80	
Series B preferred shares issued		50	
<b>Balance at end of year</b>	130	130	
<b>Common Shares</b>			
Balance at beginning of year	743	733	349
Common shares issued, net	8	10	11
Purchases of common shares under share repurchase program	(78)		
Converted from preference shares			373
<b>Balance at end of year</b>	673	743	733
<b>Additional Paid-in Capital</b>			
Balance at beginning of year	1,944,304	1,595,440	1,560,291
Cumulative effect of change in accounting for unearned stock grant compensation		(9,646)	
Series A non-cumulative preferred shares issued		193,377	
Series B non-cumulative preferred shares issued		120,881	
Common shares issued	2,577	379	8,376
Exercise of stock options	18,599	27,578	27,342
Common shares retired	(539,384)	(1,657)	(1,511)
Amortization of share-based compensation	24,605	17,259	
Other	966	693	942
<b>Balance at end of year</b>	1,451,667	1,944,304	1,595,440
<b>Deferred Compensation Under Share Award Plan</b>			
Balance at beginning of year		(9,646)	(9,879)
Cumulative effect of change in accounting for unearned stock grant compensation		9,646	
Restricted common shares issued			(6,970)
Deferred compensation expense recognized			7,203

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	Years Ended December 31,		
	2017	2016	2015
<b>Balance at end of year</b>			(9,646)
<b>Retained Earnings</b>			
Balance at beginning of year	1,593,907	901,348	644,862
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	1,596,018	901,348	644,862
Dividends declared on preferred shares	(25,844)	(20,655)	
Net income	857,943	713,214	256,486
<b>Balance at end of year</b>	<b>2,428,117</b>	<b>1,593,907</b>	<b>901,348</b>
<b>Accumulated Other Comprehensive Income (Loss)</b>			
Balance at beginning of year	51,535	(7,348)	45,910
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	49,424	(7,348)	45,910
Change in unrealized appreciation (decline) in value of investments, net of deferred income tax	92,657	61,205	(52,271)
Foreign currency translation adjustments, net of deferred income tax	13,143	(2,322)	(987)
Balance at end of year	155,224	51,535	(7,348)
<b>Total Shareholders' Equity</b>	<b>\$ 4,035,811</b>	<b>\$ 3,590,619</b>	<b>\$ 2,480,527</b>

See Notes to Consolidated Financial Statements

**ARCH CAPITAL GROUP LTD. AND SUBSIDIARIES**  
**CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME**

(U.S. dollars in thousands)

	Years Ended December 31,		
	2007	2006	2005
<b>Comprehensive Income</b>			
Net income	\$ 857,943	\$ 713,214	\$ 256,486
Other comprehensive income (loss), net of deferred income tax			
Unrealized appreciation (decline) in value of investments:			
Unrealized holding gains (losses) arising during year	134,783	39,690	(105,637)
Reclassification of net realized (gains) losses, net of income taxes, included in net income	(42,126)	21,515	53,366
Foreign currency translation adjustments	13,143	(2,322)	(987)
	105,800	58,883	(53,258)
<b>Comprehensive Income</b>	<b>\$ 963,743</b>	<b>\$ 772,097</b>	<b>\$ 203,228</b>

See Notes to Consolidated Financial Statements

**ARCH CAPITAL GROUP LTD. AND SUBSIDIARIES**  
**CONSOLIDATED STATEMENTS OF CASH FLOWS**

(U.S. dollars in thousands)

	Years Ended December 31,		
	2007	2006	2005
<b>Operating Activities</b>			
Net income	\$ 857,943	\$ 713,214	\$ 256,486
Adjustments to reconcile net income to net cash provided by operating activities:			
Net realized (gains) losses	(27,912)	21,056	55,754
Other income	(9,048)	(431)	
Share-based compensation	24,605	17,259	8,218
Changes in:			
Reserve for losses and loss adjustment expenses, net of unpaid losses and loss adjustment expenses recoverable	569,490	847,826	1,187,906
Unearned premiums, net of prepaid reinsurance premiums	(36,775)	(55,472)	157,461
Premiums receivable	24,414	(77,059)	(152,121)
Deferred acquisition costs, net	997	26,358	(39,173)
Funds held by reinsureds	7,633	85,354	42,207
Reinsurance balances payable	(3,933)	151,228	(19,051)
Deferred income tax assets, net	(5,401)	8,274	(9,075)
Other liabilities	25,961	27,250	49,787
Other items, net	8,482	(155,901)	(86,378)
<b>Net Cash Provided By Operating Activities</b>	<b>1,436,456</b>	<b>1,608,956</b>	<b>1,452,021</b>
<b>Investing Activities</b>			
Purchases of fixed maturity investments	(20,454,932)	(15,728,141)	(10,361,040)
Proceeds from sales of fixed maturity investments	18,919,430	13,860,575	9,174,319
Proceeds from redemptions and maturities of fixed maturity investments	644,047	513,982	386,523
Purchases of other investments	(542,615)	(241,703)	(57,453)
Proceeds from sale of other investments	204,026	15,192	15,679
Net sales (purchases) of short-term investments	285,310	(245,005)	(507,048)
Change in securities lending collateral	(612,347)	2,003	(893,379)
Purchases of furniture, equipment and other assets	(27,996)	(13,240)	(13,668)
<b>Net Cash Used For Investing Activities</b>	<b>(1,585,077)</b>	<b>(1,836,337)</b>	<b>(2,256,067)</b>
<b>Financing Activities</b>			
Purchases of common shares under share repurchase program	(537,066)		
Proceeds from common shares issued, net of repurchases	13,498	19,683	20,249
Proceeds from preferred shares issued, net of issuance costs		314,388	
Change in securities lending collateral	612,347	(2,003)	893,379
Excess tax benefits from share-based compensation	4,923	5,448	
Preferred dividends paid	(25,844)	(17,353)	
<b>Net Cash Provided By Financing Activities</b>	<b>67,858</b>	<b>320,163</b>	<b>913,628</b>
Effects of exchange rate changes on foreign currency cash	3,661	1,758	(157)



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Years Ended December 31,

(Decrease) increase in cash	(77,102)	94,540	109,425
Cash beginning of year	317,017	222,477	113,052
<b>Cash end of year</b>	<b>\$ 239,915</b>	<b>\$ 317,017</b>	<b>\$ 222,477</b>
Income taxes paid, net	\$ 3,863	\$ 43,967	\$ 40,090
Interest paid	\$ 22,050	\$ 22,050	\$ 22,279

See Notes to Consolidated Financial Statements

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**ARCH CAPITAL GROUP LTD. AND SUBSIDIARIES**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

**1. Organization**

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.

ACGL was formed in September 2000 and became the sole shareholder of Arch Capital Group (U.S.) Inc. ("Arch-U.S.") pursuant to an internal reorganization transaction completed in November 2000, as described below. Arch-U.S. is a Delaware company formed in March 1995 under the original name of "Risk Capital Holdings, Inc." Prior to May 5, 2000, Arch-U.S. provided reinsurance and other forms of capital for insurance companies through its wholly owned subsidiary, Arch Reinsurance Company ("Arch Re U.S."), a Nebraska corporation formed in 1995 under the original name of "Risk Capital Reinsurance Company."

On May 5, 2000, Arch-U.S. sold the prior reinsurance operations of Arch Re U.S. to Folksamerica Reinsurance Company ("Folksamerica") in an asset sale. The Folksamerica transaction was structured as a transfer and assumption agreement (and not reinsurance) and, accordingly, the loss reserves (and any related reinsurance recoverables) related to the transferred business are not included in the Company's balance sheet. However, in the event that Folksamerica refuses or is unable to make payment of claims on the reinsurance business assumed by it in the May 2000 sale and the notice given to reinsureds is found not to be an effective release by such reinsureds, Arch Re U.S. would be liable for such claims (see Note 11). On November 8, 2000, following the approval of Arch-U.S.'s shareholders, Arch-U.S. completed an internal reorganization that resulted in Arch-U.S. becoming a wholly owned subsidiary of ACGL.

In October 2001, the Company launched an underwriting initiative to meet current and future demand in the global insurance and reinsurance markets that included the recruitment of new management teams and an equity capital infusion of \$763.2 million.

As used herein, the "Company" means ACGL and its subsidiaries, except when referring to periods prior to November 8, 2000, when it means Arch-U.S. and its subsidiaries. Similarly, "Common Shares" means the common shares, par value \$0.01, of ACGL, except when referring to periods prior to November 8, 2000, when it means the common stock of Arch-U.S.

**2. Significant Accounting Policies**

*(a) Basis of Presentation*

The 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, Arch Reinsurance Ltd. ("Arch Re Bermuda"), Arch Re U.S., Arch-U.S., Arch Insurance Company ("Arch Insurance"), Arch Specialty Insurance Company ("Arch Specialty"), Arch Excess & Surplus Insurance Company ("Arch E&S"), Western Diversified Casualty Insurance Company ("Western Diversified"), Arch Risk Transfer Services Ltd. ("ART Services"), and Arch Insurance Company (Europe) Limited ("Arch-Europe"). 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

ARCH CAPITAL GROUP LTD. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

**2. Significant Accounting Policies (Continued)**

the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates and assumptions.

*(b) Premium Revenues and Related Expenses*

Insurance premiums written are generally recorded at the policy inception and are primarily earned on a pro rata basis over the terms of the policies for all products, usually 12 months. Premiums written include estimates in the Company's programs, aviation, construction and surety and collateral protection business and for participation in involuntary pools. Such premium estimates are derived from multiple sources which include the historical experience of the underlying business, similar business and available industry information. Unearned premium reserves represent the portion of premiums written that relates to the unexpired terms of in-force insurance policies.

Reinsurance premiums written include amounts reported by brokers and ceding companies, supplemented by the Company's own estimates of premiums where reports have not been received or in cases where the amounts reported by brokers and ceding companies are adjusted to reflect management's best judgments and expectations. Premium estimates are derived from multiple sources which include the Company's underwriters, the historical experience of the underlying business, similar business and available industry information. Premiums written are recorded based on the type of contracts the Company writes. Premiums on the Company's excess of loss and pro rata reinsurance contracts are estimated when the business is underwritten. For excess of loss contracts, the minimum premium, as defined in the contract, is generally recorded as an estimate of premiums written as of the inception date of the treaty. Estimates of premiums written under pro rata contracts are recorded in the period in which the underlying risks are expected to incept and are based on information provided by the brokers and the ceding companies. For multi-year reinsurance treaties which are payable in annual installments, generally, only the initial annual installment is included as premiums written at policy inception due to the ability of the reinsured to commute or cancel coverage during the term of the policy. The remaining annual installments are included as premiums written at each successive anniversary date within the multi-year term.

Reinstatement premiums for the Company's insurance and reinsurance operations are recognized at the time a loss event occurs, where coverage limits for the remaining life of the contract are reinstated under pre-defined contract terms. Reinstatement premiums, if obligatory, are fully earned when recognized. The accrual of reinstatement premiums is based on an estimate of losses and loss adjustment expenses, which reflects management's judgment.

Premium estimates are reviewed by management at least quarterly. Such review includes a comparison of actual reported premiums to expected ultimate premiums along with a review of the aging and collection of premium estimates. Based on management's review, the appropriateness of the premium estimates is evaluated, and any adjustment to these estimates is recorded in the period in which it becomes known. Adjustments to premium estimates could be material and such adjustments could directly and significantly impact earnings favorably or unfavorably in the period they are determined because the estimated premium may be fully or substantially earned. A significant portion of amounts included as premiums receivable, which represent estimated premiums written, net of commissions, are not currently due based on the terms of the underlying contracts.

ARCH CAPITAL GROUP LTD. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

**2. Significant Accounting Policies (Continued)**

Reinsurance premiums assumed, irrespective of the class of business, are generally earned on a pro rata basis over the terms of the underlying policies or reinsurance contracts. Contracts and policies written on a "losses occurring" basis cover claims that may occur during the term of the contract or policy, which is typically 12 months. Accordingly, the premium is earned evenly over the term. Contracts which are written on a "risks attaching" basis cover claims which attach to the underlying insurance policies written during the terms of such contracts. Premiums earned on such contracts usually extend beyond the original term of the reinsurance contract, typically resulting in recognition of premiums earned over a 24-month period.

Certain of the Company's reinsurance contracts include provisions that adjust premiums or acquisition expenses based upon the experience under the contracts. Premiums written and earned, as well as related acquisition expenses, are recorded based upon the projected experience under such contracts.

The Company also writes certain business that is intended to provide insurers with risk management solutions that complement traditional reinsurance. Under these contracts, the Company assumes a measured amount of insurance risk in exchange for an anticipated margin, which is typically lower than on traditional reinsurance contracts. The terms and conditions of these contracts may include additional or return premiums based on loss experience, loss corridors, sublimits and caps. Examples of such business include aggregate stop-loss coverages, financial quota share coverages and multi-year retrospectively rated excess of loss coverages. If these contracts are deemed to transfer risk, they are accounted for as reinsurance.

Acquisition expenses and other expenses that vary with, and are directly related to, the acquisition of business related to the Company's underwriting operations are deferred and amortized over the period in which the related premiums are earned. Acquisition expenses, net of ceding commissions received from unaffiliated reinsurers, consist principally of commissions, brokerage and taxes paid to obtain the Company's business. Other operating expenses also include expenses that vary with, and are directly related to, the acquisition of business. Deferred acquisition costs, which are based on the related unearned premiums, are carried at their estimated realizable value and take into account anticipated losses and loss adjustment expenses, based on historical and current experience, and anticipated investment income. A premium deficiency is recognized if the sum of anticipated losses and loss adjustment expenses, unamortized acquisition costs and maintenance costs and anticipated investment income exceed unearned premiums. A premium deficiency is recognized by charging any unamortized acquisition costs to expense to the extent required in order to eliminate the deficiency. If the premium deficiency exceeds unamortized acquisition costs then a liability is accrued for the excess deficiency. No premium deficiency charges were recorded by the Company during the years ended December 31, 2007, 2006 or 2005.

***(c) Deposit Accounting***

Certain assumed reinsurance contracts, which pursuant to Statement of Financial Accounting Standards No. 113 ("SFAS No. 113"), "Accounting and Reporting for Reinsurance of Short-Duration and Long-Duration Contracts," issued by the Financial Accounting Standards Board ("FASB"), are deemed not to transfer insurance risk, are accounted for using the deposit method of accounting as prescribed in Statement of Position 98-7 ("SOP 98-7"), "Deposit Accounting: Accounting for Insurance

## ARCH CAPITAL GROUP LTD. AND SUBSIDIARIES

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

**2. Significant Accounting Policies (Continued)**

and Reinsurance Contracts That Do Not Transfer Insurance Risk." However, it is possible that the Company could incur financial losses on such contracts. Management exercises significant judgment in the assumptions used in determining whether assumed contracts should be accounted for as reinsurance contracts under SFAS No. 113 or deposit insurance contracts under SOP 98-7. Under SOP 98-7, for those contracts that contain an element of underwriting risk, the estimated profit margin is deferred and amortized over the contract period and such amount is included in the Company's underwriting results. When the estimated profit margin is explicit, the margin is reflected as fee income and any adverse financial results on such contracts are reflected as incurred losses. When the estimated profit margin is implicit, the margin is reflected as an offset to paid losses and any adverse financial results on such contracts are reflected as incurred losses. For those contracts that do not transfer an element of underwriting risk, the projected profit is reflected in earnings over the estimated settlement period using the interest method and such profit is included in investment income. Additional judgments are required when applying the accounting guidance set forth in SOP 98-7 with respect to the revenue recognition criteria for contracts deemed not to transfer insurance risk.

***(d) Retroactive Accounting***

Retroactive reinsurance reimburses a ceding company for liabilities incurred as a result of past insurable events covered by the underlying policies reinsured. In certain instances, reinsurance contracts cover losses both on a prospective basis and on a retroactive basis and, accordingly, the Company bifurcates the prospective and retrospective elements of these reinsurance contracts and accounts for each element separately. Underwriting income generated in connection with retroactive reinsurance contracts is deferred and amortized into income over the settlement period while losses are charged to income immediately. Subsequent changes in estimated or actual cash flows under such retroactive reinsurance contracts are accounted for by adjusting the previously deferred amount to the balance that would have existed had the revised estimate been available at the inception of the reinsurance transaction, with a corresponding charge or credit to income.

***(e) Reinsurance Ceded***

In the normal course of business, the Company purchases reinsurance to increase capacity and to limit the impact of individual losses and events on its underwriting results by reinsuring certain levels of risk with other insurance enterprises or reinsurers. The Company uses pro rata, excess of loss and facultative reinsurance contracts. Reinsurance ceding commissions are recognized as income on a pro rata basis over the period of risk. The portion of such commissions that will be earned in the future is deferred and reported as a reduction to acquisition costs. The accompanying consolidated statement of income reflects premiums and losses and loss adjustment expenses and acquisition costs, net of reinsurance ceded (see Note 4). Ceded unearned premiums are reported as prepaid reinsurance premiums and estimated amounts of reinsurance recoverable on unpaid losses are reported as unpaid losses and loss adjustment expenses recoverable. Reinsurance premiums ceded and unpaid losses and loss adjustment expenses recoverable are estimated in a manner consistent with that of the original policies issued and the terms of the reinsurance contracts. To the extent that any reinsurer does not meet its obligations under reinsurance agreements, the Company must discharge the liability.

ARCH CAPITAL GROUP LTD. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

**2. Significant Accounting Policies (Continued)**

*(f) Cash Equivalents*

Cash equivalents are investments with original maturities of three months or less which are not managed by external or internal investment advisors.

*(g) Investments*

The Company currently classifies all of its fixed maturity investments, short-term investments and publicly traded equity securities as "available for sale" and, accordingly, they are carried at estimated fair value. The fair value of fixed maturity securities is generally determined from quotations received from nationally recognized pricing services, or when such prices are not available, by reference to broker or underwriter bid indications. Short-term investments comprise securities due to mature within one year of the date of issue. Short-term investments include certain cash equivalents which are part of investment portfolios under the management of external and internal investment managers.

The Company participates in a securities lending program as a mechanism for generating additional interest income on its fixed income portfolio. Under the security lending agreements, certain of its fixed income portfolio securities are loaned to third parties, primarily major brokerage firms, for short periods of time through a lending agent. Such securities have been reclassified as "Fixed maturities and short-term investments pledged under securities lending agreements." The Company maintains control over the securities it lends, retains the earnings and cash flows associated with the loaned securities and receives a fee from the borrower for the temporary use of the securities. Collateral received, primarily in the form of cash, is required at a rate of 102% of the market value of the loaned securities (or 105% of the market value of the loaned securities when the collateral and loaned securities are denominated in non-U.S. currencies) including accrued investment income and is monitored and maintained by the lending agent. Such collateral is reinvested and is reflected as "Short-term investment of funds received under securities lending agreements, at fair value."

Other investments are classified as "available for sale" and include alternative investments, which are funds with underlying ownership structures that may be limited partnerships ("LPs") or limited liability companies ("LLCs"), equity securities such as investments in mutual funds and privately held securities. For those investments in which the underlying ownership structure is an LP or an LLC (*i.e.*, when the LLC meets specific criteria requiring it to be treated similar to an LP) the Company uses the equity method to account for such investments. Under the equity method, investments are initially recorded at cost and are subsequently adjusted for changes in the Company's proportionate share of net income or loss or other changes in capital of the investee. Changes in the carrying value of such investments are recorded in net investment income or other income. Investments in equity securities are carried at estimated fair value in accordance with SFAS No. 115. The estimated fair value of investments in privately held securities, other than those carried under the equity method, is initially equal to the cost of such investments until the investments are revalued based principally on substantive events or other factors which could indicate a diminution or appreciation in value, such as an arm's-length third party transaction justifying an increased valuation or adverse development of a significant nature requiring a write-down. See Note 7 for information regarding the Company's other investments.

