

ARCH CAPITAL GROUP LTD.

Form 10-Q

November 08, 2010

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UNITED STATES
SECURITIES AND EXCHANGE COMMISSION

WASHINGTON, D.C. 20549

FORM 10-Q

(Mark One)

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

For the quarterly period ended September 30, 2010

Or

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

Commission file number: 001-26456

ARCH CAPITAL GROUP LTD.

(Exact name of registrant as specified in its charter)

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Bermuda

(State or other jurisdiction of incorporation or organization)

Not Applicable

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

Wessex House, 45 Reid Street

Hamilton HM 12, Bermuda

(Address of principal executive offices)

(441) 278-9250

(Registrant's telephone number, including area code)

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

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

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

Large accelerated filer

Accelerated filer

Non-accelerated filer

Smaller reporting company

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

The number of the registrant's common shares (par value, \$0.01 per share) outstanding as of November 4, 2010 was 48,887,727.

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Report of Independent Registered Public Accounting Firm

To the Board of Directors and Shareholders of

Arch Capital Group Ltd.:

We have reviewed the accompanying consolidated balance sheet of Arch Capital Group Ltd. and its subsidiaries (the Company) as of September 30, 2010, and the related consolidated statements of income for the three-month and nine-month periods ended September 30, 2010 and September 30, 2009, and the consolidated statements of changes in shareholders' equity, comprehensive income and cash flows for each of the nine-month periods ended September 30, 2010 and September 30, 2009. These interim financial statements are the responsibility of the Company's management.

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

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

We previously audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the consolidated balance sheet as of December 31, 2009, and the related consolidated statements of income, changes in shareholders' equity, comprehensive income, and of cash flows for the year then ended (not presented herein), and in our report dated February 26, 2010, we expressed an unqualified opinion on those consolidated financial statements. In our opinion, the information set forth in the accompanying consolidated balance sheet information as of December 31, 2009, is fairly stated in all material respects in relation to the consolidated balance sheet from which it has been derived.

/s/ PricewaterhouseCoopers LLP

New York, NY

November 8, 2010

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

	(Unaudited) September 30, 2010	December 31, 2009
Assets		
Investments:		
Fixed maturities available for sale, at market value (amortized cost: \$9,411,927 and \$9,227,432)	\$ 9,810,102	\$ 9,391,926
Short-term investments available for sale, at market value (amortized cost: \$777,989 and \$570,469)	780,671	571,489
Investment of funds received under securities lending agreements, at market value (amortized cost: \$201,072 and \$96,590)	200,020	91,160
TALF investments, at market value (amortized cost: \$393,377 and \$247,192)	410,881	250,265
Other investments (cost: \$392,446 and \$162,505)	418,411	172,172
Investment funds accounted for using the equity method	432,418	391,869
Total investments	12,052,503	10,868,881
Cash	365,997	334,571
Accrued investment income	79,180	70,673
Investment in joint venture (cost: \$100,000)	104,347	102,855
Fixed maturities and short-term investments pledged under securities lending agreements, at market value	203,221	212,820
Securities purchased under agreements to resell using funds received under securities lending agreements		115,839
Premiums receivable	662,634	595,030
Unpaid losses and loss adjustment expenses recoverable	1,654,900	1,659,500
Paid losses and loss adjustment expenses recoverable	60,222	60,770
Prepaid reinsurance premiums	267,240	277,985
Deferred acquisition costs, net	297,250	280,372
Receivable for securities sold	1,329,508	187,171
Other assets	624,395	609,323
Total Assets	\$ 17,701,397	\$ 15,375,790
Liabilities		
Reserve for losses and loss adjustment expenses	\$ 8,054,677	\$ 7,873,412
Unearned premiums	1,524,100	1,433,331
Reinsurance balances payable	130,274	156,500
Senior notes	300,000	300,000
Revolving credit agreement borrowings	125,000	100,000
TALF borrowings, at market value (par: \$332,291 and \$218,740)	331,797	217,565
Securities lending payable	209,411	219,116
Payable for securities purchased	1,649,462	136,381
Other liabilities	658,766	616,136
Total Liabilities	12,983,487	11,052,441
Commitments and Contingencies		
Shareholders Equity		
Non-cumulative preferred shares - Series A and B	325,000	325,000
Common shares (\$0.01 par, shares issued: 53,143,560 and 54,761,678)	531	548

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Additional paid-in capital	100,640	253,466
Retained earnings	4,194,902	3,605,809
Accumulated other comprehensive income, net of deferred income tax	388,370	138,526
Common shares held in treasury, at cost (shares: 3,918,189 and 0)	(291,533)	
Total Shareholders' Equity	4,717,910	4,323,349
Total Liabilities and Shareholders' Equity	\$ 17,701,397	\$ 15,375,790

See Notes to Consolidated Financial Statements

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ARCH CAPITAL GROUP LTD. AND SUBSIDIARIES

