

ARCH CAPITAL GROUP LTD.

Form 10-Q

August 08, 2012

[Table of Contents](#)

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 June 30, 2012

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, 5th Floor, 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, \$0.0033 per share) outstanding as of August 1, 2012 was 136,314,789.

Table of Contents

ARCH CAPITAL GROUP LTD.

INDEX

| | Page No. |
|-----------------------------------------------------------------------------------------------------------------------------------------------|-----------------|
| <i>PART I. Financial Information</i> | |
| <i>Item 1 Consolidated Financial Statements</i> | |
| <u>Report of Independent Registered Public Accounting Firm</u> | 2 |
| <u>Consolidated Balance Sheets</u> <u>June 30, 2012 (unaudited) and December 31, 2011</u> | 3 |
| <u>Consolidated Statements of Income</u> <u>For the three and six month periods ended June 30, 2012 and 2011 (unaudited)</u> | 4 |
| <u>Consolidated Statements of Comprehensive Income</u> <u>For the six months ended ended June 30, 2012 and 2011 (unaudited)</u> | 5 |
| <u>Consolidated Statements of Changes in Shareholders' Equity</u> <u>For the six months ended ended June 30, 2012 and 2011 (unaudited)</u> | 6 |
| <u>Consolidated Statements of Cash Flows</u> <u>For the six months ended ended June 30, 2012 and 2011 (unaudited)</u> | 7 |
| <u>Notes to Consolidated Financial Statements (unaudited)</u> | 8 |
| <i>Item 2 Management's Discussion and Analysis of Financial Condition and Results of Operations</i> | 30 |
| <i>Item 3 Quantitative and Qualitative Disclosures About Market Risk</i> | 69 |
| <i>Item 4 Controls and Procedures</i> | 69 |
| <i>PART II. Other Information</i> | |
| <i>Item 1 Legal Proceedings</i> | 70 |
| <i>Item 2 Unregistered Sales of Equity Securities and Use of Proceeds</i> | 70 |
| <i>Item 5 Other Information</i> | 70 |
| <i>Item 6 Exhibits</i> | 71 |

Table of Contents

Report of Independent Registered Public Accounting Firm

To the Board of Directors and Shareholders of

Arch Capital Group Ltd.:

We have reviewed the accompanying consolidated balance sheet of Arch Capital Group Ltd. and its subsidiaries (the Company) as of June 30, 2012, and the related consolidated statements of income for the three-month and six-month periods ended June 30, 2012 and June 30, 2011, and the consolidated statements of comprehensive income, changes in shareholders' equity and cash flows for the six-month periods ended June 30, 2012 and June 30, 2011. 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, 2011, and the related consolidated statements of income, comprehensive income, changes in shareholders' equity, and cash flows for the year then ended (not presented herein), and in our report dated February 29, 2012, we expressed an unqualified opinion on those consolidated financial statements. As discussed in Note 3 to the accompanying consolidated financial statements, the Company changed its method of accounting for costs associated with acquiring or renewing insurance contracts. The accompanying December 31, 2011 consolidated balance sheet reflects this change.