ARCH CAPITAL GROUP LTD. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

**2. Significant Accounting Policies (Continued)**

In accordance with SFAS No. 115, "Accounting for Certain Investments in Debt and Equity Securities," FASB Staff Position Nos. FAS 115-1 and FAS 124-1, "The Meaning of Other-Than-Temporary Impairment and Its Application to Certain Investments" and Securities and Exchange Commission Staff Accounting Bulletin No. 59, "Other-Than-Temporary Impairment of Certain Investments in Debt and Equity Securities," the Company reviews its investments each quarter to determine whether a decline in fair value below the amortized cost basis is other-than-temporary. 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 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. In periods subsequent to the recognition of an other-than-temporary impairment on fixed maturities (other than credit-related impairments), the Company accounts for such securities as if they had been purchased on the measurement date of the other-than-temporary impairment. The discount or reduced premium recorded for the fixed maturities, based on the new cost basis, is amortized over the remaining life of the fixed maturities into net investment income, as discussed below.

Under SFAS No. 133, "Accounting for Derivative Instruments and Hedging Activities" ("SFAS No. 133"), as amended on January 1, 2001, all derivative financial instruments, including embedded derivative instruments, are required to be recognized as either assets or liabilities in the consolidated balance sheets and measured at fair value. The accounting for gains and losses associated with changes in the fair value of a derivative and the effect on the consolidated financial statements depends on whether it has been designated and qualifies as part of a hedging relationship and whether the hedge is highly effective in achieving offsetting changes in the fair value of the asset or liability hedged. The Company's investment strategy allows for the use of derivative instruments. 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. Pursuant to SFAS No. 133, these instruments, which have no hedging designation, are recognized as assets and liabilities in the Company's balance sheet at fair market value and changes in fair value are included in net realized gains and losses in its results of operations.

Net investment income includes interest and dividend income together with amortization of market premiums and discounts, includes changes in the market value of certain alternative investments accounted for under the equity method and is net of investment management and custody fees. Anticipated prepayments and expected maturities are used in applying the interest method for certain investments such as mortgage and other asset-backed securities. When actual prepayments differ significantly from anticipated prepayments, the effective yield is recalculated to reflect actual payments to date and anticipated future payments. The net investment in such securities is adjusted to the amount that would have existed had the new effective yield been applied since the acquisition of the security. Such adjustments, if any, are included in net investment income when determined.

**ARCH CAPITAL GROUP LTD. AND SUBSIDIARIES**

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

Investment gains or losses realized on the sale of investments are determined on a first-in, first-out basis and are reflected in net income. Unrealized appreciation or decline in the value of securities, which are carried at fair value, is excluded from net income and recorded as a separate component of other comprehensive income, net of applicable deferred income tax. Unrealized appreciation or decline in the value of investments accounted for under the equity method are included in net investment income.

***(h) Reserves for Losses and Loss Adjustment Expenses***

The reserve for losses and loss adjustment expenses consists of estimates of unpaid reported losses and loss adjustment expenses and estimates for losses incurred but not reported. The reserve for unpaid reported losses and loss adjustment expenses, established by management based on reports from ceding companies and claims from insureds, is net of estimates of amounts due from insureds related to losses under high deductible policies, and represents the estimated ultimate cost of events or conditions that have been reported to or specifically identified by the Company. Such reserves are supplemented by management's estimates of reserves for losses incurred for which reports or claims have not been received. Since the Company has limited historical experience upon which to base such estimates, the estimates are primarily determined based upon industry experience, information used in pricing contracts and policies and management's judgment. The Company's reserving method, to a large extent, has been the expected loss method, which is commonly applied when limited loss experience exists. The Company selects the initial expected loss and loss adjustment expense ratios based on information derived by its underwriters and actuaries during the initial pricing of the business, supplemented by industry data where appropriate. Such ratios consider, among other things, rate changes and changes in terms and conditions that have been observed in the market. These estimates are reviewed regularly and, as experience develops and new information becomes known, the reserves are adjusted as necessary. Such adjustments, if any, are reflected in income in the period in which they are determined. As actual loss information has been reported, the Company has developed its own loss experience and its reserving methods include other actuarial techniques. Over time, such techniques will be given more weight in its reserving process based on the continuing maturation of the Company's reserves. Inherent in the estimates of ultimate losses and loss adjustment expenses are expected trends in claims severity and frequency and other factors which may vary significantly as claims are settled. Accordingly, ultimate losses and loss adjustment expenses may differ materially from the amounts recorded in the accompanying consolidated financial statements. Losses and loss adjustment expenses are recorded on an undiscounted basis, except for excess workers' compensation and employers' liability business written by the Company's insurance operations.

***(i) Foreign Exchange***

Assets and liabilities of foreign operations whose functional currency is not the U.S. Dollar are translated at the prevailing exchange rates at each balance sheet date. Revenues and expenses of such foreign operations are translated at average exchange rates during the year. The net effect of the translation adjustments for foreign operations, net of applicable deferred income taxes, is included in accumulated other comprehensive income. Monetary assets and liabilities, such as premiums receivable and the reserve for losses and loss adjustment expenses, denominated in foreign currencies are revalued at the exchange rate in effect at the balance sheet date with the resulting foreign exchange gains and losses included in net income. Accounts that are classified as non-monetary, such as deferred acquisition costs and the unearned premium reserves, are not revalued. In the case of foreign currency denominated fixed maturity securities which are classified as "available for sale," the change in



**ARCH CAPITAL GROUP LTD. AND SUBSIDIARIES**

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

exchange rates between the local currency and the Company's functional currency at each balance sheet date is included in unrealized appreciation or decline in value of securities, a component of accumulated other comprehensive income.

***(j) Income Taxes***

Deferred income taxes reflect the expected future tax consequences of temporary differences between the carrying amounts of assets and liabilities for financial reporting purposes and amounts used for income tax purposes. A valuation allowance is recorded if it is more likely than not that some or all of a deferred tax asset may not be realized. The Company considers future taxable income and feasible tax planning strategies in assessing the need for a valuation allowance. In the event the Company determines that it will not be able to realize all or part of its deferred income tax assets in the future, an adjustment to the deferred income tax assets would be charged to income in the period in which such determination is made. In addition, if the Company subsequently assesses that the valuation allowance is no longer needed, a benefit would be recorded to income in the period in which such determination is made.

The Company recognizes a tax benefit where it concludes that it is more likely than not that the tax benefit will be sustained on audit by the taxing authority based solely on the technical merits of the associated tax position. If the recognition threshold is met, the Company recognizes a tax benefit measured at the largest amount of the tax benefit that, in the Company's judgment, is greater than 50% likely to be realized. The Company records interest and penalties related to unrecognized tax benefits in the provision for income taxes.

***(k) Earnings Per Common Share Data***

The calculation of basic earnings per common share excludes dilutive securities and is computed by dividing income available to common shareholders by the weighted average number of Common Shares, including vested restricted shares, outstanding for the periods. The calculation of diluted earnings per share reflects the potential dilution that could occur if Series A convertible preference shares ("Preference Shares"), Class B Warrants, nonvested restricted shares and employee stock options were converted into Common Shares. During the 2005 fourth quarter, all remaining Preference Shares were converted by the holders thereof into an equal number of Common Shares.

## ARCH CAPITAL GROUP LTD. AND SUBSIDIARIES

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

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

(U.S. dollars in thousands, except share data)	Years Ended December 31		
	2007	2006	2005
<b>Basic Earnings Per Common Share:</b>			
Net income	\$ 857,943	\$ 713,214	\$ 256,486
Preferred dividends	(25,844)	(20,655)	
Net income available to common shareholders	\$ 832,099	\$ 692,559	\$ 256,486
Divided by:			
Weighted average common shares outstanding	70,995,672	73,212,432	35,342,650
Basic earnings per common share	\$ 11.72	\$ 9.46	\$ 7.26
<b>Diluted Earnings Per Common Share:</b>			
Net income	\$ 857,943	\$ 713,214	\$ 256,486
Preferred dividends	(25,844)	(20,655)	
Net income available to common shareholders	\$ 832,099	\$ 692,559	\$ 256,486
Divided by:			
Weighted average common shares outstanding	70,995,672	73,212,432	35,342,650
Effect of dilutive securities:			
Series A convertible preference shares			36,685,573
Warrants			42,242
Nonvested restricted shares	180,143	483,703	449,242
Stock options(1)	2,586,604	2,550,590	2,190,151
Total shares	73,762,419	76,246,725	74,709,858
Diluted earnings per share	\$ 11.28	\$ 9.08	\$ 3.43

(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 2007, 2006 and 2005, the number of stock options excluded were 258,946, 888,172 and 62,838 respectively.

**(l) Share-Based Compensation**

*Stock Options*

Effective January 1, 2006, the Company adopted the fair value method of accounting for share-based compensation arrangements in accordance with FASB Statement No. 123 (revised 2004), "Share-Based Payment" ("SFAS No. 123(R)"), using the modified prospective method of transition. Under the fair value method of accounting, compensation expense is estimated based on the fair value of the award at the grant date and is recognized in net income over the requisite service period. Such compensation cost is reduced by assumed forfeitures and adjusted based on actual forfeitures until vesting. For awards granted to retirement-eligible employees where no service is required for the

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employee to retain the award, the grant date fair value is immediately recognized as compensation cost at the grant date because the employee is able to retain the award without continuing to provide

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ARCH CAPITAL GROUP LTD. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

service. For employees near retirement eligibility, attribution of compensation cost is over the period from the grant date to the retirement eligibility date.

Under the modified prospective approach, the fair value based method described in SFAS No. 123(R) is applied to new awards granted after January 1, 2006. Additionally, compensation expense for unvested stock options that are outstanding as of January 1, 2006 will be recognized in net income as the requisite service is rendered based on the grant date fair value of those options as previously calculated under pro forma disclosures under SFAS No. 123, "Accounting for Stock-Based Compensation" ("SFAS No. 123"), as amended by SFAS No. 148, "Accounting for Stock-Based Compensation-Transition and Disclosure." Therefore, under the modified prospective method, compensation expense is recognized beginning with the effective date of adoption of SFAS No.123(R) for all stock option awards (i) granted after the effective date of adoption and (ii) granted prior to the effective date of adoption and that remain unvested on the date of adoption.

Prior to January 1, 2006, the Company accounted for its share-based compensation related to stock option awards using the intrinsic value method of accounting in accordance with Accounting Principles Board Opinion No. 25, "Accounting for Stock Issued to Employees" ("APB No. 25"), and its related interpretations permitted by SFAS No. 123, which did not require the recognition of compensation expense related to the issuance of stock options so long as the quoted market price of the Company's stock at the date of grant was less than or equal to the amount an employee must pay to acquire the stock.

The share-based compensation expense associated with stock options that have graded vesting features and vest based on service conditions only (i) granted after the effective date of adoption is calculated on a straight-line basis over the requisite service periods of the related options and (ii) granted prior to the effective date of adoption and that remain unvested as of the date of adoption is calculated on a graded-vesting basis as prescribed under FASB Interpretation No. 28, "Accounting for Stock Appreciation Rights and Other Variable Stock Option or Award Plans" an interpretation of APB Opinions No. 15 and 25," over the remaining requisite service periods of the related options. These charges had no impact on the Company's cash flows or total shareholders' equity.

*Restricted Common Shares and Restricted Units*

As discussed above, effective January 1, 2006, the Company adopted the fair value method of accounting for share-based compensation arrangements in accordance with SFAS No. 123(R), which governs the accounting for all share-based compensation. Under the fair value method of accounting pursuant to SFAS No. 123(R), the fair value for restricted shares and units is measured by the grant-date price of the Company's shares. No value is attributed to awards that employees forfeit because they fail to satisfy vesting conditions. As such, the number of shares granted is reduced by assumed forfeitures and adjusted based on actual forfeitures until vesting. Such expense is amortized over the requisite service period of the related awards, which is generally the vesting period unless the employee is retirement-eligible. Restricted share and unit awards granted prior to September 2005 generally vest over a two year period: one-third immediately on the grant date and one-third on the first and second anniversaries of the grant date. In September 2005, the Company's board of directors approved a longer vesting period for future restricted share and unit awards to vest over a three year period: one-third on the first, second and third anniversaries of the grant date.

The share-based compensation expense associated with restricted share and unit awards have graded vesting features and vest based on service conditions only (i) granted after the effective date of adoption is calculated on a straight-line basis over the requisite service periods of the related awards

ARCH CAPITAL GROUP LTD. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

and (ii) granted prior to the effective date of adoption and that remain unvested as of the date of adoption is calculated on a graded-vesting basis over the remaining requisite service periods of the related awards. These charges had no impact on the Company's cash flows or total shareholders' equity. See Note 13 for information relating to the Company's restricted share and unit awards.

Prior to January 1, 2006, the Company accounted for its share-based compensation related to restricted share and unit awards using the intrinsic value method of accounting in accordance with APB No. 25 and its related interpretations. Compensation expense equal to the market value of the restricted share awards at the measurement date was amortized and recorded in net income over the vesting period.

***(m) Goodwill and Intangible Assets***

The goodwill and intangible assets of acquired businesses, which is included in other assets in the Company's balance sheet, represents the difference between the purchase price and the fair value of the net assets of the acquired businesses. The Company assesses whether goodwill and intangible assets are impaired by comparing the fair value of each reporting unit to its carrying value, including goodwill and intangible assets. The Company estimates the fair value of each reporting unit by using various methods, including a review of the estimated discounted cash flows expected to be generated by the reporting unit in the future. Such methods include a number of assumptions, including the uncertainty regarding future results and the discount rates used. If the reporting unit's fair value is greater than its carrying value, goodwill and intangible assets are not impaired. Impairment occurs when the implied fair value of a reporting unit's goodwill and intangible assets is less than its carrying value. The implied fair value of goodwill and intangible assets is determined by deducting the fair value of a reporting unit's identifiable assets and liabilities from the fair value of the reporting unit as a whole. The Company conducts its impairment test annually. Additional impairment assessments may be performed on an interim basis if the Company encounters events or changes in circumstances indicating that more likely than not the carrying value of goodwill and intangible assets has been impaired.

***(n) Guaranty Fund and Other Related Assessments***

Liabilities for guaranty fund and other related assessments in the Company's insurance and reinsurance operations are accrued when the Company receives notice that an amount is payable, or earlier if a reasonable estimate of the assessment can be made.

***(o) Reclassifications***

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.

***(p) Recent Accounting Pronouncements***

In February 2008, the FASB issued a final Staff Position indefinitely deferring the effective date of Statement of Position 07-1 ("SOP 07-1"), "Clarification of the Scope of the Audit and Accounting Guide 'Investment Companies' and Accounting by Parent Companies and Equity Method Investors for Investments in Investment Companies" due to various implementation issues that have surfaced in practice since SOP 07-1 was issued in 2007. SOP 7-01 intended to clarify which entities are within the scope of the AICPA Audit and Accounting Guide, Investment Companies (the "Guide") and whether

**ARCH CAPITAL GROUP LTD. AND SUBSIDIARIES**

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

companies that own or have significant stakes in an investment company should retain the specialized financial statement accounting that the Guide prescribes for the investment company industry.

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 September 2006, the FASB issued SFAS No. 157, "Fair Value Measurements," 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. As a result of SFAS No. 157, there is now a common definition of fair value to be used throughout GAAP. The Company does not anticipate that the impact of adopting SFAS No. 157 will be material on its results of operations or financial position. SFAS No. 157 is effective for the Company beginning in the 2008 first quarter.

In February 2007, the FASB issued SFAS No. 159, "The Fair Value Option for Financial Assets and Financial Liabilities - Including an Amendment of FASB Statement No. 115," 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. SFAS No. 159 is effective for the Company beginning in the 2008 first quarter. The Company is reviewing the impact that adopting SFAS No. 159 will have on its financial statements.

**ARCH CAPITAL GROUP LTD. AND SUBSIDIARIES**

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

**3. Segment Information**

The Company classifies its businesses into two underwriting segments—insurance and reinsurance—and a corporate and other segment (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 eight product lines: casualty; construction, surety and national accounts; executive assurance; healthcare; professional liability; programs; property, marine and aviation; and other (consisting of collateral protection, excess workers' compensation and employers' liability 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).

The corporate and other segment (non-underwriting) includes net investment income, other income (loss), other expenses incurred by the Company, interest expense, net realized gains or losses, net foreign exchange gains or losses and income taxes. In addition, results for the corporate and other segment include dividends on the Company's non-cumulative preferred shares.

## ARCH CAPITAL GROUP LTD. AND SUBSIDIARIES

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

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

	Year Ended December 31, 2007		
	Insurance	Reinsurance	Total
<b>(U.S. dollars in thousands)</b>			
Gross premiums written(1)	\$ 2,660,302	\$ 1,517,645	\$ 4,140,143
Net premiums written(1)	1,717,548	1,184,388	2,901,936
Net premiums earned(1)	\$ 1,702,343	\$ 1,242,307	\$ 2,944,650
Fee income	5,063	2,473	7,536
Losses and loss adjustment expenses	(1,077,769)	(566,401)	(1,644,170)
Acquisition expenses, net	(201,703)	(278,828)	(480,531)
Other operating expenses	(276,388)	(81,059)	(357,447)
Underwriting income	\$ 151,546	\$ 318,492	470,038
Net investment income			463,070
Net realized gains			28,141
Other income			9,048
Other expenses			(30,691)
Interest expense			(22,093)
Net foreign exchange losses			(43,969)
Income before income taxes			873,544
Income tax expense			(15,601)
<b>Net income</b>			<b>857,943</b>
Preferred dividends			(25,844)
<b>Net income available to common shareholders</b>			<b>\$ 832,099</b>
<b>Underwriting ratios</b>			
Loss ratio	63.3%	45.6%	55.8%
Acquisition expense ratio(2)	11.7%	22.4%	16.2%
Other operating expense ratio	16.2%	6.5%	12.1%
Combined ratio	91.2%	74.5%	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 \$1.0 million and \$36.8 million, respectively, of gross and net premiums written and \$1.0 million and \$40.3 million, respectively, of net premiums earned assumed through intersegment transactions.



(2)

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

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## ARCH CAPITAL GROUP LTD. AND SUBSIDIARIES

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(U.S. dollars in thousands)	Year Ended December 31, 2006		
	Insurance	Reinsurance	Total
Gross premiums written(1)	\$ 2,624,757	\$ 1,703,796	\$ 4,282,449
Net premiums written(1)	1,652,056	1,365,362	3,017,418
Net premiums earned(1)	\$ 1,600,854	\$ 1,480,811	\$ 3,081,665
Fee income	5,085	4,729	9,814
Losses and loss adjustment expenses	(1,017,263)	(773,286)	(1,790,549)
Acquisition expenses, net	(175,740)	(368,171)	(543,911)
Other operating expenses	(249,637)	(53,533)	(303,170)
Underwriting income	\$ 163,299	\$ 290,550	453,849
Net investment income			380,205
Net realized losses			(19,437)
Other income			431
Other expenses			(29,132)
Interest expense			(22,090)
Net foreign exchange losses			(23,933)
Income before income taxes			739,893
Income tax expense			(26,679)
<b>Net income</b>			<b>713,214</b>
Preferred dividends			(20,655)
<b>Net income available to common shareholders</b>			<b>\$ 692,559</b>
<b>Underwriting ratios</b>			
Loss ratio	63.5%	52.2%	58.1%
Acquisition expense ratio(2)	10.8%	24.9%	17.5%
Other operating expense ratio	15.6%	3.6%	9.8%
Combined ratio	89.9%	80.7%	85.4%

(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. The insurance segment and reinsurance segment results include \$1.0 million and \$45.1 million, respectively, of gross and net premiums written and \$1.9 million and \$48.1 million, respectively, of net premiums earned assumed through intersegment transactions.