CONSOLIDATED STATEMENTS OF INCOME

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

	(Unaudited) Three Months Ended September 30,		(Unaudited) Nine Months Ended September 30,	
	2010	2009	2010	2009
Revenues				
Net premiums written	\$ 636,117	\$ 727,308	\$ 2,028,129	\$ 2,244,025
Change in unearned premiums	(8,708)	7,077	(107,792)	(109,818)
Net premiums earned	627,409	734,385	1,920,337	2,134,207
Net investment income	90,768	100,213	274,277	296,580
Net realized gains	68,828	70,638	178,724	53,681
Other-than-temporary impairment losses	(2,679)	(7,860)	(9,732)	(142,663)
Less investment impairments recognized in other comprehensive income, before taxes	604	3,217	1,641	81,023
Net impairment losses recognized in earnings	(2,075)	(4,643)	(8,091)	(61,640)
Fee income	874	826	2,551	2,568
Equity in net income of investment funds accounted for using the equity method	9,708	69,119	38,410	135,428
Other income	1,840	5,687	12,346	14,588
Total revenues	797,352	976,225	2,418,554	2,575,412
Expenses				
Losses and loss adjustment expenses	359,193	444,914	1,150,389	1,244,314
Acquisition expenses	111,279	122,739	336,378	373,011
Other operating expenses	103,121	99,743	311,460	286,153
Interest expense	7,371	6,001	22,547	17,425
Net foreign exchange (gains) losses	65,157	19,755	(22,069)	48,208
Total expenses	646,121	693,152	1,798,705	1,969,111
Income before income taxes	151,231	283,073	619,849	606,301
Income tax expense	3,200	2,205	11,373	20,513
Net Income	148,031	280,868	608,476	585,788
Preferred dividends	6,461	6,461	19,383	19,383
Net income available to common shareholders	\$ 141,570	\$ 274,407	\$ 589,093	\$ 566,405
Net income per common share				
Basic	\$ 2.89	\$ 4.56	\$ 11.55	\$ 9.39
Diluted	\$ 2.77	\$ 4.39	\$ 11.05	\$ 9.05
Weighted average common shares and common share equivalents outstanding				
Basic	48,997,791	60,156,219	50,993,316	60,295,144
Diluted	51,182,009	62,533,816	53,317,198	62,590,228

See Notes to Consolidated Financial Statements

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ARCH CAPITAL GROUP LTD. AND SUBSIDIARIES

CONSOLIDATED STATEMENTS OF CHANGES IN SHAREHOLDERS EQUITY

(U.S. dollars in thousands)

	(Unaudited) Nine Months Ended September 30,	
	2010	2009
Non-Cumulative Preferred Shares		
Balance at beginning and end of period	\$ 325,000	\$ 325,000
Common Shares		
Balance at beginning of year	548	605
Common shares issued, net	13	6
Purchases of common shares under share repurchase program	(30)	(16)
Balance at end of period	531	595
Additional Paid-in Capital		
Balance at beginning of year	253,466	669,715
Common shares issued	3,572	2,557
Exercise of stock options	35,150	4,138
Common shares retired	(217,562)	(104,875)
Amortization of share-based compensation	25,450	20,843
Other	564	(44)
Balance at end of period	100,640	592,334
Retained Earnings		
Balance at beginning of year	3,605,809	2,693,239
Cumulative effect of change in accounting principle (1)		61,469
Balance at beginning of year, as adjusted	3,605,809	2,754,708
Dividends declared on preferred shares	(19,383)	(19,383)
Net income	608,476	585,788
Balance at end of period	4,194,902	3,321,113
Accumulated Other Comprehensive Income (Loss)		
Balance at beginning of year	138,526	(255,594)
Cumulative effect of change in accounting principle (1)		(61,469)
Balance at beginning of year, as adjusted	138,526	(317,063)
Change in unrealized appreciation in value of investments, net of deferred income tax	252,026	609,446
Portion of other-than-temporary impairment losses recognized in other comprehensive income, net of deferred income tax	(1,641)	(81,023)
Foreign currency translation adjustments, net of deferred income tax	(541)	10,420
Balance at end of period	388,370	221,780
Common Shares Held in Treasury, at Cost		
Balance at beginning of year		
Shares repurchased for treasury	(291,533)	
Balance at end of period	(291,533)	
Total Shareholders Equity	\$ 4,717,910	\$ 4,460,822

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

See Notes to Consolidated Financial Statements

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

(U.S. dollars in thousands)

	(Unaudited) Nine Months Ended September 30,	
	2010	2009
Comprehensive Income		
Net income	\$ 608,476	\$ 585,788
Other comprehensive income, net of deferred income tax		
Unrealized appreciation in value of investments:		
Unrealized holding gains arising during period	378,543	583,138
Portion of other-than-temporary impairment losses recognized in other comprehensive income, net of deferred income tax	(1,641)	(81,023)
Reclassification of net realized (gains) losses, net of income taxes, included in net income	(126,517)	26,308
Foreign currency translation adjustments	(541)	10,420
Other comprehensive income	249,844	538,843
Comprehensive Income	\$ 858,320	\$ 1,124,631

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ARCH CAPITAL GROUP LTD. AND SUBSIDIARIES

CONSOLIDATED STATEMENTS OF CASH FLOWS

(U.S. dollars in thousands)