/s/ PricewaterhouseCoopers LLP

New York, NY
August 8, 2012

Table of Contents**ARCH CAPITAL GROUP LTD. AND SUBSIDIARIES****CONSOLIDATED BALANCE SHEETS**

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

| | (Unaudited) June 30, 2012 | December 31, 2011 |
|--------------------------------------------------------------------------------------------------------------|---------------------------------|----------------------|
| Assets | | |
| Investments: | | |
| Fixed maturities available for sale, at fair value (amortized cost: \$9,325,208 and \$9,165,438) | \$ 9,556,326 | \$ 9,375,604 |
| Short-term investments available for sale, at fair value (amortized cost: \$1,085,961 and \$909,121) | 1,087,910 | 904,219 |
| Investment of funds received under securities lending, at fair value (amortized cost: \$66,327 and \$48,577) | 66,424 | 48,419 |
| Equity securities available for sale, at fair value (cost: \$258,983 and \$299,058) | 260,864 | 299,584 |
| Other investments available for sale, at fair value (cost: \$368,826 and \$235,381) | 381,576 | 238,111 |
| Investments accounted for using the fair value option | 496,843 | 366,903 |
| TALF investments, at fair value (amortized cost: \$292,841 and \$373,040) | 307,453 | 387,702 |
| Investments accounted for using the equity method | 331,601 | 380,507 |
| Total investments | 12,488,997 | 12,001,049 |
| Cash | 355,392 | 351,699 |
| Accrued investment income | 72,095 | 70,739 |
| Investment in joint venture (cost: \$100,000) | 109,240 | 107,576 |
| Fixed maturities and short-term investments pledged under securities lending, at fair value | 74,032 | 56,393 |
| Premiums receivable | 834,116 | 501,563 |
| Reinsurance recoverable on unpaid and paid losses and loss adjustment expenses | 1,849,191 | 1,851,584 |
| Contractholder receivables | 787,389 | 748,231 |
| Prepaid reinsurance premiums | 313,264 | 265,696 |
| Deferred acquisition costs, net | 272,736 | 227,884 |
| Receivable for securities sold | 821,527 | 462,891 |
| Other assets | 518,744 | 460,052 |
| Total Assets | \$ 18,496,723 | \$ 17,105,357 |
| Liabilities | | |
| Reserve for losses and loss adjustment expenses | \$ 8,546,350 | \$ 8,456,210 |
| Unearned premiums | 1,815,135 | 1,411,872 |
| Reinsurance balances payable | 184,763 | 133,866 |
| Contractholder payables | 787,389 | 748,231 |
| Senior notes | 300,000 | 300,000 |
| Revolving credit agreement borrowings | 100,000 | 100,000 |
| TALF borrowings, at fair value (par: \$237,095 and \$310,868) | 235,818 | 310,486 |
| Securities lending payable | 76,383 | 58,546 |
| Payable for securities purchased | 927,962 | 480,230 |
| Other liabilities | 502,607 | 513,842 |
| Total Liabilities | 13,476,407 | 12,513,283 |
| Commitments and Contingencies | | |
| Shareholders Equity | | |
| Non-cumulative preferred shares | 325,000 | 325,000 |

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| | | |
|-----------------------------------------------------------------------------|---------------|---------------|
| Common shares (\$0.0033 par, shares issued: 166,748,110 and 164,636,338) | 556 | 549 |
| Additional paid-in capital | 187,013 | 161,419 |
| Retained earnings | 5,167,069 | 4,796,655 |
| Accumulated other comprehensive income, net of deferred income tax | 193,097 | 153,923 |
| Common shares held in treasury, at cost (shares: 30,456,458 and 30,277,993) | (852,419) | (845,472) |
| Total Shareholders Equity | 5,020,316 | 4,592,074 |
| Total Liabilities and Shareholders Equity | \$ 18,496,723 | \$ 17,105,357 |

See Notes to Consolidated Financial Statements

Table of Contents

ARCH CAPITAL GROUP LTD. AND SUBSIDIARIES

CONSOLIDATED STATEMENTS OF INCOME

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

| | (Unaudited) Three Months Ended June 30, | | (Unaudited) Six Months Ended June 30, | |
|------------------------------------------------------------------------------------|-----------------------------------------------|-------------|---------------------------------------------|--------------|
| | 2012 | 2011 | 2012 | 2011 |
| Revenues | | | | |
| Net premiums written | \$ 820,233 | \$ 706,543 | \$ 1,683,844 | \$ 1,470,821 |
| Change in unearned premiums | (93,577) | (63,664) | (276,876) | (194,247) |
| Net premiums earned | 726,656 | 642,879 | 1,406,968 | 1,276,574 |
| Net investment income | 73,608 | 86,671 | 147,905 | 174,978 |
| Net realized gains | 34,867 | 45,210 | 78,988 | 65,905 |
| Other-than-temporary impairment losses | (2,454) | (1,969) | (3,485) | (5,227) |
| Less investment impairments recognized in other comprehensive income, before taxes | 503 | 285 | 511 | 863 |
| Net impairment losses recognized in earnings | (1,951) | (1,684) | (2,974) | (4,364) |
| Fee income | 806 | 784 | 1,349 | 1,599 |
| Equity in net income of investment funds accounted for using the equity method | 7,787 | 5,973 | 32,613 | 35,646 |
| Other income (loss) | 695 | (4,265) | (7,373) | 302 |
| Total revenues | 842,468 | 775,568 | 1,657,476 | 1,550,640 |
| Expenses | | | | |
| Losses and loss adjustment expenses | 399,693 | 431,622 | 794,900 | 925,502 |
| Acquisition expenses | 128,289 | 110,639 | 247,251 | 219,393 |
| Other operating expenses | 117,701 | 112,842 | 224,173 | 215,724 |
| Interest expense | 7,439 | 7,758 | 14,960 | 15,479 |
| Net foreign exchange (gains) losses | (31,689) | 18,375 | (11,001) | 55,287 |
| Total expenses | 621,433 | 681,236 | 1,270,283 | 1,431,385 |
| Income before income taxes | 221,035 | 94,332 | 387,193 | 119,255 |
| Income tax expense (benefit) | 767 | (2,271) | 2,669 | (2,821) |
| Net income | 220,268 | 96,603 | 384,524 | 122,076 |
| Preferred dividends | 7,649 | 6,461 | 14,110 | 12,922 |
| Net income available to common shareholders | \$ 212,619 | \$ 90,142 | \$ 370,414 | \$ 109,154 |
| Net income per common share | | | | |
| Basic | \$ 1.58 | \$ 0.69 | \$ 2.76 | \$ 0.82 |
| Diluted | \$ 1.54 | \$ 0.65 | \$ 2.68 | \$ 0.78 |
| Weighted average common shares and common share equivalents outstanding | | | | |
| Basic | 134,529,129 | 131,232,269 | 134,241,876 | 132,359,493 |
| Diluted | 138,211,736 | 137,975,599 | 138,017,490 | 139,234,931 |