(2)

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



## ARCH CAPITAL GROUP LTD. AND SUBSIDIARIES

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(U.S. dollars in thousands)	Year Ended December 31, 2005		
	Insurance	Reinsurance	Total
Gross premiums written(1)	\$ 2,325,632	\$ 1,750,839	\$ 4,014,817
Net premiums written(1)	1,481,300	1,657,472	3,138,772
Net premiums earned(1)	\$ 1,392,114	\$ 1,585,602	\$ 2,977,716
Fee income	5,332	5,035	10,367
Losses and loss adjustment expenses	(949,996)	(1,051,953)	(2,001,949)
Acquisition expenses, net	(137,804)	(442,116)	(579,920)
Other operating expenses	(221,934)	(52,192)	(274,126)
Underwriting income	\$ 87,712	\$ 44,376	132,088
Net investment income			232,902
Net realized losses			(53,456)
Other expenses			(25,775)
Interest expense			(22,504)
Net foreign exchange gains			22,180
Income before income taxes			285,435
Income tax expense			(28,949)
<b>Net income</b>			256,486
Preferred dividends			
<b>Net income available to common shareholders</b>			\$ 256,486
<b>Underwriting ratios</b>			
Loss ratio	68.2%	66.3%	67.2%
Acquisition expense ratio(2)	9.7%	27.9%	19.4%
Other operating expense ratio	15.9%	3.3%	9.2%
<b>Combined ratio</b>	<b>93.8%</b>	<b>97.5%</b>	<b>95.8%</b>

(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 \$3.2 million and \$58.4 million, respectively, of gross and net premiums written and \$4.5 million and \$56.9 million, respectively, of net premiums earned assumed through intersegment transactions.

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

## ARCH CAPITAL GROUP LTD. AND SUBSIDIARIES

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

## 3. Segment Information (Continued)

The following tables set forth, for each of the Company's segments, net premiums written and earned by major line of business together with net premiums written by client and underwriting location:

	Years Ended December 31,					
	2007		2006		2005	
	Amount	% of Total	Amount	% of Total	Amount	% of Total
<b>INSURANCE SEGMENT</b>						
(U.S. dollars in thousands)						
<b>Net premiums written(1)</b>						
Property, marine and aviation	\$ 330,460	19.3	\$ 320,928	19.4	\$ 228,642	15.4
Professional liability(2)	328,369	19.1	289,328	17.5	227,828	15.4
Construction and surety	283,997	16.5	274,460	16.6	233,133	15.7
Programs	235,793	13.7	225,653	13.7	232,156	15.7
Executive assurance	185,351	10.8	193,694	11.8	169,430	11.4
Casualty	181,774	10.6	220,244	13.3	271,788	18.4
Healthcare	63,757	3.7	68,026	4.1	70,928	4.8
Other(3)	108,047	6.3	59,723	3.6	47,395	3.2
<b>Total</b>	<b>\$ 1,717,548</b>	<b>100.0</b>	<b>\$ 1,652,056</b>	<b>100.0</b>	<b>\$ 1,481,300</b>	<b>100.0</b>
<b>Net premiums earned(1)</b>						
Property, marine and aviation	\$ 335,569	19.7	\$ 291,119	18.2	\$ 193,423	13.9
Professional liability(2)	324,838	19.1	266,527	16.6	208,454	15.0
Construction, surety and national accounts	280,201	16.5	265,992	16.6	222,705	16.0
Programs	231,012	13.6	224,841	14.0	227,607	16.3
Executive assurance	184,154	10.8	193,295	12.2	138,641	10.0
Casualty	201,247	11.8	243,050	15.2	284,340	20.4
Healthcare	68,456	4.0	70,747	4.4	67,769	4.9
Other(3)	76,866	4.5	45,283	2.8	49,175	3.5
<b>Total</b>	<b>\$ 1,702,343</b>	<b>100.0</b>	<b>\$ 1,600,854</b>	<b>100.0</b>	<b>\$ 1,392,114</b>	<b>100.0</b>
<b>Net premiums written by client location(1)</b>						
United States	\$ 1,323,376	77.1	\$ 1,340,792	81.2	\$ 1,293,938	87.4
Europe	250,824	14.6	182,815	11.0	107,283	7.2
Other	143,348	8.3	128,449	7.8	80,079	5.4
<b>Total</b>	<b>\$ 1,717,548</b>	<b>100.0</b>	<b>\$ 1,652,056</b>	<b>100.0</b>	<b>\$ 1,481,300</b>	<b>100.0</b>
<b>Net premiums written by underwriting location(1)</b>						
United States	\$ 1,309,401	76.2	\$ 1,297,974	78.6	\$ 1,258,162	84.9
Europe	330,746	19.3	269,128	16.3	174,676	11.8
Other	77,401	4.5	84,954	5.1	48,462	3.3

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Years Ended December 31,

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Total	\$	1,717,548	100.0	\$	1,652,056	100.0	\$	1,481,300	100.0
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(1) Insurance segment results include net premiums written and earned of \$1.0 million and \$1.0 million, respectively, assumed through intersegment transactions for 2007, \$1.0 million and \$1.9 million, respectively, for 2006 and \$3.2 million and \$4.5 million, respectively, for 2005. Insurance segment results exclude premiums written and earned of \$36.8 million and \$40.3 million, respectively, ceded through intersegment transactions for 2007, \$45.1 million and \$48.1 million, respectively, for 2006 and \$58.4 million and \$56.9 million, respectively, for 2005.

(2) Includes travel and accident business.

(3) Includes excess workers' compensation and employers' liability business.

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## ARCH CAPITAL GROUP LTD. AND SUBSIDIARIES

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

## 3. Segment Information (Continued)

	Years Ended December 31,					
	2007		2006		2005	
	Amount	% of Total	Amount	% of Total	Amount	% of Total
<b>REINSURANCE SEGMENT</b>						
(U.S. dollars in thousands)						
<b>Net premiums written(1)</b>						
Casualty(2)	\$ 466,209	39.4	\$ 591,219	43.3	\$ 753,829	45.5
Property excluding property catastrophe(3)	248,367	21.0	297,080	21.8	339,643	20.5
Property catastrophe	202,203	17.1	146,751	10.7	162,519	9.8
Other specialty	148,776	12.5	218,157	16.0	251,519	15.2
Marine and aviation	110,586	9.3	109,865	8.0	108,981	6.6
Other	8,247	0.7	2,290	0.2	40,981	2.4
Total	\$ 1,184,388	100.0	\$ 1,365,362	100.0	\$ 1,657,472	100.0
<b>Net premiums earned(1)</b>						
Casualty(2)	\$ 505,578	40.7	\$ 668,086	45.1	\$ 774,309	48.9
Property excluding property catastrophe(3)	264,151	21.3	310,042	20.9	293,776	18.5
Property catastrophe	171,496	13.8	176,106	11.9	121,999	7.7
Other specialty	184,597	14.8	220,641	14.9	247,344	15.6
Marine and aviation	104,482	8.4	100,565	6.8	105,141	6.6
Other	12,003	1.0	5,371	0.4	43,033	2.7
Total	\$ 1,242,307	100.0	\$ 1,480,811	100.0	\$ 1,585,602	100.0
<b>Net premiums written(1)</b>						
Pro rata	\$ 803,352	67.8	\$ 987,391	72.3	\$ 1,314,048	79.3
Excess of loss	381,036	32.2	377,971	27.7	343,424	20.7
Total	\$ 1,184,388	100.0	\$ 1,365,362	100.0	\$ 1,657,472	100.0
<b>Net premiums earned(1)</b>						
Pro rata	\$ 874,647	70.4	\$ 1,121,329	75.7	\$ 1,199,798	75.7
Excess of loss	367,660	29.6	359,482	24.3	385,804	24.3
Total	\$ 1,242,307	100.0	\$ 1,480,811	100.0	\$ 1,585,602	100.0
<b>Net premiums written by client location(1)</b>						
United States	\$ 688,841	58.1	\$ 770,309	56.4	\$ 898,980	54.2
Europe	258,952	21.9	368,332	27.0	437,663	26.4
Bermuda	179,935	15.2	132,618	9.7	188,321	11.4
Other	56,660	4.8	94,103	6.9	132,508	8.0

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Years Ended December 31,

Total	\$	1,184,388	100.0	\$	1,365,362	100.0
<b>Net premiums written by underwriting location(1)</b>						
Bermuda	\$	691,782	58.4	\$	813,356	59.6
United States		471,551	39.8		552,006	40.4
Other		21,055	1.8			
Total	\$	1,184,388	100.0	\$	1,365,362	100.0

- (1) Reinsurance segment results include net premiums written and earned of \$36.8 million and \$40.3 million, respectively, assumed through intersegment transactions for 2007, \$45.1 million and \$48.1 million, respectively, for 2006 and \$58.4 million and \$56.9 million, respectively, for 2005. Reinsurance segment results exclude premiums written and earned of \$1.0 million and \$1.0 million, respectively, ceded through intersegment transactions for 2007, \$1.0 million and \$1.9 million, respectively, for 2006 and \$3.2 million and \$4.5 million, respectively, for 2005.
- (2) Includes professional liability and executive assurance business.
- (3) Includes facultative business.



## ARCH CAPITAL GROUP LTD. AND SUBSIDIARIES

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

## 4. 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 purchase retrocessional coverage as part of their risk management program including an agreement with Flatiron Re Ltd. discussed below. 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 (see Note 11).

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

	Years Ended December 31,		
	2007	2006	2005
<b>(U.S. dollars in thousands)</b>			
<b>Premiums Written</b>			
Direct	\$ 2,564,902	\$ 2,572,936	\$ 2,268,323
Assumed	1,575,241	1,709,513	1,746,494
Ceded	(1,238,207)	(1,265,031)	(876,045)
<b>Net</b>	<b>\$ 2,901,936</b>	<b>\$ 3,017,418</b>	<b>\$ 3,138,772</b>
<b>Premiums Earned</b>			
Direct	\$ 2,570,316	\$ 2,480,885	\$ 2,151,724
Assumed	1,622,656	1,752,683	1,677,319
Ceded	(1,248,322)	(1,151,903)	(851,327)
<b>Net</b>	<b>\$ 2,944,650</b>	<b>\$ 3,081,665</b>	<b>\$ 2,977,716</b>
<b>Losses and Loss Adjustment Expenses</b>			
Direct	\$ 1,428,610	\$ 1,595,006	\$ 1,790,973
Assumed	759,578	899,877	1,294,288
Ceded	(544,018)	(704,334)	(1,083,312)
<b>Net</b>	<b>\$ 1,644,170</b>	<b>\$ 1,790,549</b>	<b>\$ 2,001,949</b>

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.

## ARCH CAPITAL GROUP LTD. AND SUBSIDIARIES

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

## 4. Reinsurance (Continued)

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, for the period ending on December 31, 2007, the amount required to be on deposit in the Trust, together with certain other amounts, was an amount equal to the greater of (1) \$800 million and (2) 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"). For the period after December 31, 2007 through the earning of all written premium, the Requisite Funded Amount will be the calculated amount described in clause "(2)" above. 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 with Flatiron Re Ltd. 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 2007 and 2006, \$311.3 million and \$273.2 million, respectively, of premiums written, \$282.2 million and \$157.4 million, respectively, of premiums earned and \$100.4 million and \$52.2 million, respectively, of losses and loss adjustment expenses were ceded to Flatiron Re Ltd. by Arch Re Bermuda. At December 31, 2007, \$144.9 million of premiums ceded to Flatiron Re Ltd. were unearned.

## 5. Reserve for Losses and Loss Adjustment Expenses

The following table represents an analysis of losses and loss adjustment expenses and a reconciliation of the beginning and ending reserve for losses and loss adjustment expenses:

	Years Ended December 31,		
	2007	2006	2005
(U.S. dollars in thousands)			
Reserve for losses and loss adjustment expenses at beginning of year	\$ 6,463,041	\$ 5,452,826	\$ 3,492,759
Unpaid losses and loss adjustment expenses recoverable	1,552,157	1,389,768	617,607
Net reserve for losses and loss adjustment expenses at beginning of year	4,910,884	4,063,058	2,875,152
Increase (decrease) in net losses and loss adjustment expenses incurred relating to losses occurring in:			
Current year	1,829,534	1,867,344	2,120,962
Prior years	(185,364)	(76,795)	(119,013)
Total net incurred losses and loss adjustment expenses	1,644,170	1,790,549	2,001,949
Foreign exchange losses (gains)	45,192	47,711	(55,854)
Less net losses and loss adjustment expenses paid relating to losses occurring in:			
Current year	274,102	245,856	308,954
Prior years	843,311	744,578	449,235
Total net paid losses and loss adjustment expenses	1,117,413	990,434	758,189
Net reserve for losses and loss adjustment expenses at end of year	5,482,833	4,910,884	4,063,058
Unpaid losses and loss adjustment expenses recoverable	1,609,619	1,552,157	1,389,768
Reserve for losses and loss adjustment expenses at end of year	\$ 7,092,452	\$ 6,463,041	\$ 5,452,826

## ARCH CAPITAL GROUP LTD. AND SUBSIDIARIES

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

**5. Reserve for Losses and Loss Adjustment Expenses (Continued)**

During 2007, the Company recorded a redundancy on net reserves recorded in prior years of approximately \$185.4 million, which consisted of \$172.7 million from the reinsurance segment and \$12.7 million from the insurance segment. Of the net favorable development in the reinsurance segment, \$110.6 million came from short-tail lines, and \$62.1 million came from longer-tail lines. The development resulted from better than anticipated loss emergence. The net favorable development was partially offset by an increase in acquisition expenses of \$18.5 million, primarily as a result of the commutation of certain treaties. In addition, in its reserving process in 2002 and 2003, the reinsurance segment recognized that there is a possibility that the assumptions made could prove to be inaccurate due to several factors primarily related to the start up nature of its operations. Due to the availability of additional data, and based on reserve analyses, it was determined that it was no longer necessary to continue to include such factors in 2004 or subsequent periods. Following reserve reviews, and based on the level of claims activity reported to date, the reinsurance segment reduced the amount of reserves it had recorded in 2002 and 2003 by \$10.6 million in 2007. As a result of applying a small amount of weight to its own experience, the insurance segment reduced loss selections for some lines, in particular those written on a claims-made basis and for which it now has a reasonable level of credible data. The insurance segment's net favorable development of \$12.7 million was primarily due to reductions in reserves in medium-tailed and long-tailed lines of business resulting from such changes, partially offset by adverse development of \$33.3 million from short-tail lines which primarily resulted from higher than expected claims development. The net favorable development was partially offset by an increase in acquisition expenses of \$9.5 million, primarily due to sliding scale arrangements on certain policies.

During 2006, the Company recorded a redundancy on net reserves recorded in prior years of approximately \$76.8 million, which consisted of \$68.5 million from the reinsurance segment and \$8.3 million from the insurance segment. Of the net favorable development in the reinsurance segment, \$37.1 million came from short-tail lines, and \$31.4 million came from longer-tail lines. The development resulted from better than anticipated loss emergence and was net of \$38.1 million of adverse development on the 2005 catastrophic events, primarily in short-tail lines. The net favorable development was partially offset by an increase in acquisition expenses of \$7.8 million, primarily as a result of the commutation of certain treaties. As noted above, in its reserving process in 2002 and 2003, the reinsurance segment recognized that there is a possibility that the assumptions made could prove to be inaccurate due to several factors primarily related to the start up nature of its operations. Following reserve reviews, and based on the level of claims activity reported to date, the reinsurance segment reduced the amount of reserves it had recorded in 2002 and 2003 by \$7.6 million in 2006. As a result of applying a small amount of weight to its own experience, the insurance segment reduced loss selections for some lines, in particular those written on a claims-made basis and for which it now has a reasonable level of credible data. The insurance segment's net favorable development of \$8.3 million was primarily due to reductions in reserves in medium-tailed and long-tailed lines of business resulting from such changes, partially offset by adverse development of \$44.0 million from short-tail lines which included \$30.8 million of adverse development on the 2005 catastrophic events.

During 2005, the Company recorded a redundancy on net reserves recorded in prior years of approximately \$119.0 million. The net favorable development consisted of \$91.2 million from the reinsurance segment and \$27.8 million from the insurance segment. Of the net favorable development in the reinsurance segment, \$85.3 million was primarily due to short-tail lines, mainly property, and resulted from better than anticipated loss emergence. Such amount was partially offset by an increase in acquisition expenses of \$9.0 million, primarily as a result of the commutation of certain treaties. As noted above, in its reserving process in 2002 and 2003, the reinsurance segment recognized that there is a possibility that the assumptions made could prove to be inaccurate due to several factors primarily

## ARCH CAPITAL GROUP LTD. AND SUBSIDIARIES

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

## 5. Reserve for Losses and Loss Adjustment Expenses (Continued)

related to the start up nature of its operations. Following a reserve review in the 2004 fourth quarter, and based on the level of claims activity reported to date, the reinsurance segment reduced the amount of reserves it had recorded in 2002 and 2003 by \$12.1 million in 2005. Prior to 2005, the insurance segment's reserving method relied heavily on industry data. In 2005, the insurance segment began to give a relatively small amount of weight to its own experience. As a result, the insurance segment reduced reserves in certain medium-tailed and long-tailed lines of business, in particular those written on a claims-made basis and for which it now has a reasonable level of credible data.

## 6. Deposit Accounting

Certain assumed reinsurance contracts are deemed, under current financial accounting standards, not to transfer insurance risk, and are accounted for using the deposit method of accounting. However, it is possible that the Company could incur financial losses on such contracts. For those contracts that contain an element of underwriting risk, the estimated profit margin is deferred and amortized over the contract period and such amount is included in the Company's underwriting results. When the estimated profit margin is explicit, the margin is reflected as fee income and any adverse financial results on such contracts are reflected as incurred losses. For 2007, 2006 and 2005, the Company recorded \$2.5 million, \$4.1 million and \$0.4 million of fee income on such contracts, respectively. When the estimated profit margin is implicit, the margin is reflected as an offset to paid losses and any adverse financial results on such contracts are reflected as incurred losses. For 2007, the Company recorded incurred losses of \$0.4 million which were reflected as an increase to paid losses. For 2006 and 2005, the Company recorded \$2.1 million and \$6.1 million, respectively, as an offset to paid losses on such contracts. On a notional basis, the amount of premiums from those contracts that contain an element of underwriting risk was \$0.9 million, \$11.9 million and \$7.6 million, respectively, for 2007, 2006 and 2005. In making any determination to account for a contract using the deposit method of accounting, the Company is required to make many estimates and judgments under the current financial accounting standards.

## 7. Investment Information

The Company's invested assets were as follows:

(U.S. dollars in thousands)	December 31,	
	2007	2006
Fixed maturities available for sale, at fair value	\$ 7,137,998	\$ 6,876,548
Fixed maturities pledged under securities lending agreements, at fair value(1)	1,462,826	860,803
<b>Total fixed maturities</b>	<b>8,600,824</b>	<b>7,737,351</b>
Short-term investments available for sale, at fair value	699,036	957,698
Short-term investments pledged under securities lending agreements, at fair value(1)	219	
Other investments	589,669	307,082
<b>Total invested assets(1)(2)</b>	<b>\$ 9,889,748</b>	<b>\$ 9,002,131</b>

(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 December 31, 2007 and 2006 of \$1.5 billion and \$891.4 million, respectively, which is reflected as "short-term investment of

## ARCH CAPITAL GROUP LTD. AND SUBSIDIARIES

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

## 7. Investment Information (Continued)

funds received under securities lending agreements, at fair value" and included the \$1.46 billion and \$860.8 million, respectively, of "fixed maturities and short-term investments pledged under securities lending agreements, at fair value."

(2)

Includes certain securities transactions entered into but not settled at the balance sheet date. Net of such amounts, total invested assets were approximately \$9.88 billion and \$8.77 billion, respectively, at December 31, 2007 and 2006.