	(Unaudited) Nine Months Ended September 30,	
	2010	2009
Operating Activities		
Net income	\$ 608,476	\$ 585,788
Adjustments to reconcile net income to net cash provided by operating activities:		
Net realized gains	(184,423)	(53,161)
Net impairment losses recognized in earnings	8,091	61,640
Equity in net income of investment funds accounted for using the equity method and other income	(29,925)	(145,219)
Share-based compensation	25,450	20,843
Changes in:		
Reserve for losses and loss adjustment expenses, net of unpaid losses and loss adjustment expenses recoverable	212,024	168,615
Unearned premiums, net of prepaid reinsurance premiums	105,905	109,109
Premiums receivable	(73,654)	(54,585)
Deferred acquisition costs, net	(17,570)	(6,064)
Reinsurance balances payable	(22,255)	17,380
Other liabilities	8,143	2,142
Other items, net	17,299	102,176
Net Cash Provided By Operating Activities	657,561	808,664
Investing Activities		
Purchases of:		
Fixed maturity investments	(14,501,938)	(16,048,447)
Other investments	(515,570)	(40,879)
Proceeds from the sales of:		
Fixed maturity investments	13,984,442	14,723,846
Other investments	301,808	67,879
Proceeds from redemptions and maturities of fixed maturity investments	683,826	638,638
Net purchases of short-term investments	(212,093)	(109,500)
Change in investment of securities lending collateral	9,705	127,822
Purchases of furniture, equipment and other assets	(10,111)	(15,586)
Net Cash Used For Investing Activities	(259,931)	(656,227)
Financing Activities		
Purchases of common shares under share repurchase program	(503,724)	(99,746)
Proceeds from common shares issued, net	22,956	772
Proceeds from borrowings	264,526	269,843
Repayments of borrowings	(125,985)	(50,000)
Change in securities lending collateral	(9,705)	(127,822)
Other	8,950	(461)
Preferred dividends paid	(19,383)	(19,383)
Net Cash Used For Financing Activities	(362,365)	(26,797)
Effects of exchange rate changes on foreign currency cash	(3,839)	7,770

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Increase in cash	31,426	133,410
Cash beginning of year	334,571	251,739
Cash end of period	\$ 365,997	\$ 385,149

See Notes to Consolidated Financial Statements

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ARCH CAPITAL GROUP LTD. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)

1. General

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

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

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

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

2. Recent Accounting Pronouncements

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

In March 2010, the Financial Accounting Standards Board (FASB) issued an ASU that clarifies the type of embedded credit derivative that is exempt from embedded derivative bifurcation requirements. Only one form of embedded credit derivative qualifies for the exemption one that is related only to the subordination of one financial instrument to another. As a result, entities that have contracts containing an embedded credit derivative feature in a form other than such subordination may need to separately account for the embedded credit

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ARCH CAPITAL GROUP LTD. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)

derivative feature. This ASU was effective as of July 1, 2010 and its adoption did not have a material impact on the Company's consolidated financial position or results of operations.

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

3. Share Transactions

Share Repurchases

The board of directors of ACGL has authorized the investment of up to \$2.5 billion in ACGL's common shares through a share repurchase program, consisting of a \$1.0 billion authorization in February 2007, a \$500 million authorization in May 2008, and a \$1.0 billion authorization in November 2009. Repurchases under the program may be effected from time to time in open market or privately negotiated transactions through December 2011. Since the inception of the share repurchase program, ACGL has repurchased 28.8 million common shares for an aggregate purchase price of \$2.01 billion. During the 2010 third quarter, ACGL repurchased 0.7 million common shares for an aggregate purchase price of \$53.4 million, compared to 1.5 million common shares for an aggregate purchase price of \$98.2 million during the 2009 third quarter. During the nine months ended September 30, 2010, ACGL repurchased 6.9 million common shares for an aggregate purchase price of \$503.7 million, compared to 1.6 million common shares for an aggregate purchase price of \$99.7 million during the 2009 period.

At September 30, 2010, approximately \$487.7 million of share repurchases were available under the program. The timing and amount of the repurchase transactions under this program will depend on a variety of factors, including market conditions and corporate and regulatory considerations.

Treasury Shares

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In May 2010, ACGL's shareholders approved amendments to the by-laws to permit ACGL to hold its own acquired shares as treasury shares in lieu of cancellation, as determined by ACGL's board of directors. From May 5 to September 30, 2010, all repurchases of ACGL's common shares in connection with the share repurchase plan noted above and other share-based transactions were held in the treasury under the cost method, and the cost of the common shares acquired is included in Common shares held in treasury, at cost. Prior to May 5, 2010, such acquisitions were reflected as a reduction in additional paid-in capital. At September 30, 2010, the Company held 3.9 million shares for an aggregate cost of \$291.5 million in treasury, at cost.