See Notes to Consolidated Financial Statements

Table of Contents

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

(U.S. dollars in thousands)

| | (Unaudited) Six Months Ended June 30, | |
|------------------------------------------------------------------------------------------------------------------------|---------------------------------------------|------------|
| | 2012 | 2011 |
| Comprehensive Income | | |
| Net income | \$ 384,524 | \$ 122,076 |
| Other comprehensive income, net of deferred income tax | | |
| Unrealized appreciation in value of investments: | | |
| Unrealized holding gains arising during period | 112,923 | 125,232 |
| Portion of other-than-temporary impairment losses recognized in other comprehensive income, net of deferred income tax | (511) | (863) |
| Reclassification of net realized gains, net of income taxes, included in net income | (71,303) | (67,858) |
| Foreign currency translation adjustments, net of deferred income tax | (1,935) | 2,570 |
| Other comprehensive income | 39,174 | 59,081 |
| Comprehensive Income | \$ 423,698 | \$ 181,157 |

See Notes to Consolidated Financial Statements

Table of Contents

ARCH CAPITAL GROUP LTD. AND SUBSIDIARIES

CONSOLIDATED STATEMENTS OF CHANGES IN SHAREHOLDERS EQUITY

(U.S. dollars in thousands)

| | (Unaudited) Six Months Ended June 30, | |
|------------------------------------------------------------------------------------------------------------------------|---------------------------------------------|--------------|
| | 2012 | 2011 |
| Non-Cumulative Preferred Shares | | |
| Balance at beginning of period | \$ 325,000 | \$ 325,000 |
| Shares issued - Series C | 325,000 | |
| Shares repurchased - Series A and B | (325,000) | |
| Balance at end of period | 325,000 | 325,000 |
| Common Shares | | |
| Balance at beginning of year | 549 | 534 |
| Common shares issued, net | 7 | 7 |
| Balance at end of period | 556 | 541 |
| Additional Paid-in Capital | | |
| Balance at beginning of year | 161,419 | 110,325 |
| Common shares issued, net | 4,553 | 3,912 |
| Issue costs on Series C preferred shares | (9,397) | |
| Exercise of stock options | 4,822 | 6,372 |
| Amortization of share-based compensation | 23,930 | 19,505 |
| Other | 1,686 | 1,887 |
| Balance at end of period | 187,013 | 142,001 |
| Retained Earnings | | |
| Balance at beginning of year | 4,796,655 | 4,422,553 |
| Cumulative effect of adjustment resulting from adoption of new accounting guidance (1) | | (36,217) |
| Balance at beginning of year, as adjusted | 4,796,655 | 4,386,336 |
| Dividends declared on preferred shares | (14,110) | (12,922) |
| Net income | 384,524 | 122,076 |
| Balance at end of period | 5,167,069 | 4,495,490 |
| Accumulated Other Comprehensive Income | | |
| Balance at beginning of year | 153,923 | 204,503 |
| Change in unrealized appreciation in value of investments, net of deferred income tax | 41,620 | 57,374 |
| Portion of other-than-temporary impairment losses recognized in other comprehensive income, net of deferred income tax | (511) | (863) |
| Foreign currency translation adjustments, net of deferred income tax | (1,935) | 2,570 |
| Balance at end of period | 193,097 | 263,584 |
| Common Shares Held in Treasury, at Cost | | |
| Balance at beginning of year | (845,472) | (549,912) |
| Shares repurchased for treasury | (6,947) | (273,674) |
| Balance at end of period | (852,419) | (823,586) |
| Total Shareholders Equity | \$ 5,020,316 | \$ 4,403,030 |

(1) Adoption of accounting guidance regarding costs incurred that can be capitalized by insurance entities.