*Fixed Maturities and Fixed Maturities Pledged Under Securities Lending Agreements*

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

(U.S. dollars in thousands)	Estimated Fair Value	Gross Unrealized Gains	Gross Unrealized Losses	Amortized Cost
<b>December 31, 2007:</b>				
Corporate bonds	\$ 2,452,527	\$ 40,296	\$ (10,994)	\$ 2,423,225
Commercial mortgage backed securities	1,315,680	17,339	(558)	1,298,899
Mortgage backed securities	1,234,596	14,211	(4,087)	1,224,472
U.S. government and government agencies	1,165,423	21,598	(447)	1,144,272
Asset backed securities	1,008,030	9,508	(4,030)	1,002,552
Municipal bonds	990,325	13,213	(195)	977,307
Non-U.S. government securities	434,243	28,032	(3,056)	409,267
<b>Total</b>	<b>\$ 8,600,824</b>	<b>\$ 144,197</b>	<b>\$ (23,367)</b>	<b>\$ 8,479,994</b>
<b>December 31, 2006:</b>				
Corporate bonds	\$ 1,504,989	\$ 9,196	\$ (5,634)	\$ 1,501,427
Commercial mortgage backed securities	868,586	4,953	(1,098)	864,731
Mortgage backed securities	1,183,805	7,866	(1,678)	1,177,617
U.S. government and government agencies	1,922,511	12,835	(10,806)	1,920,482
Asset backed securities	907,829	923	(1,457)	908,363
Municipal bonds	815,204	1,323	(3,885)	817,766
Non-U.S. government securities	534,427	15,776	(4,718)	523,369
<b>Total</b>	<b>\$ 7,737,351</b>	<b>\$ 52,872</b>	<b>\$ (29,276)</b>	<b>\$ 7,713,755</b>

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. The fair market values of such securities at December 31, 2007 were approximately \$65.4 million. The change in market value of such securities is reflected as realized gains or losses.

The contractual maturities of the Company's fixed maturities and fixed maturities pledged under securities lending agreements are shown below. Expected maturities, which are management's best

## ARCH CAPITAL GROUP LTD. AND SUBSIDIARIES

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

## 7. Investment Information (Continued)

estimates, will differ from contractual maturities because borrowers may have the right to call or prepay obligations with or without call or prepayment penalties.

(U.S. dollars in thousands)

Maturity	December 31, 2007		December 31, 2006	
	Estimated Fair Value	Amortized Cost	Estimated Fair Value	Amortized Cost
Due in one year or less	\$ 149,908	\$ 146,444	\$ 277,649	\$ 276,563
Due after one year through five years	2,366,408	2,330,206	2,246,760	2,244,611
Due after five years through 10 years	1,749,911	1,714,010	1,635,021	1,632,988
Due after 10 years	776,291	763,411	617,701	608,882
	5,042,518	4,954,071	4,777,131	4,763,044
Commercial mortgage backed securities	1,315,680	1,298,899	868,586	864,731
Mortgage backed securities	1,234,596	1,224,472	1,183,805	1,177,617
Asset backed securities	1,008,030	1,002,552	907,829	908,363
<b>Total</b>	<b>\$ 8,600,824</b>	<b>\$ 8,479,994</b>	<b>\$ 7,737,351</b>	<b>\$ 7,713,755</b>

The Company's investment portfolio, which includes fixed maturity securities, short-term investments and other investments, had a "AA+" average credit quality rating at December 31, 2007, compared to "AAA" at December 31, 2006. The credit quality distribution of the Company's fixed maturities and fixed maturities pledged under securities lending agreements are shown below:

(U.S. dollars in thousands)

Rating(1)	December 31, 2007		December 31, 2006	
	Estimated Fair Value	% of Total	Estimated Fair Value	% of Total
AAA	\$ 6,600,258	76.7	\$ 6,366,059	82.3
AA	882,262	10.3	605,427	7.8
A	677,047	7.9	430,103	5.6
BBB	243,610	2.8	194,408	2.5
BB	25,390	0.3	32,572	0.4
B	128,459	1.5	64,636	0.8
Lower than B	11,321	0.1	11,149	0.2
Not rated	32,477	0.4	32,997	0.4
<b>Total</b>	<b>\$ 8,600,824</b>	<b>100.0</b>	<b>\$ 7,737,351</b>	<b>100.0</b>

(1)

Ratings as assigned by the major rating agencies.

At December 31, 2007 and 2006, the weighted average contractual maturities of the Company's total fixed maturity and short-term investments, based on fair value, were 12.0 years and 10.8 years, respectively, while the weighted average expected maturities of the Company's total fixed maturity and short-term investments, based on fair value, were 4.6 years and 5.0 years, respectively. Approximately 98% of the fixed

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maturities and fixed maturities pledged under securities lending agreements held by the Company were rated investment grade by the major rating agencies at December 31, 2007 and 2006. There were no investments in any entity in excess of 10% of the Company's shareholders' equity at December 31, 2007 or 2006 other than investments issued or guaranteed by the United States government or its agencies.

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ARCH CAPITAL GROUP LTD. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

**7. Investment Information (Continued)**

The Company reviews its investment portfolio each quarter to determine if declines in value are other-than-temporary. 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) 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. When the analysis of the above factors results in the Company's conclusion that declines in fair values are other-than-temporary, the cost of the securities is written down to fair value and the reduction in value is reflected as a realized loss. In periods subsequent to the recognition of an other-than-temporary impairment on fixed maturities, the Company accounts for such securities as if they had been purchased on the measurement date of the other-than-temporary impairment and the provision for other-than-temporary impairment (reflected as a discount or reduced premium based on the new cost basis) is amortized into net investment income over the remaining life of the fixed maturities, or until such securities are sold.

The Company had gross unrealized losses on its fixed maturities of \$23.4 million at December 31, 2007. At December 31, 2007, on a lot level basis, approximately 1,381 security lots out of a total of approximately 3,895 security lots were in an unrealized loss position and the largest single unrealized loss from a single lot in the Company's fixed maturity portfolio was \$0.5 million. The Company had gross unrealized losses on its fixed maturities of \$29.3 million at December 31, 2006. At December 31, 2006, on a lot level basis, approximately 1,529 security lots out of a total of approximately 3,292 security lots were in an unrealized loss position and the largest single unrealized loss from a single lot in the Company's fixed maturity portfolio was \$1.1 million.

The majority of the Company's fixed maturities which were in an unrealized loss position at December 31, 2007 were in such position for under twelve months. With respect to securities where the decline in value is determined to be temporary because the Company concluded that the investment was impaired for a minor length of time or to a minor extent and the security's value is not written down, a subsequent decision may be made to sell that security and realize a loss. Such sale would not contradict the Company's determination that the decline was temporary because subsequent decisions to sell a security are made within the context of overall risk management, new information and the assessment of such security's value relative to comparable securities. While the Company's internal and external investment managers may, at a given point in time, believe the preferred course of action is to hold securities until such losses are recovered, the dynamic nature of portfolio management may result in a subsequent decision by the Company to sell the security and realize the loss, based upon a change in market and other factors discussed above. The Company believes these subsequent decisions are consistent with the classification of its investment portfolio as "available for sale."

During 2007, the Company identified approximately 272 fixed maturity securities with a fair value of \$606.8 million which were considered to be other-than-temporarily impaired. Consequently, the cost of such securities was written down to fair value and the Company recognized a realized loss of \$28.1 million. During 2006, the Company identified approximately 423 fixed maturity securities with a fair value of \$1.44 billion which were considered to be other-than-temporarily impaired. Consequently, the cost of such securities was written down to fair value and the Company recognized a realized loss of \$31.6 million. During 2005, the Company identified approximately 374 fixed maturity securities with a fair value of \$971.0 million which were considered to be other-than-temporarily impaired.



## ARCH CAPITAL GROUP LTD. AND SUBSIDIARIES

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

## 7. Investment Information (Continued)

Consequently, the cost of such securities was written down to fair value and the Company recognized a realized loss of \$25.7 million.

The following table provides an analysis of the length of time each of those fixed maturities, fixed maturities pledged under securities lending agreements, equity securities and short-term investments with an unrealized loss has been in a continual unrealized loss position. Such investments were in an unrealized loss position principally due to changes in the interest rate environment. The information below indicates the potential effect upon future income in the event management later concludes that such declines are considered other-than-temporary.

(U.S. dollars in thousands)	Less than 12 Months		12 Months or More		Total	
	Estimated Fair Value	Gross Unrealized Losses	Estimated Fair Value	Gross Unrealized Losses	Estimated Fair Value	Gross Unrealized Losses
<b>December 31, 2007:</b>						
Fixed maturities and fixed maturities pledged under securities lending agreements:						
Corporate bonds	\$ 357,771	\$ (10,276)	\$ 26,455	\$ (718)	\$ 384,226	\$ (10,994)
Commercial mortgage backed securities	66,401	(381)	33,827	(177)	100,228	(558)
Mortgage backed securities	185,118	(3,804)	7,126	(283)	192,244	(4,087)
U.S. government and government agencies	206,710	(447)			206,710	(447)
Asset backed securities	183,412	(3,845)	11,221	(185)	194,633	(4,030)
Municipal bonds	22,908	(171)	10,988	(24)	33,896	(195)
Non-U.S. government securities	154,261	(1,987)	42,925	(1,069)	197,186	(3,056)
<b>Total</b>	<b>1,176,581</b>	<b>(20,911)</b>	<b>132,542</b>	<b>(2,456)</b>	<b>1,309,123</b>	<b>(23,367)</b>
Equity securities:						
Other investments	200,484	(5,342)			200,484	(5,342)
Short-term investments	140,709	(2,955)			140,709	(2,955)
<b>Total</b>	<b>\$ 1,517,774</b>	<b>\$ (29,208)</b>	<b>\$ 132,542</b>	<b>\$ (2,456)</b>	<b>\$ 1,650,316</b>	<b>\$ (31,664)</b>

**December 31, 2006:**

Fixed maturities and fixed maturities pledged under securities lending agreements:

Corporate bonds	\$ 645,345	\$ (4,358)	\$ 195,358	\$ (1,276)	\$ 840,703	\$ (5,634)
Commercial mortgage backed securities	185,786	(717)	47,400	(381)	233,186	(1,098)
Mortgage backed securities	516,137	(1,615)	6,893	(63)	523,030	(1,678)
U.S. government and government agencies	832,511	(6,175)	167,801	(4,631)	1,000,312	(10,806)
Asset backed securities	453,627	(1,315)	34,982	(142)	488,609	(1,457)
Municipal bonds	386,596	(1,980)	122,647	(1,905)	509,243	(3,885)
Non-U.S. government securities	384,496	(3,987)	42,358	(731)	426,854	(4,718)

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	Less than 12 Months		12 Months or More		Total	
Total	3,404,498	(20,147)	617,439	(9,129)	4,021,937	(29,276)
Equity securities:						
Other investments	55,243	(451)			55,243	(451)
Total	\$ 3,459,741	\$ (20,598)	\$ 617,439	\$ (9,129)	\$ 4,077,180	\$ (29,727)

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## ARCH CAPITAL GROUP LTD. AND SUBSIDIARIES

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

## 7. Investment Information (Continued)

*Securities Lending Agreements*

During 2005, the Company began a securities lending program under which certain of its fixed income portfolio securities are loaned to third parties, primarily major brokerage firms, for short periods of time through a lending agent. Such securities have been reclassified as "Fixed maturities and short-term investments pledged under securities lending agreements." The Company maintains control over the securities it lends, retains the earnings and cash flows associated with the loaned securities and receives a fee from the borrower for the temporary use of the securities. Collateral received, primarily in the form of cash, is required at a rate of 102% of the market value of the loaned securities (or 105% of the market value of the loaned securities when the collateral and loaned securities are denominated in non-U.S. currencies) including accrued investment income and is monitored and maintained by the lending agent. Such collateral is reinvested and is reflected as "Short-term investment of funds received under securities lending agreements, at fair value." 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. At December 31, 2006, the fair value and amortized cost of fixed maturities and short-term investments pledged under securities lending agreements were \$860.8 million and \$854.8 million, respectively, while collateral received totaled \$891.4 million 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 December 31, 2007 and 2006, the notional value of the net long position for equity futures was \$91.2 million and \$78.6 million, respectively. At December 31, 2007, the notional value of the net long position for Treasury note futures was \$61.7 million, compared to a net short position of \$35.2 million at December 31, 2006. For 2007, the Company recorded \$2.0 million of net realized losses related to changes in the fair value of all futures contracts, compared to \$2.1 million of net realized gains for 2006. At December 31, 2007, the carrying value and fair value of all futures contracts was \$0.8 million, compared to \$0.3 million at December 31, 2006.

*Other Investments*

The following table details the Company's other investments:

(U.S. dollars in thousands)	December 31, 2007		December 31, 2006	
	Estimated Fair Value	Cost	Estimated Fair Value	Cost
Alternative investment funds	\$ 424,896	\$ 429,050	\$ 167,497	\$ 167,703
Equity securities	93,831	70,045	75,496	60,619
Privately held securities	70,942	60,830	64,089	54,601
Total	\$ 589,669	\$ 559,925	\$ 307,082	\$ 282,923

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## ARCH CAPITAL GROUP LTD. AND SUBSIDIARIES

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

## 7. Investment Information (Continued)

The Company expanded its investment strategy in 2005 to include other asset sectors. Alternative investment funds primarily include funds that invest in investment grade and non-investment grade fixed income securities and funds that invest in senior floating rate loans; equity securities include certain investments in mutual funds and other preferred stocks; and privately held securities include the Company's investment in Aeolus LP (see Note 10). During 2007, the Company identified one alternative investment fund with a fair value of \$48.6 million which was considered to be other-than-temporarily impaired. Consequently, the cost of such securities was written down to fair value and the Company recognized a realized loss of \$2.1 million. The Company's unfunded investment commitments relating to its other investments totaled approximately \$150.2 million at December 31, 2007. The commitments were primarily to alternative investment funds that invest in investment grade and non-investment grade fixed income securities.

*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:

(U.S. dollars in thousands)	December 31,	
	2007	2006
Assets used for collateral or guarantees	\$ 736,938	\$ 798,437
Deposits with U.S. regulatory authorities	251,586	221,864
Trust funds	133,238	104,408
Deposits with non-U.S. regulatory authorities	46,789	34,112
<b>Total restricted assets</b>	<b>\$ 1,168,551</b>	<b>\$ 1,158,821</b>

In addition, Arch Re Bermuda maintains assets in trust accounts as collateral for insurance and reinsurance transactions with affiliated companies. At December 31, 2007 and 2006, such amounts approximated \$3.8 billion and \$3.61 billion, respectively.

## ARCH CAPITAL GROUP LTD. AND SUBSIDIARIES

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

## 7. Investment Information (Continued)

*Net Investment Income*

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

(U.S. dollars in thousands)	Years Ended December 31,		
	2007	2006	2005
Fixed maturities	\$ 407,977	\$ 327,331	\$ 229,800
Short-term investments	41,690	45,144	6,673
Other(1)	27,504	19,667	5,900
Gross investment income	477,171	392,142	242,373
Investment expenses	(14,101)	(11,937)	(9,471)
Net investment income	\$ 463,070	\$ 380,205	\$ 232,902

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

*Net Realized Gains (Losses)*

Net realized gains (losses) were as follows:

(U.S. dollars in thousands)	Years Ended December 31,		
	2007	2006	2005
Fixed maturities	\$ 38,611	\$ (27,379)	\$ (56,770)
Other investments	847	4,186	1,016
Other	(11,317)	3,756	2,298
Net realized gains (losses)	\$ 28,141	\$ (19,437)	\$ (53,456)

Proceeds from the sales of fixed maturities during 2007, 2006 and 2005 were \$18.92 billion, \$13.86 billion and \$9.17 billion, respectively. Gross gains of \$133.4 million, \$77.3 million and \$36.1 million were realized on those transactions during 2007, 2006 and 2005, respectively. Gross losses of \$94.8 million, \$104.7 million and \$92.9 million were realized during 2007, 2006 and 2005, respectively. The net realized gains on fixed maturities of \$38.6 million in 2007 and net realized losses on fixed maturities during 2006 and 2005 of \$27.4 million and \$56.8 million, respectively, included provisions of \$28.1 million, \$31.6 million and \$25.7 million, respectively, 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, as described above.

## ARCH CAPITAL GROUP LTD. AND SUBSIDIARIES

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

## 8. Comprehensive Income

Following are the related tax effects allocated to each component of other comprehensive income (loss):

(U.S. dollars in thousands)	Before Tax Amount	Tax Expense (Benefit)	Net of Tax Amount
<b>Year Ended December 31, 2007</b>			
Unrealized appreciation (decline) in value of investments:			
Unrealized holding gains arising during year	\$ 143,105	\$ 8,322	\$ 134,783
Less reclassification of net realized gains included in net income	40,182	(1,944)	42,126
Foreign currency translation adjustments	14,920	1,777	13,143
Other comprehensive income (loss)	\$ 117,843	\$ 12,043	\$ 105,800
<b>Year Ended December 31, 2006</b>			
Unrealized appreciation (decline) in value of investments:			
Unrealized holding gains arising during year	\$ 36,884	\$ (2,806)	\$ 39,690
Less reclassification of net realized losses included in net income	(23,192)	(1,677)	(21,515)
Foreign currency translation adjustments	(2,384)	(62)	(2,322)
Other comprehensive income (loss)	\$ 57,692	\$ (1,191)	\$ 58,883
<b>Year Ended December 31, 2005</b>			
Unrealized appreciation (decline) in value of investments:			
Unrealized holding losses arising during year	\$ (111,053)	\$ (5,416)	\$ (105,637)
Less reclassification of net realized losses included in net income	(55,754)	(2,388)	(53,366)
Foreign currency translation adjustments	(761)	226	(987)
Other comprehensive income (loss)	\$ (56,060)	\$ (2,802)	\$ (53,258)

## 9. Income Taxes

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

ACGL and its non-U.S. subsidiaries will be subject to U.S. federal income tax only to the extent that they derive U.S. source income that is subject to U.S. withholding tax or income that is effectively connected with the conduct of a trade or business within the U.S. and is not exempt from U.S. tax under an applicable income tax treaty with the U.S. ACGL and its non-U.S. subsidiaries will be subject to a withholding tax on dividends from U.S. investments and interest from certain U.S. payors (subject to reduction by any applicable income tax treaty). ACGL and its non-U.S. subsidiaries intend to conduct their operations in a manner that will not cause them to be treated as engaged in a trade or business in the United States and, therefore, will not be required to pay U.S. federal income taxes (other than U.S. excise taxes on insurance and reinsurance premium and withholding taxes on

## ARCH CAPITAL GROUP LTD. AND SUBSIDIARIES

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

## 9. Income Taxes (Continued)

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 components of income taxes attributable to operations were as follows:

(U.S. dollars in thousands)	Years Ended December 31,		
	2007	2006	2005
<b>Current expense:</b>			
U.S. Federal	\$ 13,487	\$ 13,430	\$ 34,548
U.S. State	629	1,235	1,195
Non-U.S.	6,886	3,740	2,281
	<u>\$ 21,002</u>	<u>\$ 18,405</u>	<u>38,024</u>
<b>Deferred expense (benefit):</b>			
U.S. Federal	(2,382)	7,210	(9,731)
Non-U.S.	(3,019)	1,064	656
	<u>(5,401)</u>	<u>8,274</u>	<u>(9,075)</u>
Income tax expense	<u>\$ 15,601</u>	<u>\$ 26,679</u>	<u>\$ 28,949</u>

The expected tax provision computed on pre-tax income at the weighted average tax rate has been calculated as the sum of the pre-tax income in each jurisdiction multiplied by that jurisdiction's applicable statutory tax rate. A reconciliation of the difference between the provision for income taxes and the expected tax provision at the weighted average tax rate follows:

(U.S. dollars in thousands)	Years Ended December 31,		
	2007	2006	2005
Expected income tax expense computed on pre-tax income at weighted average income tax rate	\$ 25,894	\$ 36,272	\$ 32,914
Addition (reduction) in income tax expense (benefit) resulting from:			
Valuation allowance	(1,358)		(1)
Tax-exempt investment income	(9,703)	(6,887)	(5,141)
State taxes, net of U.S. federal tax benefit	409	803	777
Prior year adjustment	(512)	523	43
Other(1)	871	(4,032)	357
Income tax expense	<u>\$ 15,601</u>	<u>\$ 26,679</u>	<u>\$ 28,949</u>

- (1) For 2006, amount includes a tax benefit relating to the reduction of a tax reserve related to transfer pricing in the amount of \$2.6 million.