Non-Cumulative Preferred Shares

ACGL's outstanding non-cumulative preferred shares consist of \$200.0 million principal amount of 8.0% series A non-cumulative preferred shares (Series A Preferred Shares) and \$125.0 million principal amount of 7.875% series B non-cumulative preferred shares (Series B Preferred Shares) and together with the Series A Preferred Shares, the Preferred Shares). ACGL has the right to redeem all or a portion of each series of

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ARCH CAPITAL GROUP LTD. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)

Preferred Shares at a redemption price of \$25.00 per share on or after (1) February 1, 2011 for the Series A Preferred Shares and (2) May 15, 2011 for the Series B Preferred Shares. During the nine month periods ended September 30, 2010 and 2009, the Company paid \$19.4 million to holders of the Preferred Shares. At September 30, 2010, the Company had declared an aggregate of \$3.3 million of dividends to be paid to holders of the Preferred Shares.

4. Debt and Financing Arrangements

Senior Notes

On May 4, 2004, ACGL completed a public offering of \$300 million principal amount of 7.35% senior notes (Senior Notes) due May 1, 2034 and received net proceeds of \$296.4 million. ACGL used \$200 million of the net proceeds to repay all amounts outstanding under a revolving credit agreement. The Senior Notes are ACGL's senior unsecured obligations and rank equally with all of its existing and future senior unsecured indebtedness. Interest payments on the Senior Notes are due on May 1st and November 1st of each year. ACGL may redeem the Senior Notes at any time and from time to time, in whole or in part, at a make-whole redemption price. For the nine month periods ended September 30, 2010 and 2009, interest expense on the Senior Notes was \$16.5 million. The market value of the Senior Notes at September 30, 2010 and December 31, 2009 was \$321.9 million and \$298.6 million, respectively.

Letter of Credit and Revolving Credit Facilities

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

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

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ARCH CAPITAL GROUP LTD. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)

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 September 30, 2010. At such date, the Company had \$703.2 million in outstanding letters of credit under the LOC Facilities, which were secured by investments with a market value of \$785.4 million. At September 30, 2010, the Company had \$125.0 million of borrowings outstanding under the Credit Agreement at a Company-selected variable interest rate that is based on 1 month, 3 month or 6 month reset option terms and their corresponding term LIBOR rates plus 27.5 basis points.

TALF Program

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

The Company elected to carry the securities and related borrowings at fair value under the fair value option afforded by accounting guidance regarding the fair value option for financial assets and financial liabilities. As of September 30, 2010, the Company had \$410.9 million of securities under TALF which are reflected as TALF investments, at market value and \$331.8 million of secured financing from the FRBNY which is reflected as TALF borrowings, at market value. As of December 31, 2009, the Company had \$250.3 million of securities under TALF which are reflected as TALF investments, at market value and \$217.6 million of secured financing from the FRBNY which is reflected as TALF borrowings, at market value. The original maturity dates for the TALF borrowings vary between 1.5 to 4.5 years with floating or fixed coupons depending on the related TALF investments.

Interest Paid

During the nine months ended September 30, 2010, the Company made interest payments of \$17.1 million related to its debt and financing arrangements, compared to \$12.0 million for the nine months ended September 30, 2009. The growth was primarily attributable to payments on the Company's TALF borrowings.

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ARCH CAPITAL GROUP LTD. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)

5. Segment Information

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

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

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

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

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

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The following tables set forth an analysis of the Company's underwriting income by segment, together with a reconciliation of underwriting income to net income available to common shareholders, summary information regarding net premiums written and earned by major line of business and net premiums written by location:

	Three Months Ended September 30, 2010		
	Insurance	Reinsurance	Total
Gross premiums written (1)	\$ 624,490	\$ 208,770	\$ 831,788
Net premiums written (1)	431,361	204,756	636,117
Net premiums earned (1)	\$ 411,881	\$ 215,528	\$ 627,409
Fee income	864	10	874
Losses and loss adjustment expenses	(265,411)	(93,782)	(359,193)
Acquisition expenses, net	(67,309)	(43,970)	(111,279)
Other operating expenses	(77,078)	(20,247)	(97,325)
Underwriting income	\$ 2,947	\$ 57,539	60,486
Net investment income			90,768
Net realized gains			68,828
Net impairment losses recognized in earnings			(2,075)
Equity in net income of investment funds accounted for using the equity method			9,708
Other income			1,840
Other expenses			(5,796)
Interest expense			(7,371)
Net foreign exchange losses			(65,157)
Income before income taxes			151,231
Income tax expense			(3,200)
Net income			148,031
Preferred dividends			(6,461)
Net income available to common shareholders			\$ 141,570
Underwriting Ratios			
Loss ratio	64.4%	43.5%	57.3%
Acquisition expense ratio (2)	16.1%	20.4%	17.6%
Other operating expense ratio	18.7%	9.4%	15.5%
Combined ratio	99.2%	73.3%	90.4%

(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 nil and \$1.5 million, respectively, of gross and net premiums written and \$0.3 million and \$2.7 million, respectively, of net premiums earned assumed through intersegment transactions.

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

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ARCH CAPITAL GROUP LTD. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)

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

(1) Certain amounts included in the gross premiums written of each segment are related to intersegment transactions. Accordingly, the sum of gross premiums written for each segment does not agree to the total gross premiums written as shown in the table above due to the elimination of intersegment transactions in the total. The insurance segment and reinsurance segment results include nil and \$2.8 million, respectively, of gross and net premiums written and \$0.4 million and \$3.0 million, respectively, of net premiums earned assumed through intersegment transactions.