See Notes to Consolidated Financial Statements

Table of Contents

ARCH CAPITAL GROUP LTD. AND SUBSIDIARIES

CONSOLIDATED STATEMENTS OF CASH FLOWS

(U.S. dollars in thousands)

| Operating Activities | | | |
|----------------------------------------------------------------------------------------------------------------|----|-------------|-------------|
| Net income | \$ | 384,524 | \$ 122,076 |
| Adjustments to reconcile net income to net cash provided by operating activities: | | | |
| Net realized gains | | (80,753) | (71,367) |
| Net impairment losses recognized in earnings | | 2,974 | 4,364 |
| Equity in net income of investment funds accounted for using the equity method and other income | | (18,141) | 18,590 |
| Share-based compensation | | 23,930 | 19,505 |
| Changes in: | | | |
| Reserve for losses and loss adjustment expenses, net of unpaid losses and loss adjustment expenses recoverable | | 107,670 | 286,223 |
| Unearned premiums, net of prepaid reinsurance premiums | | 276,877 | 194,123 |
| Premiums receivable | | (273,735) | (196,244) |
| Deferred acquisition costs, net | | (45,390) | (27,520) |
| Reinsurance balances payable | | 37,129 | 15,987 |
| Other liabilities | | (2,526) | 6,753 |
| Other items, net | | (15,291) | 74,057 |
| Net Cash Provided By Operating Activities | | 397,268 | 446,547 |
| Investing Activities | | | |
| Purchases of: | | | |
| Fixed maturity investments | | (7,546,498) | (7,386,907) |
| Equity securities | | (110,303) | (248,947) |
| Other investments | | (386,243) | (207,365) |
| Proceeds from the sales of: | | | |
| Fixed maturity investments | | 6,887,186 | 6,555,997 |
| Equity securities | | 198,485 | 199,650 |
| Other investments | | 216,964 | 204,747 |
| Proceeds from redemptions and maturities of fixed maturity investments | | 598,792 | 537,410 |
| Net (purchases) sales of short-term investments | | (174,607) | 235,676 |
| Change in investment of securities lending collateral | | (17,837) | (77,051) |
| Purchase of business, net of cash acquired | | 28,948 | |
| Purchases of furniture, equipment and other assets | | (10,208) | (12,348) |
| Net Cash Used For Investing Activities | | (315,321) | (199,138) |
| Financing Activities | | | |
| Proceeds from issuance of Series C preferred shares, net | | 315,789 | |
| Repurchase of Series A and B preferred shares | | (325,000) | |
| Purchases of common shares under share repurchase program | | | (266,725) |
| Proceeds from common shares issued, net | | 348 | 1,478 |
| Repayments of borrowings | | (73,773) | (7,614) |
| Change in securities lending collateral | | 17,837 | 77,051 |
| Other | | 3,464 | 3,181 |
| Preferred dividends paid | | (17,412) | (12,922) |

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| | | |
|-----------------------------------------------------------|------------|------------|
| Net Cash Used For Financing Activities | (78,747) | (205,551) |
| Effects of exchange rate changes on foreign currency cash | 493 | 6,403 |
| Increase in cash | 3,693 | 48,261 |
| Cash beginning of year | 351,699 | 362,740 |
| Cash end of period | \$ 355,392 | \$ 411,001 |

See Notes to Consolidated Financial Statements

Table of Contents

ARCH CAPITAL GROUP LTD. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)

1. General

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

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

Certain information and footnote disclosures normally included in financial statements prepared in accordance with GAAP have been condensed or omitted; however, management believes that the disclosures are adequate to make the information presented not misleading. This report should be read in conjunction with the Company s Annual Report on Form 10-K for the year ended December 31, 2011, 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. Share Transactions

Share Repurchases

The board of directors of ACGL has authorized the investment 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 December 2012. Since the inception of the share repurchase program, ACGL has repurchased approximately 104.8 million common shares for an aggregate purchase price of \$2.56 billion. During the 2012 periods, ACGL did not repurchase any common shares, compared to 0.9 million common shares for an aggregate purchase price of \$29.6 million during the 2011 second quarter and 8.9 million common shares for an aggregate purchase price of \$266.7 during the six months ended June 30, 2011. At June 30, 2012, \$942.0 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.

Preferred Share Offering

On April 2, 2012, the Company completed the underwritten public offering of \$325 million of its 6.75% Series C non-cumulative preferred shares. Except in specified circumstances relating to certain tax or corporate events, the Series C non-cumulative preferred shares are not redeemable prior to April 2, 2017. The net proceeds from the offering of approximately \$316 million and other available funds were used to redeem all of the Company's \$200 million of 8.0% Series A preferred shares and \$125 million of 7.875% Series B preferred shares on May 2, 2012. The preferred shares were redeemed at a redemption price equal to \$25.00 per share, plus all declared and unpaid dividends to (but excluding) the redemption date.