## ARCH CAPITAL GROUP LTD. AND SUBSIDIARIES

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

## 9. Income Taxes (Continued)

The Company has net operating loss carryforwards in its U.S. operating subsidiaries totaling \$11.6 million at December 31, 2007. Such net operating losses are currently available to offset future taxable income of the subsidiaries. Under applicable law, the U.S. net operating loss carryforwards expire between 2018 and 2020. The Company also has a net capital loss carryforward of \$0.8 million which will expire between 2010 and 2011 and an alternative minimum tax ("AMT") credit carryforward in the amount of \$1.0 million which can be carried forward without expiration.

On November 20, 2001, the Company underwent an ownership change for U.S. federal income tax purposes as a result of the investment led by investment funds associated with Warburg Pincus LLC ("Warburg Pincus") and Hellman and Friedman LLC ("Hellman & Friedman"). As a result of this ownership change, limitations have been imposed upon the utilization by the Company's U.S. operating subsidiaries of existing net operating losses. Utilization by such subsidiaries of the net operating losses and the AMT credit carryforward is limited to approximately \$5.1 million per year in accordance with Section 382 of the Internal Revenue Code of 1986 as amended (the "Code").

The Company's Swiss branch has a net operating loss carryforward of \$5.5 million which is available to offset income of the Swiss branch until it expires between 2013 and 2014. The Company's Danish subsidiary has a net operating loss carryforward of \$1.4 million which can be carried forward without expiration.

Deferred income tax assets and liabilities reflect temporary differences based on enacted tax rates between the carrying amounts of assets and liabilities for financial reporting and income tax purposes. Significant components of the Company's deferred income tax assets and liabilities were as follows:

	December 31,	
	2007	2006
<b>(U.S. dollars in thousands)</b>		
<b>Deferred income tax assets:</b>		
Net operating loss	\$ 5,058	\$ 5,923
Deferred ceding commission	9,534	14,996
AMT credit carryforward	967	959
Discounting of net loss reserves	28,553	25,345
Net unearned premium reserve	13,805	11,124
Compensation liabilities	18,132	13,153
Capital loss carryforward	283	418
Other than temporary impairment on securities	2,523	3,173
Net unrealized depreciation of investments		1,851
Other, net		
<b>Total deferred tax assets</b>	<b>78,855</b>	<b>76,942</b>
<b>Deferred income tax liabilities:</b>		
Depreciation and amortization	(1,901)	(3,002)
Deferred acquisition costs, net	(3,104)	(2,029)
Deposit accounting liability	(5,008)	(5,367)
Foreign transaction exchange gains	(1,299)	(586)
Net unrealized foreign exchange gains	(1,977)	(200)
Net unrealized appreciation of investments	(7,744)	
Other, net	(771)	(794)
<b>Total deferred tax liabilities</b>	<b>(21,804)</b>	<b>(11,978)</b>
Valuation allowance		(1,358)

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	December 31,	
Net deferred income tax asset	\$ 57,051	\$ 63,606

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**ARCH CAPITAL GROUP LTD. AND SUBSIDIARIES**

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

**9. Income Taxes (Continued)**

In September 2006, the FASB issued FASB Interpretation No. 48 ("FIN No. 48"), "Accounting for Uncertainty in Income Taxes," an interpretation of SFAS No. 109, "Accounting for Income Taxes." FIN No. 48 prescribes a "more likely than not" threshold for the financial statement recognition of a tax position taken or expected to be taken in a tax return, assuming the relevant tax authority has full knowledge of all relevant information. The amount recognized represents the largest amount of tax benefit that is greater than 50% likely of being ultimately realized. A liability is recognized for any benefit claimed, or expected to be claimed, in a tax return in excess of the benefit recorded in the financial statements, along with any interest and penalty (if applicable) on the excess. The Company recognizes interest and penalties relating to unrecognized tax benefits in the provision for income taxes.

The Company adopted the provisions of FIN No. 48 on January 1, 2007. As prescribed, the cumulative effects of applying FIN 48 is reported as an adjustment to the opening balance of retained earnings. As a result of the adoption on January 1, 2007, the Company's retained earnings remained unchanged. As of January 1, 2007 and December 31, 2007, the Company's total unrecognized tax benefits, including interest and penalties, were zero.

The Company or its subsidiaries or branches files income tax returns in the U.S. federal jurisdiction and various state, local and foreign jurisdictions. With few exceptions, the Company is no longer subject to U.S. federal, state, local, or non-U.S. income tax examination for years before 2004. During 2006, the U.S. Internal Revenue Service commenced an examination of the Company's U.S. income tax returns for the 2004 tax year that is anticipated to be completed within the next twelve months.

In addition to unrecognized tax benefits, the Company has provided a valuation allowance to reduce certain deferred tax assets to an amount which management expects to more likely than not be realized. As of December 31, 2007, the Company's valuation allowance was zero, compared to \$1.4 million at December 31, 2006. The reduction in the valuation allowance in 2007 resulted from the ability of one of the Company's U.S. subsidiaries to utilize a net operating loss.

The Company paid income taxes totaling \$3.9 million and \$44.0 million for 2007 and 2006, respectively. As of December 31, 2007, the Company's current income tax recoverable (included in other assets) was \$7.6 million.

***Federal Excise Taxes***

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 2007, 2006 and 2005, the Company withheld and paid approximately \$14.5 million, \$16.4 million and \$19.1 million, respectively, of federal excise taxes.

**10. Transactions with Related Parties**

Pursuant to an agreement, dated September 6, 2005 (the "Clements Agreement"), ACGL and Robert Clements, former Chairman of the Board of Directors of the Company, terminated all consulting and related payment obligations under a consulting agreement, dated as of March 17, 2005, between ACGL and Mr. Clements which had a term extending through December 31, 2009. Pursuant

ARCH CAPITAL GROUP LTD. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

**10. Transactions with Related Parties (Continued)**

to the Clements Agreement, ACGL made payments to, and on behalf of, Mr. Clements in the aggregate amount of \$1.4 million and wrote off fixed assets of \$0.5 million related to the Clements Agreement in 2005.

In December 2005, Marc Grandisson succeeded Dwight Evans as the Chairman and Chief Executive Officer of Arch Worldwide Reinsurance Group. In connection with Mr. Evans' departure from ACGL, on December 5, 2005, ACGL and Mr. Evans entered into an agreement (the "Evans Agreement") pursuant to which Mr. Evans received a payment in the amount of \$4.9 million, which is inclusive of all earned but unpaid incentive compensation. Among other things, the Evans Agreement also provided that certain medical benefits would remain in effect for Mr. Evans and his covered dependents for one year and that Mr. Evans would be reimbursed for certain relocation and other expenses.

During 2006, the Company invested \$50.0 million in Aeolus LP ("Aeolus"), which 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, at fair value" 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 16.3% of the Company's outstanding voting shares as of December 31, 2007. In addition, one of the founders of Aeolus is Peter Appel, former President and CEO and a former director of the Company.

**11. Commitments and Contingencies**

*Concentrations of Credit Risk*

The creditworthiness of a counterparty is evaluated by the Company, taking into account credit ratings assigned by independent agencies. The credit approval process involves an assessment of factors, including, among others, the counterparty, country and industry credit exposure limits. Collateral may be required, at the discretion of the Company, on certain transactions based on the creditworthiness of the counterparty.

The areas where significant concentrations of credit risk may exist include unpaid losses and loss adjustment expenses recoverable, prepaid reinsurance premiums and paid losses and loss adjustment expenses recoverable net of reinsurance balances payable (collectively "reinsurance recoverables"), investments and cash and cash equivalent balances. The Company's reinsurance recoverables at December 31, 2007 and 2006 amounted to \$1.92 billion and \$1.84 billion, respectively, and primarily resulted from reinsurance arrangements entered into in the course of its operations. A credit exposure exists with respect to reinsurance recoverables as they may become uncollectible. The Company manages its credit risk in its reinsurance relationships by transacting with reinsurers that it considers financially sound and, if necessary, the Company may hold collateral in the form of funds, trust accounts and/or irrevocable letters of credit. This collateral can be drawn on for amounts that remain unpaid beyond specified time periods on an individual reinsurer basis.

In addition, the Company underwrites a significant amount of its business through brokers and a credit risk exists should any of these brokers be unable to fulfill their contractual obligations with respect to the payments of insurance and reinsurance balances owed to the Company. During 2007,

ARCH CAPITAL GROUP LTD. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

**11. Commitments and Contingencies (Continued)**

approximately 19.6% and 16.4% of the Company's consolidated gross written premiums were generated from or placed by Marsh & McLennan Companies and its subsidiaries and AON Corporation and its subsidiaries, respectively. During 2006, approximately 18.8% and 15.4% of the Company's consolidated gross written premiums were generated from or placed by Marsh & McLennan Companies and its subsidiaries and AON Corporation and its subsidiaries, respectively. During 2005, approximately 19.2% and 13.3% of the Company's consolidated gross written premiums were generated from or placed by Marsh & McLennan Companies and its subsidiaries and AON Corporation and its subsidiaries, respectively. No other broker and no one insured or reinsured accounted for more than 10% of gross premiums written for 2007, 2006 and 2005.

The Company's available for sale investment portfolio is managed in accordance with guidelines that have been tailored to meet specific investment strategies, including standards of diversification, which limit the allowable holdings of any single issue. There were no investments in any entity in excess of 10% of the Company's shareholders' equity at December 31, 2007 other than investments issued or guaranteed by the United States government or its agencies. The Company's unfunded investment commitments relating to its other investments totaled approximately \$150.2 million at December 31, 2007.

***Variable Interest Entities***

The Company concluded that, under FASB Interpretation No. 46R ("FIN 46R"), "Consolidation of Variable Interest Entities," that it is required to consolidate the assets, liabilities and results of operations (if any) of a certain managing general agency in which one of its subsidiaries has an investment. Such agency ceased producing business in 1999 and is currently running-off its operations. Based on current information, there are no assets or liabilities of such agency required to be reflected on the face of the Company's consolidated financial statements that are not, or have not been previously, otherwise reflected therein.

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. is assuming a 45% quota share (the "Treaty") of certain lines of property and marine business underwritten by Arch Re Bermuda for unaffiliated third parties for the 2006 and 2007 underwriting years (January 1, 2006 to December 31, 2007). 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. As a result of the terms of the Treaty, the Company has 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. See Note 4.

***Letter of Credit and Revolving Credit Facilities***

As of December 31, 2007, 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

ARCH CAPITAL GROUP LTD. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

**11. Commitments and Contingencies (Continued)**

to \$100 million for 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 December 31, 2007. The Credit Agreement expires on August 30, 2011.

Including the secured letter of credit portion of the Credit Agreement and another letter of credit facility (together, the "LOC Facilities"), the Company has access to letter of credit facilities for up to a total of \$1.45 billion. The principal purpose of the LOC Facilities is to issue, as required, evergreen standby letters of credit in favor of primary insurance or reinsurance counterparties with which the Company has entered into reinsurance arrangements to ensure that such counterparties are permitted to take credit for reinsurance obtained from the Company's reinsurance subsidiaries in United States jurisdictions where such subsidiaries are not licensed or otherwise admitted as an insurer, as required under insurance regulations in the United States, and to comply with requirements of Lloyd's of London in connection with qualifying quota share and other arrangements. The amount of letters of credit issued is driven by, among other things, the timing and payment of catastrophe losses, 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 December 31, 2007. At such date, the Company had approximately \$612.4 million in outstanding letters of credit under the LOC Facilities, which were secured by investments totaling \$652.8 million. The other letter of credit facility was replaced on substantially the same terms in December 2007. 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.

## ARCH CAPITAL GROUP LTD. AND SUBSIDIARIES

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

## 11. Commitments and Contingencies (Continued)

*Leases and Purchase Obligations*

At December 31, 2007, the future minimum rental commitments, exclusive of escalation clauses and maintenance costs and net of rental income, for all of the Company's operating leases with remaining non-cancelable terms in excess of one year are as follows:

(U.S. dollars in thousands)	
2008	\$ 14,346
2009	15,672
2010	15,942
2012	14,733
2013	11,835
Thereafter	18,676
	<hr/>
Total	\$ 91,204
	<hr/>

All of these leases are for the rental of office space, with expiration terms that range from 2009 to 2016. Rental expense, net of income from subleases, was approximately \$14.8 million, \$12.9 million and \$11.1 million for 2007, 2006 and 2005, respectively.

The Company has also entered into certain agreements which commit the Company to purchase goods or services, primarily related to software and computerized systems. Such purchase obligations were approximately \$22.0 million and \$21.5 million at December 31, 2007 and 2006, respectively.

*Employment and Other Arrangements*

At December 31, 2007, the Company has entered into employment agreements with certain of its executive officers for periods extending up to November 2012. Such employment arrangements provide for compensation in the form of base salary, annual bonus, share-based awards, participation in the Company's employee benefit programs and the reimbursements of expenses.

*Folksamerica Transaction and Related Contingencies*

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 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

**ARCH CAPITAL GROUP LTD. AND SUBSIDIARIES**

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

**11. Commitments and Contingencies (Continued)**

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 December 31, 2007.

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.

**12. 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 each of the years ended December 31, 2007, 2006 and 2005, interest expense on the Senior Notes was \$22.1 million. The fair value of the Senior Notes at December 31, 2007 and 2006 was \$325.4 million and \$332.0 million, respectively.

**13. Share Capital**

*Authorized and Issued*

The authorized share capital of the Company consists of 200,000,000 Common Shares, par value of \$0.01 per share, and 50,000,000 Preference Shares, par value of \$0.01 per share.



## ARCH CAPITAL GROUP LTD. AND SUBSIDIARIES

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

## 13. Share Capital (Continued)

*Common Shares*

Changes in the Company's outstanding Common Shares are reflected in the table below:

	Years Ended December 31,		
	2007	2006	2005
<b>Common Shares:</b>			
Balance, beginning of year	74,270,466	73,334,870	34,902,923
Shares issued(1)	523,723	823,682	830,924
Shares issued from conversion of preference shares(2)			37,348,150
Shares issued from exercise of warrants			114,110
Restricted shares issued, net of cancellations	329,057	139,166	173,567
Shares repurchased and retired(3)	(7,804,780)	(27,252)	(34,804)
Balance, end of year	67,318,466	74,270,466	73,334,870

(1)

Includes shares issued from the exercise of stock options and, in 2007, shares issued from the employee share purchase plan.

(2)

During the 2005 fourth quarter, all outstanding Preference Shares were converted into Common Shares. Prior to such conversion, the Preference Shares voted, together with the Common Shares, on an as-converted basis.

(3)

Includes shares repurchased and retired from the share repurchase program.

*Share Repurchase Plan*

On February 28, 2007, ACGL's board of directors authorized the investment of up to \$1 billion in ACGL's common shares through a share repurchase program. Repurchases under the program may be effected from time to time in open market or privately negotiated transactions through February 2009. In 2007, approximately 7.8 million common shares were repurchased for an aggregate purchase price of \$537.1 million. As a result of share repurchase transactions, book value per common share at December 31, 2007 was reduced by \$1.45 per share and weighted average shares outstanding were reduced by 3.3 million. The timing and amount of the repurchase transactions under this program will depend on a variety of factors, including market conditions and corporate and regulatory considerations. In connection with the repurchase program, the Warburg Pincus funds and Hellman & Friedman funds waived their rights relating to share repurchases under the shareholders agreement for all repurchases of common shares by ACGL under the repurchase program in open market transactions and certain privately negotiated transactions. In May 2007, the Hellman & Friedman funds ceased to own shares of ACGL and their rights under the shareholders agreement with ACGL terminated.

ARCH CAPITAL GROUP LTD. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

13. Share Capital (Continued)

*Long Term Incentive and Share Award Plans*

On May 11, 2007, following shareholder approval, the Company adopted the 2007 Employee Share Purchase Plan (the "ESPP"). The purpose of the ESPP is to give employees of ACGL and its subsidiaries an opportunity to purchase common shares through payroll deductions, thereby encouraging employees to share in the economic growth and success of ACGL and its subsidiaries. The ESPP is designed to qualify as an "employee share purchase plan" under Section 423 of the Code. A total of 750,000 common shares are reserved for issuance under the plan. The ESPP provides for consecutive six-month offering periods (or other periods of not more than 27 months as determined by the compensation committee) under which participating employees can elect to have up to 20% of their total compensation withheld and applied to the purchase of common shares of the Company at the end of the period. Unless otherwise determined by the compensation committee before an offering period commences, (1) the purchase price will be 85% of the fair market value of the common shares at the beginning of the offering period; and (2) the maximum number of common shares that may be purchased by an employee in any offering period is 3,000 shares. In addition, applicable Code limitations specify, in general, that a participant's right to purchase stock under the plan cannot accumulate at a rate in excess of \$25,000 (based on the value at the beginning of the applicable offering periods) per calendar year.

On May 11, 2007, following shareholder approval, the Company adopted the 2007 Long Term Incentive and Share Award Plan (the "2007 Plan"). The 2007 Plan is intended to provide for competitive compensation opportunities, to encourage long-term service, to recognize individual contributions and reward achievement of performance goals and to promote the creation of long-term value for shareholders by aligning the interests of such persons with those of shareholders. The 2007 Plan will provide for the grant to eligible employees and directors stock options, stock appreciation rights, restricted shares, restricted share units payable in common shares or cash, share awards in lieu of cash awards, dividend equivalents and other share-based awards. The 2007 Plan also will provide our non-employee directors with the opportunity to receive the annual retainer fee for Board service in common shares.

Following shareholder approval on May 11, 2007, the 2005 Long Term Incentive and Share Award Plan (the "2005 Plan"), whose terms are substantially similar to the 2007 Plan, was merged into the 2007 Plan. As of the effective date, the 1,533,527 remaining shares available for issuance under the 2005 Plan were transferred into the 2007 Plan. No additional grants will be made thereafter under the 2005 Plan.

Grants which were outstanding at May 11, 2007 under the 2005 Plan will continue in accordance with their original terms (subject to such amendments as the compensation committee determines appropriate, consistent with the terms of the 2005 Plan), and the shares with respect to such outstanding grants will be issued or transferred under the 2007 Plan. The number of common shares reserved for issuance under the 2007 Plan, subject to anti-dilution adjustments in the event of certain changes in our capital structure, is equal to the sum of (i) 2,500,000 and (ii) the number of common shares subject to outstanding grants under the 2005 Plan as of the effective date as well as common shares remaining available for issuance under the 2005 Plan but not subject to previously exercised or vested grants as of the effective date, except that no more than 2,000,000 common shares may be

ARCH CAPITAL GROUP LTD. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

**13. Share Capital (Continued)**

issued as incentive stock options under Section 422 of the Code. At December 31, 2007, approximately 3,374,205 shares are available for grant under the 2007 Plan.

In June 2002, following shareholder approval, the Company adopted the 2002 Long Term Incentive and Share Award Plan (the "2002 Plan"). An aggregate of 3,165,830 Common Shares has been reserved for issuance under the 2002 Plan. The 2002 Plan provides for the grant to eligible employees and directors of stock options, stock appreciation rights, restricted shares, restricted share units payable in Common Shares or cash, share awards in lieu of cash awards, dividend equivalents and other share-based awards. The 2002 Plan provides the Company's non-employee directors with the opportunity to receive their annual retainer fee for service as a director in Common Shares. As of December 31, 2007, approximately 4,970 shares are available for grant under the 2002 Plan.

With respect to certain subsidiaries, the Company may withhold, or require a participant to remit to the Company, an amount sufficient to satisfy any federal, state or local withholding tax requirements associated with awards under the Company's share award plans. This includes the authority to withhold or receive shares or other property and to make cash payments in respect thereof.