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

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ARCH CAPITAL GROUP LTD. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)

	Nine Months Ended September 30, 2010		Total
	Insurance	Reinsurance	
Gross premiums written (1)	\$ 1,874,419	\$ 735,942	\$ 2,602,575
Net premiums written (1)	1,307,122	721,007	2,028,129
Net premiums earned (1)	\$ 1,246,831	\$ 673,506	\$ 1,920,337
Fee income	2,491	60	2,551
Losses and loss adjustment expenses	(852,716)	(297,673)	(1,150,389)
Acquisition expenses, net	(200,099)	(136,279)	(336,378)
Other operating expenses	(229,525)	(59,948)	(289,473)
Underwriting income (loss)	\$ (33,018)	\$ 179,666	146,648
Net investment income			274,277
Net realized gains			178,724
Net impairment losses recognized in earnings			(8,091)
Equity in net income of investment funds accounted for using the equity method			38,410
Other income			12,346
Other expenses			(21,987)
Interest expense			(22,547)
Net foreign exchange gains			22,069
Income before income taxes			619,849
Income tax expense			(11,373)
Net income			608,476
Preferred dividends			(19,383)
Net income available to common shareholders			\$ 589,093
Underwriting Ratios			
Loss ratio	68.4%	44.2%	59.9%
Acquisition expense ratio (2)	15.8%	20.2%	17.4%
Other operating expense ratio	18.4%	8.9%	15.1%
Combined ratio	102.6%	73.3%	92.4%

(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 nil and \$7.8 million, respectively, of gross and net premiums written and \$0.8 million and \$9.5 million, respectively, of net premiums earned assumed through intersegment transactions.

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

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ARCH CAPITAL GROUP LTD. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)

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

(1) Certain amounts included in the gross premiums written of each segment are related to intersegment transactions. Accordingly, the sum of gross premiums written for each segment does not agree to the total gross premiums written as shown in the table above due to the elimination of intersegment transactions in the total. The insurance segment and reinsurance segment results include \$0.1 million and \$9.4 million, respectively, of gross and net premiums written and \$1.3 million and \$11.3 million, respectively, of net premiums earned assumed through intersegment transactions.

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

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)

	2010		Three Months Ended September 30,		2009	
	Amount	% of Total	Amount	% of Total	Amount	% of Total
INSURANCE SEGMENT						
Net premiums written (1)						
Property, energy, marine and aviation	\$ 88,412	20.5	\$ 118,536	25.0		
Professional liability	72,787	16.9	66,002	13.9		
Programs	68,264	15.8	66,964	14.1		
Executive assurance	53,538	12.4	58,529	12.4		
Casualty	28,493	6.6	26,753	5.6		
Construction	24,296	5.6	36,823	7.8		
Travel and accident	19,673	4.6	15,998	3.4		
National accounts casualty	19,215	4.5	30,726	6.5		
Surety	11,128	2.6	12,025	2.5		
Healthcare	8,705	2.0	10,854	2.3		
Other (2)	36,850	8.5	30,466	6.5		
Total	\$ 431,361	100.0	\$ 473,676	100.0		
Net premiums earned (1)						
Property, energy, marine and aviation	\$ 82,301	20.0	\$ 94,471	21.3		
Professional liability	63,522	15.4	57,540	13.0		
Programs	68,404	16.6	69,436	15.7		
Executive assurance	52,369	12.7	56,094	12.7		
Casualty	27,503	6.7	30,004	6.8		
Construction	31,348	7.6	42,495	9.6		
Travel and accident	17,418	4.2	18,193	4.1		
National accounts casualty	18,595	4.5	19,969	4.5		
Surety	9,876	2.4	12,239	2.8		
Healthcare	9,738	2.4	12,303	2.8		
Other (2)	30,807	7.5	30,575	6.7		
Total	\$ 411,881	100.0	\$ 443,319	100.0		
Net premiums written by client location (1)						
United States	\$ 298,188	69.1	\$ 342,112	72.2		
Europe	64,320	14.9	68,109	14.4		
Other	68,853	16.0	63,455	13.4		
Total	\$ 431,361	100.0	\$ 473,676	100.0		
Net premiums written by underwriting location (1)						
United States	\$ 285,126	66.1	\$ 336,552	71.1		
Europe	133,349	30.9	117,900	24.9		
Other	12,886	3.0	19,224	4.0		
Total	\$ 431,361	100.0	\$ 473,676	100.0		

(1) Insurance segment results include premiums written and earned assumed through intersegment transactions of nil and \$0.3 million, respectively, for the 2010 third quarter and premiums written and earned of nil and \$0.4 million, respectively, for the 2009 third quarter. Insurance segment results exclude premiums written and earned ceded through intersegment transactions of \$1.5 million and \$2.7 million,

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respectively, for the 2010 third quarter and premiums written and earned of \$2.8 million and \$3.0 million, respectively, for the 2009 third quarter.