Table of Contents

ARCH CAPITAL GROUP LTD. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)

Share-Based Compensation

During the 2012 second quarter, the Company made a stock grant of 782,248 stock appreciation rights and stock options and 728,864 restricted shares and units to certain employees and directors. The weighted average grant-date fair value of the stock appreciation rights and options and restricted shares and units granted during the 2012 second quarter were approximately \$9.91 and \$38.59 per share, respectively. During the 2011 second quarter, the Company made a stock grant of 697,632 stock appreciation rights and stock options and 727,641 restricted shares and units to certain employees and directors. The weighted average grant-date fair value of the stock appreciation rights and options and restricted shares and units granted during the 2011 second quarter were approximately \$9.75 and \$33.91 per share, respectively. The stock appreciation rights and stock options were valued at the grant date using the Black-Scholes option pricing model. Such values are being amortized over the respective substantive vesting period. 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 expense 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.

3. Recent Accounting Pronouncements

Effective January 1, 2012, the Company adopted an Accounting Standards Update (ASU) issued by the Financial Accounting Standards Board (FASB) concerning the accounting for costs associated with acquiring or renewing insurance contracts. This guidance was adopted retrospectively and has been applied to all prior period financial information contained in these consolidated financial statements. The impact of the adoption of the new guidance on the consolidated financial statements was as follows:

| | As Previously Reported | Effect of Change | As Currently Reported |
|-----------------------------------------|---------------------------|---------------------|--------------------------|
| December 31, 2010 | | | |
| Deferred acquisition costs, net | \$ 277,861 | \$ (50,583) | \$ 227,278 |
| Other assets (1) | 475,911 | 14,366 | 490,277 |
| Retained earnings | 4,422,553 | (36,217) | 4,386,336 |
| Three Months Ended June 30, 2011 | | | |
| Other operating expenses | \$ 110,563 | \$ 2,279 | \$ 112,842 |
| Income tax benefit | (1,731) | (540) | (2,271) |
| Net income | 98,342 | (1,739) | 96,603 |
| Net income per common share - basic | \$ 0.70 | \$ (0.01) | \$ 0.69 |
| Net income per common share - diluted | \$ 0.67 | \$ (0.02) | \$ 0.65 |
| Six Months Ended June 30, 2011 | | | |
| Other operating expenses | \$ 212,983 | \$ 2,741 | \$ 215,724 |
| Income tax benefit | (2,102) | (719) | (2,821) |

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| | | | | | | |
|---------------------------------------|----|---------|----|---------|----|---------|
| Net income | | 124,098 | | (2,022) | | 122,076 |
| Net income per common share - basic | \$ | 0.84 | \$ | (0.02) | \$ | 0.82 |
| Net income per common share - diluted | \$ | 0.80 | \$ | (0.02) | \$ | 0.78 |

(1) Effect of change equals tax benefit included in other assets on the Company's balance sheet.

Table of Contents

ARCH CAPITAL GROUP LTD. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)

Effective January 1, 2012, the Company prospectively adopted an ASU that provides clarification or changes to existing fair value measurement and disclosure requirements, including, for example, additional disclosure for fair value measurements categorized within Level 3 of the fair value hierarchy. See Note 8, Fair Value, for the Company's disclosures on fair value.

Effective January 1, 2012, the Company adopted an ASU that is intended to increase the prominence of other comprehensive income in the financial statements by allowing only two options for reporting comprehensive income: (1) A single statement that presents the components of net income and total net income, the components of other comprehensive income and total other comprehensive income, and a total for comprehensive income or (2) in a two-statement approach that presents the components of net income and total net income in the first statement. That statement must be immediately followed by a financial statement that presents the components of other comprehensive income, a total for other comprehensive income, and a total for comprehensive income. The adoption of this ASU did not impact the presentation of the Company's consolidated financial statements.

In December 2011, the FASB issued an ASU that expands the required disclosures about financial instruments and derivative instruments that are either offset for balance sheet presentation purposes or subject to an enforceable master netting arrangement or similar arrangement, regardless of whether they are offset for balance sheet presentation purposes. This ASU is effective for periods beginning on or after January 1, 2013. This new guidance is disclosure-related only and does not amend existing guidance on offsetting on the balance sheet. As such, the Company does not believe that the adoption of this ASU will impact the presentation of its consolidated financial statements.