***Stock Options***

The Company generally issues stock options to officers, with exercise prices equal to the fair market values of the Company's Common Shares on the grant dates. For grants prior to September 2005, options generally vest over a two year period as follows: one-third on the grant date and one-third each year thereafter. In September 2005, the Company's Board of Directors approved extending the vesting period for future awards to vest over a three year period as follows: one-third on the anniversary of the grant date and one-third each year thereafter. Option awards have a 10 year contractual life. Refer to Note 2(l) for details related to the Company's accounting for stock options.

As required by the provisions of SFAS No. 123(R), the Company recorded after-tax share-based compensation expense of \$7.2 million, or \$0.10 per basic and diluted share related to stock option awards for the year ended December 31, 2007, net of a tax benefit of \$1.8 million compared to \$7.7 million, or \$0.10 per basic and diluted share, related to stock option awards for the year ended December 31, 2006, net of a tax benefit of \$1.5 million. As of December 31, 2007, there was approximately \$10.2 million of unrecognized compensation cost related to nonvested stock options. Such cost is expected to be recognized over a weighted average period of 1.5 years.

Under the modified prospective method of transition under SFAS No.123(R), the Company is not required to restate its prior period financial statements to reflect expensing of share-based compensation under SFAS No. 123(R). Therefore, the results for 2007 and 2006 are not comparable to 2005. As required by SFAS No.123(R), the Company has presented pro forma disclosures of its net

## ARCH CAPITAL GROUP LTD. AND SUBSIDIARIES

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

## 13. Share Capital (Continued)

income and earnings per share for 2005 assuming the estimated fair value of the options granted prior to January 1, 2006 is amortized to expense over the requisite service period, as indicated below:

	<b>Year Ended December 31, 2005</b>
<b>(U.S. dollars in thousands, except share data)</b>	
Net income, as reported	\$ 256,486
Total share-based employee compensation expense under fair value method, net of income taxes	(4,307)
<b>Pro forma net income</b>	<b>\$ 252,179</b>
Earnings per share basic:	
As reported	\$ 7.26
Pro forma	\$ 7.14
Earnings per share diluted:	
As reported	\$ 3.43
Pro forma	\$ 3.37

For purposes of disclosure in the foregoing table and for purposes of determining estimated fair value under SFAS No. 123(R), the Company has computed the estimated fair values of share-based compensation related to stock options using the Black-Scholes option valuation model and has applied the assumptions set forth in the following table. As described above, in September 2005, the Company's board of directors approved a longer vesting period for future awards to vest over a three year period: one-third on the first, second and third anniversaries of the grant date. The Company increased the expected life assumption for stock options granted beginning in September 2005 to six years after considering the increase in the vesting period, the ten year contractual term of the option awards, the historical share option exercise experience, peer data and guidance from the Securities and Exchange Commission as contained in Staff Accounting Bulletin No. 107 permitting the initial application of a "simplified" method for options granted, which is based on the average of the vesting term and the contractual term of the option. Previously, the Company calculated the estimated life based on the expectation that options would be exercised within five years on average after consideration of the vesting and contractual terms, historical share option exercise experience and peer data. The Company based its estimate of expected volatility for options granted during the year ended December 31, 2007 on daily historical trading data of its common shares from September 20, 2002, the date marking the completion of the Company's transition as a worldwide insurance and reinsurance company. For options granted during the years ended December 31, 2006 and 2005, the Company based its volatility estimate under the same method used for 2007, using the period from September 20, 2002 through the last day of the applicable period.

	<b>Years Ended December 31,</b>		
	<b>2007</b>	<b>2006</b>	<b>2005</b>
Dividend yield	0.0%	0.0%	0.0%
Expected volatility	19.6%	21.3%	20.9%
Risk free interest rate	5.0%	4.6%	4.2%
Expected option life	6.0 years	6.0 years	5.8 years

## ARCH CAPITAL GROUP LTD. AND SUBSIDIARIES

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

## 13. Share Capital (Continued)

The Black-Scholes option pricing model requires the input of highly subjective assumptions. Because the Company's employee stock options have characteristics significantly different from those of traded options, and because changes in the subjective input assumptions can materially affect the fair value estimate, in management's opinion, the existing models may not provide a reliable single measure of the fair value of its employee stock options. In addition, management will continue to assess the assumptions and methodologies used to calculate estimated fair value of share-based compensation. Circumstances may change and additional data may become available over time, which result in changes to these assumptions and methodologies, and which could materially impact the Company's fair value determination.

A summary of option activity under the Company's Long Term Incentive and Share Award Plans during the year ended December 31, 2007 is presented below:

	Year Ended December 31, 2007	
	Number of Options	Weighted Average Exercise Price
Outstanding, beginning of year	5,669,994	\$ 30.97
Granted	338,430	\$ 69.96
Exercised	(497,063)	\$ 28.79
Forfeited or expired	(25,328)	\$ 58.22
Outstanding, end of period	5,486,033	\$ 33.45
Exercisable, end of period	4,436,702	\$ 27.03

The weighted average grant-date fair value of options granted during the years ended December 31, 2007, 2006 and 2005 was \$22.48, \$18.21 and \$15.08, respectively. The aggregate intrinsic value of options exercised during the years ended December 31, 2007, 2006 and 2005 was approximately \$20.0 million, \$27.4 million, and \$19.9 million, respectively and represents the difference between the exercise price of the option and the closing market price of the Company's common shares on the exercise dates.

The aggregate intrinsic value of the Company's outstanding and exercisable stock options at December 31, 2007 was \$202.5 million and \$192.2 million, respectively. The weighted average remaining contractual life of the Company's outstanding and exercisable stock options at December 31, 2007 was 5.4 years and 4.6 years, respectively. During the year ended December 31, 2007, the Company received proceeds of \$13.7 million from the exercise of stock options and recognized a tax benefit of \$5.1 million from the exercise of such options.

***Restricted Common Shares and Restricted Units***

The Company also issues restricted share and unit awards to officers, for which the fair value is equal to the fair market values of the Company's Common Shares on the grant dates. Compensation equal to the fair value of the shares at the measurement date is amortized and charged to income over the requisite service period, which is generally the vesting period unless the employee is retirement eligible. Restricted share and unit awards granted prior to September 2005 generally vest over a two

## ARCH CAPITAL GROUP LTD. AND SUBSIDIARIES

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

## 13. Share Capital (Continued)

year period: one-third immediately on the grant date and one-third on the first and second anniversaries of the grant date. In September 2005, the Company's board of directors approved a longer vesting period for future restricted share and unit awards to vest over a three year period: one-third on the first, second and third anniversaries of the grant date. Refer to Note 2(l) for details related to the Company's accounting for restricted share and unit awards.

The Company recorded \$12.9 million of share-based compensation expense, net of a tax benefit of \$2.3 million, related to restricted share and unit awards for 2007 as required by the provisions of SFAS No.123(R), compared to \$7.0 million, net of a tax benefit of \$1.1 million, for 2006 and \$6.8 million, net of a tax benefit of \$1.4 million, for 2005. As of December 31, 2007, there were \$17.4 million and \$1.9 million, respectively, of unrecognized compensation costs related to unvested restricted share and unit awards which are expected to be recognized over a weighted average period of 1.8 years and 2.0 years, respectively.

A summary of restricted share and unit activity under the Company's Long Term Incentive and Share Award Plans for 2007 is presented below:

	<b>Restricted Common Shares</b>	<b>Restricted Unit Awards</b>
	<u>                    </u>	<u>                    </u>
<b>Non-Vested Shares:</b>		
Unvested balance, beginning of year	332,371	91,514
Granted	331,732	29,750
Vested	(205,104)	(4,811)
Forfeited	(7,486)	
	<u>                    </u>	<u>                    </u>
Unvested balance, end of year	451,513	116,453
	<u>                    </u>	<u>                    </u>
<b>Weighted Average Grant Date Fair Value:</b>		
Unvested balance, beginning of year	\$ 48.15	
Granted	\$ 69.95	
Vested	\$ 47.83	
Forfeited	\$ 58.70	
Unvested balance, end of year	\$ 64.13	

During 2007, 2006 and 2005, the Company granted an aggregate of 361,482, 141,516 and 184,256 restricted share and restricted unit awards, respectively, with weighted average grant date fair values of \$69.94, \$56.94 and \$48.97, respectively. During 2007, 2006 and 2005, the aggregate fair value of restricted shares and units that vested was \$14.3 million, \$31.0 million and \$7.5 million, respectively. The aggregate intrinsic value of restricted units outstanding and exercisable at December 31, 2007 was \$8.2 million and \$5.6 million, respectively. The issuance of restricted shares and units and amortization thereon has no effect on the Company's consolidated shareholders' equity.

## ARCH CAPITAL GROUP LTD. AND SUBSIDIARIES

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

## 13. Share Capital (Continued)

*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. For 2007 and 2006, the Company paid \$25.8 million and \$17.4 million to holders of the Preferred Shares and, at December 31, 2007, had declared an aggregate of \$3.3 million of dividends to be paid to holders of the Preferred Shares.

*Series A Convertible Preference Shares*

On November 20, 2001, the Company issued 35,687,735 Preference Shares and 3,776,025 Class A Warrants in exchange for \$763.2 million in cash and entered into subscription agreements with investors led by Warburg Pincus and Hellman & Friedman and certain members of management (the "Subscription Agreement"). During the 2005 fourth quarter, all outstanding Preference Shares were converted into Common Shares. Prior to such conversion, the Preference Shares voted, together with the Common Shares, on an as-converted basis.

Pursuant to the Subscription Agreement, an adjustment basket relating to certain non-core operations was calculated during the 2003 fourth quarter for purposes of determining whether the Company would be required to issue additional Preference Shares to the investors as a purchase price adjustment. In February 2004, the parties agreed that no purchase price adjustment was required pursuant to such calculation and, accordingly, no additional preference shares were issued to the investors. In November 2005, a final adjustment basket was calculated based on (1) liabilities owed to Folksamerica (if any) under the Asset Purchase Agreement, dated as of January 10, 2000, between the Company and Folksamerica, and (2) specified tax and ERISA matters under the Subscription Agreement. No additional shares were issued as a result of such calculation. In May 2007, the Hellman & Friedman funds ceased to own shares of ACGL and their rights under the shareholders agreement with ACGL terminated.

Pursuant to the shareholders agreement, the Company agreed to restrictions on the composition of its Board of Directors. Pursuant to this agreement, Warburg Pincus is entitled (until 2011) to nominate

ARCH CAPITAL GROUP LTD. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

**13. Share Capital (Continued)**

a prescribed number of directors based on the respective retained percentages of their Preference Shares purchased in November 2001. Currently, the Company's Board of Directors consists of nine members, including three directors nominated by Warburg Pincus.

In addition, the Company agreed (until 2011) not to declare any dividend or make any other distribution on its Common Shares, and not to repurchase any Common Shares, until it has repurchased from funds affiliated with Warburg Pincus, pro rata, on the basis of the amount of their investment in the Company at the time of such repurchase, Common Shares (which were issued pursuant to the conversion of all outstanding Preference Shares in the 2005 fourth quarter) having an aggregate value of \$250 million, at a per share price acceptable to them. No such shares have yet been repurchased.

***Voting Rights Limitation***

At December 31, 2003, the bye-laws of the Company contain a provision limiting the rights of any U.S. person (as defined in section 7701(a)(30) of the Code), that owns shares of the Company, directly, indirectly or constructively (within the meaning of section 958 of the Code), representing more than 9.9% of the voting power of all shares entitled to vote generally at an election of directors. The votes conferred by such shares or such U.S. person will be reduced by whatever amount is necessary so that after any such reduction the votes conferred by the shares of such person will constitute 9.9% of the total voting power of all shares entitled to vote generally at an election of directors. Notwithstanding this provision, the Board of Directors may make such final adjustments to the aggregate number of votes conferred by the shares of any U.S. person that the Board of Directors considers fair and reasonable in all circumstances to ensure that such votes represent 9.9% of the aggregate voting power of the votes conferred by all shares of the Company entitled to vote generally at an election of directors. The Company will assume that all shareholders (other than Warburg Pincus) are U.S. persons unless they otherwise receive assurance satisfactory to them that they are not U.S. persons.

**14. Retirement Plans**

For purposes of providing employees with retirement benefits, the Company maintains defined contribution retirement plans. Contributions are based on the participants' eligible compensation. For 2007, 2006 and 2005, the Company expensed approximately \$15.4 million, \$13.8 million and \$11.3 million, respectively, related to these retirement plans.

**15. Statutory Information**

***Bermuda***

Under The Insurance Act 1978, as Amended, and Related Regulations of Bermuda (the "Insurance Act"), Arch Re Bermuda, the Company's Bermuda reinsurance and insurance subsidiary, is required to prepare statutory financial statements and file a statutory financial return in Bermuda. The Insurance Act also requires Arch Re Bermuda to maintain certain measures of solvency and liquidity during the year. Declarations of dividends from retained earnings and distributions from additional paid-in-capital are subject to these solvency and liquidity requirements being met. At December 31, 2007, 2006 and 2005, such requirements were met.

At December 31, 2007 and 2006, as determined under Bermuda law, Arch Re Bermuda had statutory capital of \$2.0 billion and \$1.98 billion, respectively, and statutory capital and surplus of \$3.73 billion and \$3.32 billion, respectively. Such amounts include interests in U.S. insurance and



**ARCH CAPITAL GROUP LTD. AND SUBSIDIARIES**

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

**15. Statutory Information (Continued)**

reinsurance subsidiaries. Arch Re Bermuda recorded statutory net income of \$909.1 million, \$774.3 million and \$271.4 million for 2007, 2006 and 2005, respectively. The primary difference between net income and capital and surplus presented under Bermuda statutory accounting principles and net income and shareholder's equity presented in accordance with U.S. GAAP relates to deferred acquisition costs.

Under the Insurance Act, Arch Re Bermuda is registered as a Class 4 insurer and reinsurer, and is restricted with respect to the payment of dividends. Arch Re Bermuda is prohibited from declaring or paying in any financial year dividends of more than 25% of its total statutory capital and surplus (as shown on its previous financial year's statutory balance sheet) unless it files, at least seven days before payment of such dividends, with the Bermuda Monetary Authority an affidavit stating that it will continue to meet the required margins. In addition, Arch Re Bermuda is prohibited, without prior approval of the Bermuda Monetary Authority, from reducing by 15% or more its total statutory capital, as set out in its previous year's statutory financial statements. Accordingly, Arch Re Bermuda can pay approximately \$933 million to ACGL during 2008 without providing an affidavit to the Bermuda Monetary Authority, as discussed above.

*United States*

The Company's U.S. insurance and reinsurance subsidiaries file financial statements prepared in accordance with statutory accounting practices prescribed or permitted by insurance regulators. Statutory net income and statutory surplus, as reported to the insurance regulatory authorities, differ in certain respects from the amounts prepared in accordance with GAAP. The main differences between statutory net income and GAAP net income relate to deferred acquisition costs and deferred income taxes. In addition to deferred acquisition costs and deferred income tax assets, other differences between statutory surplus and GAAP shareholder's equity are unrealized appreciation or decline in value of investments and non-admitted assets.

Combined statutory surplus of the Company's U.S. insurance and reinsurance subsidiaries was \$719.0 million and \$691.7 million at December 31, 2007 and 2006, respectively. The Company's U.S. insurance and reinsurance subsidiaries had combined statutory net income of \$42.2 million, \$55.1 million and \$54.5 million for 2007, 2006 and 2005, respectively.

The Company's U.S. insurance and reinsurance subsidiaries are subject to insurance laws and regulations in the jurisdictions in which they operate. The ability of the Company's regulated insurance subsidiaries to pay dividends or make distributions is dependent on their ability to meet applicable regulatory standards. These regulations include restrictions that limit the amount of dividends or other distributions, such as loans or cash advances, available to shareholders without prior approval of the insurance regulatory authorities. Dividends or distributions, if any, made by the Company's U.S. regulated insurance and reinsurance subsidiaries to non-insurance affiliates would result in an increase in available capital at Arch-U.S., the Company's U.S. holding company, which is owned by Arch Re Bermuda. The Company's U.S. insurance and reinsurance subsidiaries can pay approximately \$113.9 million in dividends or distributions during 2008 without prior regulatory approval. Such dividends or distributions may be subject to applicable withholding or other taxes.

*United Kingdom*

The Company's U.K. subsidiary, Arch-Europe, was licensed and authorized by the Financial Services Authority ("FSA") to underwrite all classes of general insurance in the U.K. in May 2004.

**ARCH CAPITAL GROUP LTD. AND SUBSIDIARIES**

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

**15. Statutory Information (Continued)**

Arch-Europe must file annual audited financial statements in accordance with United Kingdom Generally Accepted Accounting Principles ("U.K. GAAP") with Companies House under the Companies Act 1985 (as amended). In addition, Arch Europe is required to file regulatory returns with the FSA, which regulates insurance and reinsurance companies operating from the U.K. The financial statements required to be submitted to Companies House form the basis for the regulatory return required to be submitted to the FSA. The FSA's capital adequacy and solvency regulations require a margin of capital to be determined by the Company's own individual capital assessment ("ICA") to value capital adequacy. The model the company uses to determine the capital requirement is reviewed and approved by the FSA who then issue an individual capital guidance ("ICG"). For Arch-Europe, the ICG is the same as its own ICA.

Under U.K. law, all U.K. companies are restricted from declaring a dividend to their shareholders unless they have "profits available for distribution." The calculation as to whether a company has sufficient profits is based on its accumulated realized profits minus its accumulated realized losses. U.K. insurance regulatory laws do not prohibit the payment of dividends, but the FSA requires that insurance companies maintain certain solvency margins and may restrict the payment of a dividend by Arch-Europe. Arch-Europe can pay approximately £8.4 million, or \$16.7 million, in dividends to ACGL during 2008 without prior notice and approval by the FSA. Shareholder's equity of Arch-Europe under U.K. GAAP at December 31, 2007 was £58.6 million, or approximately \$117.1 million, compared to £54.5 million, or approximately \$106.5 million, at December 31, 2006. Arch-Europe had U.K. GAAP net income of £2.8 million, or approximately \$5.6 million, for 2007, compared to £0.8 million, or approximately \$1.5 million, for 2006 and £4.3 million, or approximately \$7.6 million, for 2005.

**16. 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 December 31, 2007, the Company was not a party to any material litigation or arbitration other than as a part of the ordinary course of business in relation to claims and reinsurance recoverable matters, none of which is expected by management to have a significant adverse effect on the Company's results of operations and financial condition and liquidity.

**17. Subsequent Event**

On January 22, 2008, Arch Re Bermuda and Gulf Investment Corporation GSC ("GIC" and, together with Arch Re Bermuda, the "Shareholders"), entered into a Joint Venture Agreement (the "Agreement"), for the purpose of forming a reinsurance company (the "Joint Venture") in the Dubai International Financial Centre. GIC is owned equally by the six member states of the Gulf Cooperation Council ("GCC"), 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, primarily in those member states of the GCC. The initial total capital of the Joint Venture, which will be provided by Arch Re Bermuda and GIC equally, will consist of \$200 million, plus an additional \$200 million to be funded depending on the Joint Venture's business needs. The Joint Venture's underwriting activities are expected to commence during the first half of 2008, subject to approval by the Dubai Financial Services Authority.