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

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	2010		Three Months Ended September 30,		2009	
	Amount	% of Total	Amount	% of Total	Amount	% of Total
REINSURANCE SEGMENT						
Net premiums written (1)						
Property excluding property catastrophe (2)	\$ 70,149	34.3	\$ 90,845	35.8	\$ 90,845	35.8
Property catastrophe	40,255	19.7	50,539	19.9	50,539	19.9
Casualty (3)	38,276	18.7	85,084	33.5	85,084	33.5
Other specialty	30,468	14.9	10,595	4.2	10,595	4.2
Marine and aviation	24,913	12.2	16,187	6.4	16,187	6.4
Other	695	0.2	382	0.2	382	0.2
Total	\$ 204,756	100.0	\$ 253,632	100.0	\$ 253,632	100.0
Net premiums earned (1)						
Property excluding property catastrophe (2)	\$ 66,438	30.8	\$ 94,837	32.6	\$ 94,837	32.6
Property catastrophe	54,206	25.2	61,772	21.2	61,772	21.2
Casualty (3)	52,792	24.5	88,721	30.5	88,721	30.5
Other specialty	25,254	11.7	23,251	8.0	23,251	8.0
Marine and aviation	16,106	7.5	21,666	7.4	21,666	7.4
Other	732	0.3	819	0.3	819	0.3
Total	\$ 215,528	100.0	\$ 291,066	100.0	\$ 291,066	100.0
Net premiums written (1)						
Pro rata	\$ 105,844	51.7	\$ 147,132	58.0	\$ 147,132	58.0
Excess of loss	98,912	48.3	106,500	42.0	106,500	42.0
Total	\$ 204,756	100.0	\$ 253,632	100.0	\$ 253,632	100.0
Net premiums earned (1)						
Pro rata	\$ 103,698	48.1	\$ 170,571	58.6	\$ 170,571	58.6
Excess of loss	111,830	51.9	120,495	41.4	120,495	41.4
Total	\$ 215,528	100.0	\$ 291,066	100.0	\$ 291,066	100.0
Net premiums written by client location (1)						
United States	\$ 126,882	62.0	\$ 174,932	69.0	\$ 174,932	69.0
Europe	25,050	12.2	30,291	11.9	30,291	11.9
Bermuda	16,330	8.0	30,209	11.9	30,209	11.9
Other	36,494	17.8	18,200	7.2	18,200	7.2
Total	\$ 204,756	100.0	\$ 253,632	100.0	\$ 253,632	100.0
Net premiums written by underwriting location (1)						
Bermuda	\$ 116,433	56.9	\$ 140,448	55.4	\$ 140,448	55.4
United States	76,183	37.2	106,305	41.9	106,305	41.9
Other	12,140	5.9	6,879	2.7	6,879	2.7
Total	\$ 204,756	100.0	\$ 253,632	100.0	\$ 253,632	100.0

(1) Reinsurance segment results include premiums written and earned assumed through intersegment transactions of \$1.5 million and \$2.7 million, respectively, for the 2010 third quarter and premiums written and earned of \$2.8 million and \$3.0 million, respectively, for the 2009

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third quarter. Reinsurance segment results exclude premiums written and earned ceded through intersegment transactions of nil and \$0.3 million, respectively, for the 2010 third quarter and premiums written and earned of nil and \$0.4 million, respectively, for the 2009 third quarter.

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

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ARCH CAPITAL GROUP LTD. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)

	2010		Nine Months Ended September 30,		2009	
	Amount	% of Total	Amount	% of Total	Amount	% of Total
INSURANCE SEGMENT						
Net premiums written (1)						
Property, energy, marine and aviation Programs	\$ 277,271	21.2	\$ 310,950	23.3		
Professional liability	212,107	16.2	214,050	16.0		
Executive assurance	195,602	15.0	175,783	13.2		
Construction	167,785	12.8	161,527	12.1		
Casualty	111,053	8.5	129,584	9.7		
Travel and accident	80,573	6.2	80,509	6.0		
National accounts casualty	56,751	4.3	53,089	4.0		
Healthcare	53,901	4.1	62,535	4.7		
Surety	27,218	2.1	31,740	2.4		
Other (2)	26,231	2.0	32,637	2.4		
Total	\$ 98,630	7.6	\$ 82,176	6.2		
Total	\$ 1,307,122	100.0	\$ 1,334,580	100.0		
Net premiums earned (1)						
Property, energy, marine and aviation Programs	\$ 258,156	20.7	\$ 246,881	19.6		
Professional liability	202,944	16.3	207,914	16.5		
Executive assurance	183,670	14.7	172,323	13.7		
Construction	163,834	13.1	156,198	12.4		
Casualty	99,369	8.0	126,279	10.0		
Travel and accident	83,720	6.7	93,948	7.4		
National accounts casualty	51,086	4.1	49,547	3.9		
Healthcare	57,178	4.6	47,487	3.8		
Surety	30,021	2.4	34,061	2.7		
Other (2)	28,157	2.3	37,771	3.0		
Total	\$ 88,696	7.1	\$ 89,461	7.0		
Total	\$ 1,246,831	100.0	\$ 1,261,870	100.0		
Net premiums written by client location (1)						
United States	\$ 923,012	70.6	\$ 998,531	74.8		
Europe	227,783	17.4	208,631	15.6		
Other	156,327	12.0	127,418	9.6		
Total	\$ 1,307,122	100.0	\$ 1,334,580	100.0		
Net premiums written by underwriting location (1)						
United States	\$ 884,974	67.7	\$ 972,847	72.9		
Europe	357,751	27.4	301,518	22.6		
Other	64,397	4.9	60,215	4.5		
Total	\$ 1,307,122	100.0	\$ 1,334,580	100.0		