4. Commitments and Contingencies

Letter of Credit and Revolving Credit Facilities

As of June 30, 2012, the Company had a \$300 million unsecured revolving loan and letter of credit facility and a \$500 million secured letter of credit facility (the Credit Agreement). The Credit Agreement expires on August 18, 2014. In addition, the Company had access to secured letter of credit facilities of approximately \$81 million as of June 30, 2012, 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). At June 30, 2012, the Company had \$445.4 million in outstanding letters of credit under the LOC Facilities, which were secured by investments with a fair value of \$514.4 million, and had \$100.0 million of borrowings outstanding under the Credit Agreement. The Company was in compliance with all covenants contained in the LOC Facilities at June 30, 2012.

Investment Commitments

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The Company's investment commitments, which are primarily related to agreements entered into by the Company to invest in funds and separately managed accounts when called upon, were approximately \$537.0 million at June 30, 2012.

Table of Contents

ARCH CAPITAL GROUP LTD. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)

5. Earnings Per Common Share

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

| | Three Months Ended June 30, | | Six Months Ended June 30, | |
|---------------------------------------------------------------------------------|--------------------------------|-------------|------------------------------|-------------|
| | 2012 | 2011 | 2012 | 2011 |
| Numerator: | | | | |
| Net income | \$ 220,268 | \$ 96,603 | \$ 384,524 | \$ 122,076 |
| Preferred dividends | (7,649) | (6,461) | (14,110) | (12,922) |
| Net income available to common shareholders | \$ 212,619 | \$ 90,142 | \$ 370,414 | \$ 109,154 |
| Denominator: | | | | |
| Weighted average common shares outstanding basic | 134,529,129 | 131,232,269 | 134,241,876 | 132,359,493 |
| Effect of dilutive common share equivalents: | | | | |
| Nonvested restricted shares | 800,455 | 931,305 | 909,524 | 1,040,514 |
| Stock options (1) | 2,882,152 | 5,812,025 | 2,866,090 | 5,834,924 |
| Weighted average common shares and common share equivalents outstanding diluted | 138,211,736 | 137,975,599 | 138,017,490 | 139,234,931 |
| Earnings per common share: | | | | |
| Basic | \$ 1.58 | \$ 0.69 | \$ 2.76 | \$ 0.82 |
| Diluted | \$ 1.54 | \$ 0.65 | \$ 2.68 | \$ 0.78 |

(1) Certain stock options were not included in the computation of diluted earnings per share where the exercise price of the stock options exceeded the average market price and would have been anti-dilutive or where, when applying the treasury stock method to in-the-money options, the sum of the proceeds, including unrecognized compensation, exceeded the average market price and would have been anti-dilutive. For the 2012 second quarter and 2011 second quarter, the number of stock options excluded were 912,056 and 430,758, respectively. For the six months ended June 30, 2012 and 2011, the number of stock options excluded were 688,634 and 223,063, respectively.

Table of Contents

ARCH CAPITAL GROUP LTD. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)

6. Segment Information

The following table summarizes the Company's underwriting income or loss by segment, together with a reconciliation of underwriting income or loss to net income available to common shareholders:

| | Three Months Ended June 30, 2012 | | | Three Months Ended June 30, 2011 | | |
|--------------------------------------------------------------------------------|-------------------------------------|-------------|--------------|-------------------------------------|-------------|------------|
| | Insurance | Reinsurance | Total | Insurance | Reinsurance | Total |
| Gross premiums written (1) | \$ 676,090 | \$ 376,981 | \$ 1,051,813 | \$ 635,005 | \$ 277,766 | \$ 911,939 |
| Net premiums written | 464,584 | 355,649 | 820,233 | 438,263 | 268,280 | 706,543 |
| Net premiums earned | \$ 446,594 | \$ 280,062 | \$ 726,656 | \$ 410,819 | \$ 232,060 | \$ 642,879 |
| Fee income | 628 | 178 | 806 | 702 | 82 | 784 |
| Losses and loss adjustment expenses | (290,416) | (109,277) | (399,693) | (301,642) | (129,980) | (431,622) |
| Acquisition expenses, net | (76,058) | (52,231) | (128,289) | (66,543) | (44,096) | (110,639) |
| Other operating expenses | (76,617) | (29,140) | (105,757) | (77,774) | (23,671) | (101,445) |
| Underwriting income (loss) | \$ 4,131 | \$ 89,592 | 93,723 | \$ (34,438) | \$ 34,395 | (43) |
| Net investment income | | | 73,608 | | | 86,671 |
| Net realized gains | | | 34,867 | | | 45,210 |
| Net impairment losses recognized in earnings | | | (1,951) | | | (1,684) |
| Equity in net income of investment funds accounted for using the equity method | | | 7,787 | | | 5,973 |
| Other income (loss) | | | 695 | | | (4,265) |
| Other expenses | | | (11,944) | | | (11,397) |
| Interest expense | | | (7,439) | | | (7,758) |
| Net foreign exchange gains (losses) | | | 31,689 | | | (18,375) |
| Income before income taxes | | | 221,035 | | | 94,332 |
| Income tax (expense) benefit | | | (767) | | | 2,271 |
| Net income | | | 220,268 | | | 96,603 |
| Preferred dividends | | | (7,649) | | | (6,461) |
| Net income available to common shareholders | | | \$ 212,619 | | | \$ 90,142 |
| Underwriting Ratios | | | | | | |
| Loss ratio | 65.0% | 39.0% | 55.0% | 73.4% | 56.0% | 67.1% |
| Acquisition expense ratio (2) | 16.9% | 18.6% | 17.6% | 16.0% | 19.0% | 17.1% |
| Other operating expense ratio | 17.2% | 10.4% | 14.6% | 18.9% | 10.2% | 15.8% |
| Combined ratio | 99.1% | 68.0% | 87.2% | 108.3% | 85.2% | 100.0% |