## ARCH CAPITAL GROUP LTD. AND SUBSIDIARIES

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

## 18. Unaudited Quarterly Financial Information

Following is a summary of quarterly financial data:

(U.S. dollars in thousands, except share data)	Fourth Quarter	Third Quarter	Second Quarter	First Quarter
<b>2007 Income Statement Data:</b>				
Net premiums written	\$ 577,666	\$ 694,630	\$ 757,895	\$ 871,745
Net premiums earned	\$ 712,216	\$ 735,529	\$ 751,412	\$ 745,493
Fee income	1,866	1,610	2,091	1,969
Other income	5,483	2,696	265	604
Net investment income	119,901	113,181	117,299	112,689
Net realized gains (losses)	18,732	14,147	(3,757)	(981)
Losses and loss adjustment expenses	(395,751)	(402,695)	(425,663)	(420,061)
Acquisition expenses	(111,702)	(131,424)	(117,277)	(120,128)
Other operating expenses	(101,275)	(95,545)	(100,505)	(90,813)
Interest expense	(5,523)	(5,524)	(5,523)	(5,523)
Net foreign exchange losses	(4,121)	(23,656)	(6,450)	(9,742)
Income tax benefit (expense)	1,044	(2,113)	(6,037)	(8,495)
Net income	240,870	206,206	205,855	205,012
Preferred dividends	(6,461)	(6,461)	(6,461)	(6,461)
Net income available to common shareholders	\$ 234,409	\$ 199,745	\$ 199,394	\$ 198,551
Net income per common share data				
Basic	\$ 3.44	\$ 2.87	\$ 2.75	\$ 2.69
Diluted	\$ 3.31	\$ 2.76	\$ 2.65	\$ 2.59
<b>2006 Income Statement Data:</b>				
Net premiums written	\$ 601,916	\$ 747,225	\$ 794,558	\$ 873,719
Net premiums earned	\$ 765,041	\$ 757,573	\$ 797,450	\$ 761,601
Fee income	2,272	2,269	3,468	1,805
Other income	431			
Net investment income	107,754	101,622	90,503	80,326
Net realized gains (losses)	27,263	(11,115)	(32,202)	(3,383)
Losses and loss adjustment expenses	(414,368)	(445,748)	(462,255)	(468,178)
Acquisition expenses	(148,129)	(117,529)	(148,581)	(129,672)
Other operating expenses	(82,167)	(82,791)	(84,367)	(82,977)
Interest expense	(5,523)	(5,361)	(5,651)	(5,555)
Net foreign exchange losses	(8,283)	(4,251)	(1,146)	(10,253)
Income tax benefit (expense)	1,448	(2,371)	(14,332)	(11,424)
Net income	245,739	192,298	142,887	132,290
Preferred dividends	(6,461)	(6,488)	(5,039)	(2,667)
Net income available to common shareholders	\$ 239,278	\$ 185,810	\$ 137,848	\$ 129,623
Net income per common share data				
Basic	\$ 3.25	\$ 2.54	\$ 1.88	\$ 1.78

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(U.S. dollars in thousands, except share data)	Fourth Quarter	Third Quarter	Second Quarter	First Quarter
Diluted	\$ 3.12 F-57	\$ 2.44	\$ 1.81	\$ 1.71

## ARCH CAPITAL GROUP LTD. AND SUBSIDIARIES

## SUMMARY OF INVESTMENTS

## OTHER THAN INVESTMENTS IN RELATED PARTIES

(U.S. dollars in thousands)

	December 31, 2007		
	Amortized Cost	Fair Value	Amount at Which Shown in the Balance Sheet
Fixed maturities and fixed maturities pledged under securities lending agreements(1):			
Corporate bonds	\$ 2,423,225	\$ 2,452,527	\$ 2,452,527
Commercial mortgage backed securities	1,298,899	1,315,680	1,315,680
Mortgage backed securities	1,224,472	1,234,596	1,234,596
U.S. government and government agencies	1,144,272	1,165,423	1,165,423
Asset backed securities	1,002,552	1,008,030	1,008,030
Municipal bonds	977,307	990,325	990,325
Non-U.S. government securities	409,267	434,243	434,243
<b>Total</b>	<b>8,479,994</b>	<b>8,600,824</b>	<b>8,600,824</b>
Other investments	559,925	589,669	589,669
Short-term investments	700,489	699,255	699,255
<b>Total investments(2)</b>	<b>\$ 9,740,408</b>	<b>\$ 9,889,748</b>	<b>\$ 9,889,748</b>

(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 \$1.5 billion of collateral received which is reflected as "short-term investment of funds received under securities lending agreements, at fair value" and included the \$1.46 billion of "fixed maturities and short-term investments pledged under securities lending agreements, at fair value."

(2)

Includes certain securities transactions entered into but not settled at the balance sheet date. Net of such amounts, total investments at fair value were approximately \$9.88 billion.

**ARCH CAPITAL GROUP LTD. AND SUBSIDIARIES**  
**CONDENSED FINANCIAL INFORMATION OF REGISTRANT**

**Balance Sheet**  
**(Parent Company Only)**  
**(U.S. dollars in thousands)**

	December 31,	
	2007	2006
<b>Assets</b>		
Investments in wholly owned subsidiaries	\$ 4,309,166	\$ 3,882,313
Short-term investments available for sale, at fair value	28,688	5,867
Cash	7,631	8,323
Other assets	4,750	6,507
	<b>Total Assets</b>	<b>\$ 3,903,010</b>
<b>Liabilities</b>		
Senior notes	\$ 300,000	\$ 300,000
Accounts payable and other liabilities	14,424	12,391
	<b>Total Liabilities</b>	<b>312,391</b>
<b>Shareholders' Equity</b>		
Non-cumulative preferred shares (\$0.01 par value, 50,000,000 shares authorized)		
Series A (issued: 2007 and 2006, 8,000,000)	80	80
Series B (issued: 2007 and 2006, 5,000,000)	50	50
Common shares (\$0.01 par value, 200,000,000 shares authorized, issued: 2007, 67,318,466; 2006, 74,270,466)	673	743
Additional paid-in capital	1,451,667	1,944,304
Retained earnings	2,428,117	1,593,907
Accumulated other comprehensive income, net of deferred income tax	155,224	51,535
	<b>Total Shareholders' Equity</b>	<b>4,035,811</b>
	<b>Total Liabilities and Shareholders' Equity</b>	<b>\$ 3,903,010</b>

**ARCH CAPITAL GROUP LTD. AND SUBSIDIARIES**  
**CONDENSED FINANCIAL INFORMATION OF REGISTRANT (Continued)**

**Statement of Income**  
**(Parent Company Only)**  
**(U.S. dollars in thousands)**

	Years Ended December 31,		
	2007	2006	2005
<b>Revenues</b>			
Net investment income	\$ 1,185	\$ 801	\$ 220
Net realized gains (losses)	206	(27)	(41)
<b>Total revenues</b>	<b>1,391</b>	<b>774</b>	<b>179</b>
<b>Expenses</b>			
Operating expenses	31,560	28,537	26,146
Interest expense	22,093	22,090	22,504
<b>Total expenses</b>	<b>53,653</b>	<b>50,627</b>	<b>48,650</b>
<b>Loss before income taxes</b>	<b>(52,262)</b>	<b>(49,853)</b>	<b>(48,471)</b>
Income tax benefit			
<b>Loss before equity in net income of wholly owned subsidiaries</b>	<b>(52,262)</b>	<b>(49,853)</b>	<b>(48,471)</b>
Equity in net income of wholly owned subsidiaries	910,205	763,067	304,957
<b>Net income</b>	<b>857,943</b>	<b>713,214</b>	<b>256,486</b>
Preferred dividends	(25,844)	(20,655)	
<b>Net income available to common shareholders</b>	<b>\$ 832,099</b>	<b>\$ 692,559</b>	<b>\$ 256,486</b>

**ARCH CAPITAL GROUP LTD. AND SUBSIDIARIES**  
**CONDENSED FINANCIAL INFORMATION OF REGISTRANT (Continued)**

**Statement of Cash Flows**  
**(Parent Company Only)**  
**(U.S. dollars in thousands)**

	Years Ended December 31,		
	2007	2006	2005
<b>Operating Activities</b>			
Net income	\$ 857,943	\$ 713,214	\$ 256,486
Adjustments to reconcile net income to net cash provided by (used for) operating activities:			
Equity in net income of wholly owned subsidiaries	(910,205)	(763,067)	(304,957)
Net realized (gains) losses	(206)	27	41
Share-based compensation	9,063	7,639	3,152
Dividends received from subsidiary	602,050	22,050	22,050
Net change in other assets and liabilities	12,645	11,042	17,689
<b>Net Cash Provided By (Used For) Operating Activities</b>	<b>571,290</b>	<b>(9,095)</b>	<b>(5,539)</b>
<b>Investing Activities:</b>			
Purchases of fixed maturity investments			(55)
Proceeds from sales of fixed maturity investments		628	2,303
Net (purchases) sales of short-term investments	(22,540)	6,847	(9,499)
Change in short-term investment of funds received under securities lending agreements, at fair value		691	(691)
Capital contributed to subsidiaries		(314,350)	
Purchase of furniture, equipment and other	(30)		
<b>Net Cash Used For Investing Activities</b>	<b>(22,570)</b>	<b>(306,184)</b>	<b>(7,942)</b>
<b>Financing Activities:</b>			
Purchases of common shares under share repurchase program	(537,066)		
Proceeds from common shares issued, net of repurchases	13,498	19,683	20,249
Proceeds from preferred shares issued, net of issuance costs		314,388	
Change in securities lending collateral		(691)	691
Preferred dividends paid	(25,844)	(17,353)	
<b>Net Cash (Used For) Provided By Financing Activities</b>	<b>(549,412)</b>	<b>316,027</b>	<b>20,940</b>
Decrease (increase) in cash	(692)	748	7,459
Cash beginning of year	8,323	7,575	116
<b>Cash end of year</b>	<b>\$ 7,631</b>	<b>\$ 8,323</b>	<b>\$ 7,575</b>



**ARCH CAPITAL GROUP LTD. AND SUBSIDIARIES**  
**SUPPLEMENTARY INSURANCE INFORMATION**  
(U.S. dollars in thousands)

	Deferred Acquisition Costs, Net	Reserves for Losses and Loss Adjustment Expenses	Unearned Premiums	Net Premiums Earned	Net Investment Income(1)	Net Losses and Loss Adjustment Expenses Incurred	Amortization of Deferred Acquisition Costs	Other Operating Expenses(2)	Net Premiums Written
<b>December 31, 2007</b>									
Insurance	\$ 146,455	\$ 4,301,647	\$ 1,028,785	\$ 1,702,343	NM	\$ 1,077,769	\$ 201,703	\$ 276,388	\$ 1,717,548
Reinsurance	143,604	2,790,805	737,096	1,242,307	NM	566,401	278,828	81,059	1,184,388
<b>Total</b>	<b>\$ 290,059</b>	<b>\$ 7,092,452</b>	<b>\$ 1,765,881</b>	<b>\$ 2,944,650</b>	<b>NM</b>	<b>\$ 1,644,170</b>	<b>\$ 480,531</b>	<b>\$ 357,447</b>	<b>\$ 2,901,936</b>
<b>December 31, 2006</b>									
Insurance	\$ 125,001	\$ 3,806,618	\$ 1,011,490	\$ 1,600,854	NM	\$ 1,017,263	\$ 175,740	\$ 249,637	\$ 1,652,056
Reinsurance	165,998	2,656,422	780,432	1,480,811	NM	773,286	368,171	53,533	1,365,362
<b>Total</b>	<b>\$ 290,999</b>	<b>\$ 6,463,040</b>	<b>\$ 1,791,922</b>	<b>\$ 3,081,665</b>	<b>NM</b>	<b>\$ 1,790,549</b>	<b>\$ 543,911</b>	<b>\$ 303,170</b>	<b>\$ 3,017,418</b>
<b>December 31, 2005</b>									
Insurance	\$ 108,477	\$ 3,069,354	\$ 913,084	\$ 1,392,114	NM	\$ 949,996	\$ 137,804	\$ 221,934	\$ 1,481,300
Reinsurance	208,880	2,383,472	786,607	1,585,602	NM	1,051,953	442,116	52,192	1,657,472
<b>Total</b>	<b>\$ 317,357</b>	<b>\$ 5,452,826</b>	<b>\$ 1,699,691</b>	<b>\$ 2,977,716</b>	<b>NM</b>	<b>\$ 2,001,949</b>	<b>\$ 579,920</b>	<b>\$ 274,126</b>	<b>\$ 3,138,772</b>

(1) The Company does not manage its assets by segment and, accordingly, net investment income is not allocated to each underwriting segment. See Note 3.

(2) Certain other operating expenses relate to the Company's corporate and other segment (non-underwriting). Such amounts are not reflected in the table above. See Note 3.

**ARCH CAPITAL GROUP LTD. AND SUBSIDIARIES**  
**REINSURANCE**  
(U.S. dollars in thousands)

	<u>Gross Amount</u>	<u>Ceded to Other Companies(1)</u>	<u>Assumed From Other Companies(1)</u>	<u>Net Amount</u>	<u>Percentage of Amount Assumed to Net</u>
<b>Year Ended December 31, 2007</b>					
Premiums Written:					
Insurance	\$ 2,563,011	\$ (942,754)	\$ 97,291	\$ 1,717,548	5.7%
Reinsurance	1,891	(333,257)	1,515,754	1,184,388	128.0%
<b>Total</b>	<b>\$ 2,564,902</b>	<b>\$ (1,238,207)</b>	<b>\$ 1,575,241</b>	<b>\$ 2,901,936</b>	<b>54.3%</b>
<b>Year Ended December 31, 2006</b>					
Premiums Written:					
Insurance	\$ 2,572,775	\$ (972,701)	\$ 51,982	\$ 1,652,056	3.1%
Reinsurance	161	(338,434)	1,703,635	1,365,362	124.8%
<b>Total</b>	<b>\$ 2,572,936</b>	<b>\$ (1,265,031)</b>	<b>\$ 1,709,513</b>	<b>\$ 3,017,418</b>	<b>56.7%</b>
<b>Year Ended December 31, 2005</b>					
Premiums Written:					
Insurance	\$ 2,268,418	\$ (844,332)	\$ 57,214	\$ 1,481,300	3.9%
Reinsurance	(95)	(93,367)	1,750,934	1,657,472	105.6%
<b>Total</b>	<b>\$ 2,268,323</b>	<b>\$ (876,045)</b>	<b>\$ 1,746,494</b>	<b>\$ 3,138,772</b>	<b>55.6%</b>

(1)

Certain amounts included in the gross premiums written of each segment are related to intersegment transactions and are included in the gross premiums written of each segment. 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. For 2007, 2006 and 2005, the insurance segment results include \$1.0 million, \$1.0 million and \$3.2 million, respectively, of gross premiums written and assumed through intersegment transactions. For 2007, 2006 and 2005, the reinsurance segment results include \$36.8 million, \$45.1 million and \$58.4 million, respectively, of gross premiums written and assumed through intersegment transactions. See Note 3.

**ARCH CAPITAL GROUP LTD. AND SUBSIDIARIES**  
**SUPPLEMENTARY INFORMATION FOR PROPERTY AND CASUALTY INSURANCE UNDERWRITERS**  
(U.S. dollars in thousands)

Column A	Column B	Column C	Column D	Column E	Column F	Column G	Column H		Column I	Column J	Column K	
							Net Losses and Loss Adjustment Expenses Incurred Related to					
Affiliation with Registrant	Deferred Acquisition Costs, Net	Reserves for Losses and Loss Adjustment Expenses	Discount, if any, deducted in Column C	Unearned Premiums	Net Premiums Earned	Net Investment Income(1)	(1) Current Year	(2) Prior Years	Amortization of Deferred Acquisition Costs	Net Paid Losses and Adjustment Expenses	Net Premiums Written	
<b>Insurance</b>												
2007	\$ 146,455	\$ 4,301,647	\$ 2,081	\$ 1,028,785	\$ 1,702,343	NM	\$ 1,090,423	\$ (12,654)	\$ 201,703	\$ 603,156	\$ 1,717,548	
2006	125,001	3,806,618		1,011,490	1,600,854	NM	1,025,564	(8,301)	175,740	518,662	1,652,056	
2005	108,477	3,069,354		913,084	1,392,114	NM	977,763	(27,767)	137,804	318,195	1,481,300	
<b>Reinsurance</b>												
2007	\$ 143,604	\$ 2,790,805		\$ 737,096	\$ 1,242,307	NM	\$ 739,108	\$ (172,707)	\$ 278,828	\$ 514,257	\$ 1,184,388	
2006	165,998	2,656,422		780,432	1,480,811	NM	841,780	(68,494)	368,171	471,772	1,365,362	
2005	208,880	2,383,472		786,607	1,585,602	NM	1,143,199	(91,246)	442,116	439,994	1,657,472	

(1) The Company does not manage its assets by segment and, accordingly, net investment income is not allocated to each underwriting segment. See Note 3.

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### EXHIBIT INDEX

Exhibit Number	Description
3.1	Memorandum of Association of Arch Capital Group Ltd. ("ACGL")(l)
3.2	Bye-Laws of ACGL(l)
3.3.1	Form of Amended and Restated Bye-law 45 and Bye-law 75(q)
3.3.2	Form of Amended and Restated Bye-law 20(u)
4.1.1	Certificate of Designations of Series A Non-Cumulative Preferred Shares(ss)
4.1.2	Certificate of Designations of Series B Non-Cumulative Preferred Shares(xx)
4.2.1	Specimen Common Share Certificate(n)
4.2.2	Specimen Series A Non-Cumulative Preferred Share Certificate(ss)
4.2.3	Specimen Series B Non-Cumulative Preferred Share Certificate(xx)
4.3	Shareholders Agreement, dated as of November 20, 2001, by and among ACGL and the shareholders party thereto, conformed to reflect amendments dated as of January 3, 2002, March 15, 2002 and September 16, 2002(x)
4.4	Subscription Agreement, dated as of October 24, 2001, by and among ACGL and the purchasers party thereto, conformed to reflect amendments dated as of November 20, 2001, January 3, 2002, March 15, 2002 and January 20, 2003 ("Subscription Agreement")(x)
4.5	Agreement, dated as of January 27, 2004, by and among ACGL and the parties thereto, relating to the Subscription Agreement(bb)
4.6	Indenture and First Supplemental Indenture, dated as of May 4, 2004, between ACGL and JPMorgan Chase Bank, N.A. (formerly JPMorgan Chase Bank) ("JPMCB")(cc)
10.1.1	Lease Agreement, dated as of September 26, 2002, between Arch Insurance Company ("Arch Insurance") and BFP One Liberty Plaza Co. LLC ("BFP") ("Lease")(x)
10.1.2	First Lease Modification Agreement, dated as of May 7, 2003, to the Lease(z)
10.1.3	Second Lease Modification Agreement, dated as of July 31, 2003, to the Lease(z)
10.1.4	Third Lease Modification Agreement, dated as of February 18, 2004, to the Lease(bb)
10.1.5	Fourth Lease Modification Agreement, dated as of May 13, 2004, to the Lease(mm)
10.1.6	Fifth Lease Modification Agreement, dated as of December 15, 2005, to the Lease(tt)
10.1.7	Sixth Lease Modification Agreement, dated as of March 29, 2007, to the Lease (filed herewith)
10.2.1	ACGL 1995 Long Term Incentive and Share Award Plan ("1995 Stock Plan")(b)
10.2.2	First Amendment to the 1995 Stock Plan(c)
10.3	ACGL 1999 Long Term Incentive and Share Award Plan(g)
10.4	ACGL Long Term Incentive Plan for New Employees(s)
10.5.1	ACGL 2002 Long Term Incentive and Share Award Plan ("2002 Plan")(w)

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Exhibit Number	Description
10.5.2	First Amendment to the 2002 Plan(z)
E-1	