(1) Insurance segment results include premiums written and earned assumed through intersegment transactions of nil and \$0.8 million, respectively, for the 2010 period and premiums written and earned of \$0.1 million and \$1.3 million, respectively, for the 2009 period. Insurance segment results exclude premiums written and earned ceded through intersegment transactions of \$7.8 million and \$9.5 million, respectively, for

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the 2010 period and premiums written and earned of \$9.4 million and \$11.3 million, respectively, for the 2009 period.

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

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ARCH CAPITAL GROUP LTD. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)

	2010		Nine Months Ended September 30,		2009	
	Amount	% of Total	Amount	% of Total	Amount	% of Total
REINSURANCE SEGMENT						
Net premiums written (1)						
Property excluding property catastrophe (2)	\$ 202,956	28.1	\$ 300,502	33.0		
Property catastrophe	199,460	27.7	234,423	25.8		
Casualty (3)	154,500	21.4	257,006	28.3		
Other specialty	104,150	14.4	54,611	6.0		
Marine and aviation	55,760	7.7	60,101	6.6		
Other	4,181	0.7	2,802	0.3		
Total	\$ 721,007	100.0	\$ 909,445	100.0		
Net premiums earned (1)						
Property excluding property catastrophe (2)	\$ 211,419	31.4	\$ 278,372	31.9		
Property catastrophe	160,380	23.8	179,136	20.5		
Casualty (3)	182,729	27.1	258,745	29.7		
Other specialty	65,315	9.7	82,613	9.5		
Marine and aviation	50,441	7.5	71,559	8.2		
Other	3,222	0.5	1,912	0.2		
Total	\$ 673,506	100.0	\$ 872,337	100.0		
Net premiums written (1)						
Pro rata	\$ 308,838	42.8	\$ 469,293	51.6		
Excess of loss	412,169	57.2	440,152	48.4		
Total	\$ 721,007	100.0	\$ 909,445	100.0		
Net premiums earned (1)						
Pro rata	\$ 336,943	50.0	\$ 540,754	62.0		
Excess of loss	336,563	50.0	331,583	38.0		
Total	\$ 673,506	100.0	\$ 872,337	100.0		
Net premiums written by client location (1)						
United States	\$ 433,257	60.1	\$ 598,090	65.8		
Europe	165,570	23.0	171,574	18.9		
Bermuda	62,027	8.6	100,441	11.0		
Other	60,153	8.3	39,340	4.3		
Total	\$ 721,007	100.0	\$ 909,445	100.0		
Net premiums written by underwriting location (1)						
Bermuda	\$ 397,935	55.2	\$ 520,940	57.3		
United States	250,204	34.7	331,650	36.5		
Other	72,868	10.1	56,855	6.2		
Total	\$ 721,007	100.0	\$ 909,445	100.0		

(1) Reinsurance segment results include premiums written and earned assumed through intersegment transactions of \$7.8 million and \$9.5 million, respectively, for the 2010 period and premiums written and earned of \$9.4 million and \$11.3 million, respectively, for the 2009 period.

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Reinsurance segment results exclude premiums written and earned ceded through intersegment transactions of nil and \$0.8 million, respectively, for the 2010 period and premiums written and earned of \$0.1 million and \$1.3 million, respectively, for the 2009 period.

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

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ARCH CAPITAL GROUP LTD. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)

6. Reinsurance

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

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

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2010	2009	2010	2009
Premiums Written				
Direct	\$ 601,918	\$ 650,072	\$ 1,819,627	\$ 1,894,121
Assumed	229,870	287,256	782,948	980,098
Ceded	(195,671)	(210,020)	(574,446)	(630,194)
Net	\$ 636,117	\$ 727,308	\$ 2,028,129	\$ 2,244,025
Premiums Earned				
Direct	\$ 591,060	\$ 632,673	\$ 1,769,707	\$ 1,828,103
Assumed	233,385	320,913	730,510	961,604
Ceded	(197,036)	(219,201)	(579,880)	(655,500)
Net	\$ 627,409	\$ 734,385	\$ 1,920,337	\$ 2,134,207
Losses and Loss Adjustment Expenses				
Direct	\$ 332,233	\$ 368,515	\$ 1,125,291	\$ 1,119,934
Assumed	112,399	141,349	311,625	415,076
Ceded	(85,439)	(64,950)	(286,527)	(290,696)
Net	\$ 359,193	\$ 444,914	\$ 1,150,389	\$ 1,244,314

The Company monitors the financial condition of its reinsurers and attempts to place coverages only with substantial, financially sound carriers. At September 30, 2010, approximately 91.7% of the Company's reinsurance recoverables on paid and unpaid losses (not including prepaid reinsurance premiums) of \$1.72 billion were due from carriers which had an A.M. Best rating of A- or better and the largest reinsurance recoverables from any one carrier was approximately 5.1% of the Company's total shareholders' equity. At December 31, 2009, approximately 90.0% of the Company's reinsurance recoverables on paid and unpaid losses (not including prepaid reinsurance premiums) of \$1.72 billion were due from carriers which had an A.M. Best rating of A- or better and the largest reinsurance recoverables from any one carrier was approximately

5.8% of the Company's total shareholders' equity.