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

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

Table of Contents

ARCH CAPITAL GROUP LTD. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)

The following table summarizes the Company's underwriting income or loss by segment, together with a reconciliation of underwriting income or loss to net income available to common shareholders, for the six months ended June 30, 2012 and 2011:

| | Six Months Ended June 30, 2012 | | | Six Months Ended June 30, 2011 | | |
|--------------------------------------------------------------------------------|-----------------------------------|-------------|--------------|-----------------------------------|-------------|--------------|
| | Insurance | Reinsurance | Total | Insurance | Reinsurance | Total |
| Gross premiums written (1) | \$ 1,364,203 | \$ 756,957 | \$ 2,118,469 | \$ 1,269,588 | \$ 608,779 | \$ 1,876,505 |
| Net premiums written | 955,264 | 728,580 | 1,683,844 | 887,554 | 583,267 | 1,470,821 |
| Net premiums earned | \$ 888,334 | \$ 518,634 | \$ 1,406,968 | \$ 818,410 | \$ 458,164 | \$ 1,276,574 |
| Fee income | 1,158 | 191 | 1,349 | 1,480 | 119 | 1,599 |
| Losses and loss adjustment expenses | (593,580) | (201,320) | (794,900) | (599,365) | (326,137) | (925,502) |
| Acquisition expenses, net | (149,928) | (97,323) | (247,251) | (127,958) | (91,435) | (219,393) |
| Other operating expenses | (149,987) | (55,263) | (205,250) | (152,403) | (44,898) | (197,301) |
| Underwriting income (loss) | \$ (4,003) | \$ 164,919 | 160,916 | \$ (59,836) | \$ (4,187) | (64,023) |
| Net investment income | | | 147,905 | | | 174,978 |
| Net realized gains | | | 78,988 | | | 65,905 |
| Net impairment losses recognized in earnings | | | (2,974) | | | (4,364) |
| Equity in net income of investment funds accounted for using the equity method | | | 32,613 | | | 35,646 |
| Other income (loss) | | | (7,373) | | | 302 |
| Other expenses | | | (18,923) | | | (18,423) |
| Interest expense | | | (14,960) | | | (15,479) |
| Net foreign exchange gains (losses) | | | 11,001 | | | (55,287) |
| Income before income taxes | | | 387,193 | | | 119,255 |
| Income tax (expense) benefit | | | (2,669) | | | 2,821 |
| Net income | | | 384,524 | | | 122,076 |
| Preferred dividends | | | (14,110) | | | (12,922) |
| Net income available to common shareholders | | | \$ 370,414 | | | \$ 109,154 |
| Underwriting Ratios | | | | | | |
| Loss ratio | 66.8% | 38.8% | 56.5% | 73.2% | 71.2% | 72.5% |
| Acquisition expense ratio (2) | 16.7% | 18.8% | 17.5% | 15.5% | 20.0% | 17.1% |
| Other operating expense ratio | 16.9% | 10.7% | 14.6% | 18.6% | 9.8% | 15.5% |
| Combined ratio | 100.4% | 68.3% | 88.6% | 107.3% | 101.0% | 105.1% |

(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.