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- 10.6 Amended and Restated ACGL Incentive Compensation Plan(vv)
- 10.7 ACGL 2007 Long Term Incentive and Share Award Plan(zz)
- 10.8.1 ACGL 2007 Employee Share Purchase Plan ("2007 ESPP")(zz)
- 10.8.2 Amendment to ACGL 2007 ESPP, dated as of November 7, 2007 (filed herewith)
- 10.9.1 Restricted Share Agreements with ACGL Executive Officers of ACGL September 19, 1995 grants(d)
- 10.9.2 Restricted Share Agreements with ACGL Marc Grandisson October 23, 2001 grant(p), February 26, 2004 grant(hh), September 22, 2004 grant(ee) and November 15, 2005 grant(tt)
- 10.9.3 Restricted Share Agreement with ACGL W. Preston Hutchings July 1, 2005(tt)
- 10.9.4 Restricted Share Agreements with ACGL Louis T. Petrillo January 30, 2001 grant(p), February 20, 2003 grant(bb) and September 22, 2004 grant(ee)
- 10.9.5 Restricted Share Agreements with ACGL Constantine Iordanou January 1, 2002 grants(q), February 26, 2004 grant(hh) and September 22, 2004 grant(ee)
- 10.9.6 Restricted Share Agreements with ACGL John D. Vollaro January 18, 2002 grant ("January Restricted Share Agreement")(v), February 20, 2003 grant(bb), Amendment No. 1 to January Restricted Share Agreement(x) and September 22, 2004 grant(ee)
- 10.9.7 Restricted Share Agreement with ACGL substantially in the form signed by Constantine Iordanou, John D. Vollaro and Marc Grandisson May 11, 2007 grant (filed herewith)
- 10.9.8 Restricted Share Agreement with ACGL substantially in the form signed by W. Preston Hutchings and Louis T. Petrillo May 11, 2007 grant (filed herewith)
- 10.9.9 Restricted Share Unit Agreement, dated as of February 20, 2003, between ACGL and Constantine Iordanou(bb)
- 10.9.10 Restricted Share Unit Agreements with ACGL Ralph E. Jones III February 26, 2004(hh), April 19, 2004(mm), September 22, 2004 grant(ee), May 11, 2007 grant (filed herewith) and Amendment to all of such Restricted Share Unit Agreements, dated as of October 26, 2007 (filed herewith)
- 10.9.11 Agreement, dated as of September 17, 2003, between ACGL and John D. Vollaro(bb)
- 10.9.12 Restricted Share Agreements with ACGL substantially in the form signed by the Non-Employee Directors of ACGL 2003 annual grants(gg), 2004 annual grants(ff) and 2005 annual grants (filed herewith)
- 10.9.13 Restricted Share Agreements with Constantine Iordanou, John D. Vollaro and Marc Grandisson February 23, 2006(yy)
- 10.9.14 Restricted Share Agreements with W. Preston Hutchings and Louis T. Petrillo February 23, 2006(yy)
- 10.9.15 Restricted Share Agreements with Ralph E. Jones III February 23, 2006(yy)
- 10.10.1 Stock Option Agreements with ACGL Executive Officers of ACGL 1995 and 1996 grants(d), 1997 and 1998 grants(f) and 2000 grants(m)

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- 10.10.2 Amendments to Stock Option Agreements with ACGL Executive Officers and Directors of ACGL (dated May 5, 2000)(n)
- 10.10.3 Stock Option Agreements with ACGL Non-Employee Directors of ACGL initial grants(f)(i), 1996 and 1997 annual grants(c), 1998 annual grants(e), 1999 annual grants(f), 2000 annual grants(i) and 2001 annual grants(n)
- 10.10.4 Stock Option Agreements with ACGL Louis T. Petrillo January 30, 2001 grant(p), October 23, 2001 grant(p) and September 22, 2004 grant(ee)(kk)
- 10.10.5 Stock Option Agreements with ACGL Marc Grandisson October 23, 2001 grant(p), September 22, 2004 grant(ee)(kk) and November 15, 2005(tt)
- 10.10.6 Stock Option Agreement, dated July 1, 2005, between ACGL and W. Preston Hutchings(tt)
- 10.10.7 Amended and Restated Stock Option Agreement, dated as of October 23, 2001, between ACGL and Paul Ingrey(x)
- 10.10.8 Stock Option Agreements with ACGL John M. Pasquesi October 23, 2001 grants(q)
- 10.10.9 Stock Option Agreements with ACGL Constantine Iordanou January 1, 2002 grant(q) and September 22, 2004 grant(ee)(ll)
- 10.10.10 Stock Option Agreements with ACGL John D. Vollaro January 18, 2002 grant(v) and September 22, 2004 grant(ee)(ll)
- 10.10.11 Stock Option Agreements with ACGL Ralph E. Jones III July 1, 2003 grant(aa) and September 22, 2004 grant(ee)(ll)
- 10.10.12 Stock Option Agreements with Constantine Iordanou, John D. Vollaro, Marc Grandisson and Ralph E. Jones III February 23, 2006(yy)
- 10.10.13 Stock Option Agreements with W. Preston Hutchings and Louis T. Petrillo(yy)
- 10.11.1 Share Appreciation Right Agreement with ACGL substantially in the form signed by Louis T. Petrillo and W. Preston Hutchings May 11, 2007 grant (filed herewith)
- 10.11.2 Share Appreciation Right Agreement with ACGL substantially in the form signed by Constantine Iordanou, John D. Vollaro, Marc Grandisson and Ralph E. Jones III May 11, 2007 grant (filed herewith)
- 10.12.1 Employment and Change in Control Agreement, dated as of May 5, 2000, between ACGL and Louis T. Petrillo(k)
- 10.12.2 Agreement, dated as of December 5, 2005, between ACGL and Dwight Evans(rr)
- 10.12.3 Employment Agreement, dated as of October 23, 2001, among ACGL, Arch Re Bermuda and Marc Grandisson ("Grandisson Employment Agreement")(q)
- 10.12.4 Amendment, dated as of November 16, 2005, to Grandisson Employment Agreement(tt)
- 10.12.5 Employment Letter Agreement, dated as of May 29, 2005, between ACGL and W. Preston Hutchings(pp)
- 10.12.6 Employment Agreement, dated as of November 28, 2007 between ACGL and Constantine Iordanou(bbb)
- 10.12.7 Employment Agreement, dated as of January 18, 2002, between ACGL and John Vollaro ("Vollaro Employment Agreement")(v)

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- 10.12.8 Amendment, dated as of April 27, 2005, to Vollaro Employment Agreement(nn)
- 10.12.9 Employment Agreement, dated as of June 4, 2003, between Arch Insurance Group Inc. ("Arch Insurance Group") and Ralph E. Jones III(y)
- 10.12.10 Agreement, dated as of September 6, 2005, between ACGL and Robert Clements(qq)
- 10.12.11 Agreement, effective as of July 31, 2003, between ACGL and Peter A. Appel(aa)
- 10.12.12 Employment Agreement, dated as of April 6, 2004, between ACGL and Paul Ingrey ("Ingrey Employment Agreement")(gg)
- 10.12.13 Amendment, dated as of September 18, 2006, to Ingrey Employment Agreement(yy)
- 10.13 Assumption of Change in Control Agreements(n)
- 10.14 ACGL 1995 Employee Stock Purchase Plan(a)
- 10.15.1 Arch U.S. Executive Supplemental Non-Qualified Savings and Retirement Plan (formerly sponsored by and known as the Arch Re Executive Supplemental Non-Qualified Savings and Retirement Plan) ("Supplemental Plan") and related Trust Agreement(b)
- 10.15.2 Amendment No. 1 to the Adoption Agreement relating to the Supplemental Plan(c)
- 10.15.3 Amendment No. 2 to the Adoption Agreement relating to the Supplemental Plan(f)
- 10.15.4 Amendments to the Adoption Agreement and Trust Agreement relating to the Supplemental Plan(tt)
- 10.16 Asset Purchase Agreement, dated as of January 10, 2000, by and among Arch U.S., Folksamerica Holding Company, Inc. ("FHC") and Folksamerica(h)
- 10.17 Transfer and Assumption Agreement, dated May 5, 2000, between Arch Reinsurance Company (formerly Risk Capital Reinsurance Company) ("Arch Re U.S.") and Folksamerica(j)
- 10.18 Escrow Agreement, dated December 28, 2000, by and among ACGL, FHC, Folksamerica and the Escrow Agent(n)
- 10.19 Agreement, dated May 5, 2000, by and among Arch U.S., Arch Re U.S., FHC and Folksamerica regarding Aviation Business(l)
- 10.20 Agreement and Plan of Merger, dated as of September 25, 2000, by and among Arch U.S., ACGL, The Arch Purpose Trust and Arch Merger Corp.(l)
- 10.21 Agreement, dated November 20, 2001, by and among ACGL, Warburg Pincus Private Equity VIII, L.P., Warburg Pincus International Partners, L.P., Warburg Pincus Netherlands International Partners I, C.V., Warburg Pincus Netherlands International II, C.V. and HFCP IV (Bermuda), L.P. (collectively, the "Original Signatories") and Orbital Holdings, Ltd.(q)
- 10.22 Agreement, dated November 20, 2001, by and among ACGL, the Original Signatories and Insurance Private Equity Investors, L.L.C.(q)
- 10.23 Agreement, dated November 20, 2001, by and among ACGL, the Original Signatories and Farallon Capital Partners, L.P., Farallon Capital Institutional Partners II, L.P., Farallon Capital Institutional Partners III, L.P. and RR Capital Partners, L.P.(q)
- 10.24 Agreement, dated as of November 8, 2001, by and among ACGL, the Original Signatories, Trident, Trident II, L.P., Mash & McLennan Risk Capital Holdings, Ltd., Marsh & McLennan Capital Professionals Fund, L.P. and Marsh & McLennan Employees' Securities Company, L.P.(p)



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- 10.25 Management Subscription Agreement, dated as of October 24, 2001, between ACGL and certain members of management(p)
- 10.26.1 Second Amended and Restated Credit Agreement, dated as of August 30, 2006 ("Second Amended and Restated Credit Agreement"), by and among ACGL, Arch Capital Group (U.S.) Inc., Arch Reinsurance Ltd. ("Arch Re Bermuda"), Arch Reinsurance Company, Arch Insurance Company, Arch Specialty Insurance Company, Arch Excess & Surplus Insurance Company, Western Diversified Casualty Insurance Company and Arch Insurance Company (Europe) Limited, with Barclays Bank Plc, The Bank of New York, Calyon, New York Branch, Citibank, N.A., ING Bank N.V., London Branch, Lloyd's TSB Bank plc, and Wachovia Bank, N.A., as documentation agents, Bank of America, N.A., as syndication agent, JPMCB, as administrative agent, and the lenders named therein(ww)
- 10.26.2 First Amendment to the Second Amended and Restated Credit Agreement, dated as of October 1, 2007(aaa)
- 10.27 Letter of Credit and Reimbursement Agreement, dated as of December 12, 2007, Arch Re Bermuda, Lloyds TSB Bank plc, as agent ("Lloyds TSB"), Lloyds TSB, ING Bank N.V., London Branch, and Barclays Bank plc, as original lenders, and Lloyds TSB as mandated lead arranger(ccc)
- 10.28.1 Stock Purchase Agreement, dated as of May 13, 2004, by and among Protective Underwriting Services, Inc. ("Protective"), Arch Capital Holdings Ltd. ("Arch Capital Holdings") and ACGL, as amended by Amendment No. 1, dated as of July 9, 2004, Amendment No. 2, dated as of July 13, 2004, Amendment No. 3, dated as of July 16, 2004 and Amendment No. 4, dated as of July 28, 2004(hh)
- 10.28.2 Waiver Letter Agreement related to the Stock Purchase Agreement, dated as of October 5, 2004, signed by Arch Capital Holdings, ACGL and Protective(ii)
  - 12 Statement regarding computation of ratios (filed herewith)
  - 21 Subsidiaries of Registrant (filed herewith)
  - 23 Consent of PricewaterhouseCoopers LLP (filed herewith)
  - 24 Powers of Attorney (filed herewith)
  - 25 Form T-1 Statement of Eligibility of Trustee(jj)
- 31.1 Certification of Chief Executive Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002 (filed herewith)
- 31.2 Certification of Chief Financial Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002 (filed herewith)
- 32.1 Certification of Chief Executive Officer pursuant to Section 906 of the Sarbanes-Oxley Act of 2002 (filed herewith)

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32.2 Certification of Chief Financial Officer pursuant to Section 906 of the Sarbanes-Oxley Act of 2002 (filed herewith)

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- (a) Filed as an exhibit to our Registration Statement on Form S-8 (No. 33-99974), as filed with the SEC on December 4, 1995, and incorporated by reference.
- (b) Filed as an exhibit to our Annual Report on Form 10-K for the year ended December 31, 1995, as filed with the SEC on March 29, 1996, and incorporated by reference.
- (c) Filed as an exhibit to our Annual Report on Form 10-K for the year ended December 31, 1996, as filed with the SEC on March 31, 1997, and incorporated by reference.
- (d) Filed as an exhibit to our Report on Form 10-Q for the period ended June 30, 1997, as filed with the SEC on August 14, 1997, and incorporated by reference.
- (e) Filed as an exhibit to our Annual Report on Form 10-K for the year ended December 31, 1997, as filed with the SEC on March 27, 1998, and incorporated by reference.
- (f) Filed as an exhibit to our Annual Report on Form 10-K for the year ended December 31, 1998, as filed with the SEC on March 30, 1999, and incorporated by reference.
- (g) Filed as an exhibit to our Definitive Proxy Statement, as filed with the SEC on April 14, 1999, and incorporated by reference.
- (h) Filed as an exhibit to our Report on Form 8-K as filed with the SEC on January 18, 2000, and incorporated by reference.
- (i) Filed as an exhibit to our Annual Report on Form 10-K for the year ended December 31, 1999, as filed with the SEC on March 30, 2000, and incorporated by reference.
- (j) Filed as an exhibit to our Report on Form 8-K, as filed with the SEC on May 19, 2000, and incorporated by reference.
- (k) Filed as an exhibit to our Report on Form 8-K, as filed with the SEC on September 8, 2000, and incorporated by reference.
- (l) Filed as an annex to our Definitive Proxy Statement/Prospectus included in our Registration Statement on Form S-4 (No. 333-45418), as filed with the SEC on September 26, 2000, and incorporated by reference.
- (m) Filed as an exhibit to our Report on Form 10-Q for the period ended September 30, 2000, as filed with the SEC on November 14, 2000, and incorporated by reference.
- (n) Filed as an exhibit to our Annual Report on Form 10-K for the year ended December 31, 2000, as filed with the SEC on April 2, 2001, and incorporated by reference.
- (o) Filed as an exhibit to our Report on Form 8-K, as filed with the SEC on July 6, 2001, and incorporated by reference.
- (p)

## Edgar Filing: - Form

Filed as an exhibit to our Report on Form 10-Q for the period ended September 30, 2001, as filed with the SEC on November 14, 2001, and incorporated by reference.

(q) Filed as an exhibit to our Report on Form 8-K, as filed with the SEC on January 4, 2002, and incorporated by reference.

(r) Filed as an exhibit to our Report on Form 8-K/A, as filed with the SEC on January 7, 2002, and incorporated by reference.

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## Edgar Filing: - Form

- (s) Filed as an exhibit to our Registration Statement on Form S-8 (No. 333-72182), as filed with the SEC on January 8, 2002, and incorporated by reference.
- (t) Filed as an exhibit to our Registration Statement on Form S-3 (No. 333-82612), as filed with the SEC on February 12, 2002, and incorporated by reference.
- (u) Filed as an annex to our Definitive Proxy Statement, as filed with the SEC on June 3, 2002, and incorporated by reference.
- (v) Filed as an exhibit to our Annual Report on Form 10-K for the year ended December 31, 2001, as filed with the SEC on March 18, 2002, and incorporated by reference.
- (w) Filed as an exhibit to our Report on Form 10-Q for the period ended June 30, 2002, as filed with the SEC on August 14, 2002, and incorporated by reference.
- (x) Filed as an exhibit to our Annual Report on Form 10-K for the year ended December 31, 2002, as filed with the SEC on March 31, 2003, and incorporated by reference.
- (y) Filed as an exhibit to our Report on Form 10-Q for the period ended June 30, 2003, as filed with the SEC on August 14, 2003, and incorporated by reference.
- (z) Filed as an exhibit to our Report on Form 10-Q for the period ended September 30, 2003, as filed with the SEC on November 12, 2003, and incorporated by reference, and incorporated by reference.
- (aa) Filed as an exhibit to our Report on Form 8-K, as filed with the SEC on August 5, 2003, and incorporated by reference.
- (bb) Filed as an exhibit to our Annual Report on Form 10-K for the year ended December 31, 2003, as filed with the SEC on March 10, 2004, and incorporated by reference.
- (cc) Filed as an exhibit to our Report on Form 8-K, as filed with the SEC on May 7, 2004, and incorporated by reference.
- (dd) Filed as an exhibit to our Report on Form 8-K, as filed with the SEC on September 22, 2004, and incorporated by reference.
- (ee) Form of agreement filed as an exhibit to our Report on Form 8-K, as filed with the SEC on September 28, 2004, and incorporated by reference.
- (ff) Filed as an exhibit to our Report on Form 8-K, as filed with the SEC on October 6, 2004, and incorporated by reference.
- (gg) Filed as an exhibit to our Report on Form 10-Q for the period ended March 31, 2004, as filed with the SEC on May 10, 2004, and incorporated by reference.
- (hh) Filed as an exhibit to our Report on Form 10-Q for the period ended June 30, 2004, as filed with the SEC on August 9, 2004, and incorporated by reference.
- (ii) Filed as an exhibit to our Report on Form 10-Q for the period ended September 30, 2004, as filed with the SEC on November 9, 2004, and incorporated by reference.

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- (jj) Filed as an exhibit to our Report on Form 8-K, as filed with the SEC on May 3, 2004, and incorporated by reference.
- (kk) Revised form of agreement originally filed as an exhibit to our Report on Form 8-K, as filed with the SEC on September 28, 2004, and incorporated by reference.
- (ll) Revised form of agreement originally filed as an exhibit to our Report on Form 8-K, as filed with the SEC on September 28, 2004, and incorporated by reference.

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## Edgar Filing: - Form

- (mm) Filed as an exhibit to our Annual Report on Form 10-K for the year ended December 31, 2004, as filed with the SEC on March 15, 2005, and incorporated by reference.
  - (nn) Filed as an exhibit to our Report on Form 8-K, as filed with the SEC on May 3, 2005, and incorporated by reference.
  - (oo) Filed as an exhibit to our Report on Form 10-Q, as filed with the SEC on May 6, 2005, and incorporated by reference.
  - (pp) Filed as an exhibit to our Report on Form 8-K, as filed with the SEC on June 9, 2005, and incorporated by reference.
  - (qq) Filed as an exhibit to our Report on Form 8-K, as filed with the SEC on September 9, 2005, and incorporated by reference.
  - (rr) Filed as an exhibit to our Report on Form 8-K, as filed with the SEC on December 7, 2005, and incorporated by reference.
  - (ss) Filed as an exhibit to our Report on Form 8-K, as filed with the SEC on February 2, 2006, and incorporated by reference.
  - (tt) Filed as an exhibit to our Annual Report on Form 10-K for the year ended December 31, 2005, as filed with the SEC on March 13, 2006, and incorporated by reference
  - (uu) Filed as an exhibit to our Report on Form 8-K, as filed with the SEC on April 19, 2006, and incorporated by reference.
  - (vv) Filed as an exhibit to our Report on Form 10-Q for the period ended March 31, 2006, as filed with the SEC on May 8, 2006, and incorporated by reference
  - (ww) Filed as an exhibit to our Report on Form 8-K, as filed with the SEC on August 31, 2006, and incorporated by reference.
  - (xx) Filed as an exhibit to our Report on Form 8-K, as filed with the SEC on May 24, 2006, and incorporated by reference.
  - (yy) Filed as an exhibit to our Report on Form 10-Q for the period ending September 30, 2006, as filed with the SEC on November 9, 2006.
  - (zz) Filed as an appendix to our Definitive Proxy Statement, as filed with the SEC on April 3, 2007, and incorporated by reference.
  - (aaa) Filed as an exhibit to our Report on Form 8-K, as filed with the SEC on October 2, 2007, and incorporated by reference.
  - (bbb) Filed as an exhibit to our Report on Form 8-K, as filed with the SEC on December 3, 2007, and incorporated by reference.
  - (ccc) Filed as an exhibit to our Report on Form 8-K, as filed with the SEC on December 14, 2007, and incorporated by reference.
- Management contract or compensatory plan or arrangement.

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