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ARCH CAPITAL GROUP LTD. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)

7. Investment Information

The following table summarizes the Company's invested assets:

	September 30, 2010	December 31, 2009
Fixed maturities available for sale, at market value	\$ 9,810,102	\$ 9,391,926
Fixed maturities pledged under securities lending agreements, at market value (1)	184,226	208,826
Total fixed maturities	9,994,328	9,600,752
Short-term investments available for sale, at market value	780,671	571,489
Short-term investments pledged under securities lending agreements, at market value (1)	18,995	3,994
TALF investments, at market value	410,881	250,265
Other investments	418,411	172,172
Investment funds accounted for using the equity method	432,418	391,869
Total investments (1)	12,055,704	10,990,541
Securities transactions entered into but not settled at the balance sheet date	(319,954)	50,790
Total investments, net of securities transactions	\$ 11,735,750	\$ 11,041,331

(1) In securities lending transactions, the Company receives collateral in excess of the market value of the fixed maturities and short-term investments pledged under securities lending agreements. For purposes of this table, the Company has excluded the collateral received and reinvested of \$200.0 million and \$207.0 million at September 30, 2010 and December 31, 2009, respectively, and included the \$203.2 million and \$212.8 million, respectively, of fixed maturities and short-term investments pledged under securities lending agreements, at market value.

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ARCH CAPITAL GROUP LTD. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)

Fixed Maturities and Fixed Maturities Pledged Under Securities Lending Agreements

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

	Estimated Market Value	Gross Unrealized Gains	Gross Unrealized Losses	Amortized Cost	OTTI Unrealized Losses (1)
September 30, 2010:					
Corporate bonds	\$ 2,920,213	\$ 150,824	\$ (6,593)	\$ 2,775,982	\$ (18,510)
Mortgage backed securities	1,840,250	34,192	(18,698)	1,824,756	(28,122)
U.S. government and government agencies	1,578,958	70,592	(89)	1,508,455	(207)
Municipal bonds	1,164,523	63,776	(628)	1,101,375	(125)
Commercial mortgage backed securities	1,162,076	44,958	(7,575)	1,124,693	(3,738)
Non-U.S. government securities	779,959	56,879	(4,430)	727,510	(72)
Asset backed securities	548,349	25,323	(4,632)	527,658	(4,046)
Total	\$ 9,994,328	\$ 446,544	\$ (42,645)	\$ 9,590,429	\$ (54,820)
December 31, 2009:					
Corporate bonds	\$ 3,134,088	\$ 99,446	\$ (12,983)	\$ 3,047,625	\$ (19,667)
Mortgage backed securities	1,449,382	13,158	(45,536)	1,481,760	(43,930)
U.S. government and government agencies	1,553,672	8,716	(12,999)	1,557,955	(499)
Municipal bonds	957,752	44,043	(2,284)	915,993	(145)
Commercial mortgage backed securities	1,185,799	35,161	(11,724)	1,162,362	(3,750)
Non-U.S. government securities	752,215	41,858	(7,712)	718,069	(351)
Asset backed securities	567,844	21,713	(8,220)	554,351	(6,111)
Total	\$ 9,600,752	\$ 264,095	\$ (101,458)	\$ 9,438,115	\$ (74,453)

(1) Represents the total other-than-temporary impairments (OTTI) recognized in accumulated other comprehensive income (AOCI). It does not include the change in market value subsequent to the impairment measurement date. At September 30, 2010, the net unrealized loss related to securities for which a non-credit OTTI was recognized in AOCI was \$10.4 million, compared to \$37.9 million at December 31, 2009.

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

	Less than 12 Months		12 Months or More		Total	
	Estimated Market Value	Gross Unrealized Losses	Estimated Market Value	Gross Unrealized Losses	Estimated Market Value	Gross Unrealized Losses
September 30, 2010:						
Corporate bonds	\$ 71,836	\$ (2,547)	\$ 40,962	\$ (4,046)	\$ 112,798	\$ (6,593)
Mortgage backed securities	266,265	(11,692)	57,090	(7,006)	323,355	(18,698)
U.S. government and government agencies	103,189	(89)			103,189	(89)
Commercial mortgage backed securities	85,086	(1,252)	58,007	(6,323)	143,093	(7,575)
Municipal bonds	76,937	(628)			76,937	(628)
Non-U.S. government securities	137,673	(1,837)	23,279	(2,593)	160,952	(4,430)
Asset backed securities	62,901	(1,835)	6,818	(2,797)	69,719	(4,632)
	803,887	(19,880)	186,156	(22,765)	990,043	(42,645)
Other investments	34,003	(1,096)	2,992	(375)	36,995	(1,471)
Short-term investments	45,275	(1,161)			45,275	(1,161)
Total						