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

Table of Contents

ARCH CAPITAL GROUP LTD. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)

7. Investment Information

Available For Sale Investments

The following table summarizes the fair value and cost or amortized cost of the Company's investments classified as available for sale:

| | Estimated Fair Value | Gross Unrealized Gains | Gross Unrealized Losses | Cost or Amortized Cost | OTTI Unrealized Losses (2) |
|----------------------------------------------------------------------------------------------|----------------------------|------------------------------|-------------------------------|------------------------------|----------------------------------|
| <u>At June 30, 2012</u> | | | | | |
| Fixed maturities and fixed maturities pledged under securities lending agreements (1): | | | | | |
| Corporate bonds | \$ 2,519,832 | \$ 92,282 | \$ (11,533) | \$ 2,439,083 | \$ (716) |
| Mortgage backed securities | 1,670,108 | 23,743 | (18,286) | 1,664,651 | (14,772) |
| Municipal bonds | 1,542,262 | 67,946 | (1,541) | 1,475,857 | (65) |
| Commercial mortgage backed securities | 961,326 | 31,685 | (2,412) | 932,053 | (3,259) |
| U.S. government and government agencies | 1,380,074 | 29,797 | (1,872) | 1,352,149 | (207) |
| Non-U.S. government securities | 986,585 | 32,558 | (17,976) | 972,003 | (157) |
| Asset backed securities | 570,171 | 17,294 | (8,579) | 561,456 | (3,876) |
| Total | 9,630,358 | 295,305 | (62,199) | 9,397,252 | (23,052) |
| Equity securities | 260,864 | 24,129 | (22,248) | 258,983 | |
| Other investments | 381,576 | 15,512 | (2,762) | 368,826 | |
| Short-term investments | 1,087,910 | 3,279 | (1,330) | 1,085,961 | |
| Total | \$ 11,360,708 | \$ 338,225 | \$ (88,539) | \$ 11,111,022 | \$ (23,052) |
| <u>At December 31, 2011</u> | | | | | |
| Fixed maturities and fixed maturities pledged under securities lending agreements (1): | | | | | |
| Corporate bonds | \$ 2,596,118 | \$ 79,407 | \$ (29,922) | \$ 2,546,633 | \$ (1,138) |
| Mortgage backed securities | 1,592,762 | 27,633 | (23,226) | 1,588,355 | (20,466) |
| Municipal bonds | 1,430,565 | 77,977 | (886) | 1,353,474 | (105) |
| Commercial mortgage backed securities | 1,046,326 | 28,780 | (2,904) | 1,020,450 | (3,259) |
| U.S. government and government agencies | 1,451,993 | 34,811 | (3) | 1,417,185 | (207) |
| Non-U.S. government securities | 737,477 | 33,486 | (17,684) | 721,675 | |
| Asset backed securities | 576,757 | 14,649 | (10,078) | 572,186 | (3,876) |
| Total | 9,431,998 | 296,743 | (84,703) | 9,219,958 | (29,051) |
| Equity securities | 299,584 | 22,870 | (22,344) | 299,058 | |
| Other investments | 238,111 | 8,340 | (5,610) | 235,381 | |

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| | | | | | | | | | | |
|------------------------|----|------------|----|---------|----|-----------|----|------------|----|----------|
| Short-term investments | | 904,219 | | 390 | | (5,292) | | 909,121 | | |
| Total | \$ | 10,873,912 | \$ | 328,343 | \$ | (117,949) | \$ | 10,663,518 | \$ | (29,051) |

(1) In securities lending transactions, the Company receives collateral in excess of the fair value of the fixed maturities and short-term investments pledged. For purposes of this table, the Company has excluded the collateral received and reinvested and included the fixed maturities and short-term investments pledged. See Securities Lending Agreements.

(2) Represents the total other-than-temporary impairments (OTTI) recognized in accumulated other comprehensive income (AOCI). It does not include the change in fair value subsequent to the impairment measurement date. At June 30, 2012, the net unrealized loss related to securities for which a non-credit OTTI was recognized in AOCI was \$9.2 million, compared to a net unrealized loss of \$18.0 million at December 31, 2011.

Table of Contents

ARCH CAPITAL GROUP LTD. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)

The following table summarizes, for all available for sale securities in an unrealized loss position, the fair value and gross unrealized loss by length of time the security has been in a continual unrealized loss position:

| | 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 |
| <u>At June 30, 2012</u> | | | | | | |
| Fixed maturities and fixed maturities pledged under securities lending agreements (1): | | | | | | |
| Corporate bonds | \$ 289,690 | \$ (8,308) | \$ 36,087 | \$ (3,225) | \$ 325,777 | \$ (11,533) |
| Mortgage backed securities | 664,985 | (7,631) | 72,287 | (10,655) | 737,272 | (18,286) |
| Municipal bonds | 187,671 | (943) | 16,583 | (598) | 204,254 | (1,541) |
| Commercial mortgage backed securities | 74,376 | (728) | 20,739 | (1,684) | 95,115 | (2,412) |
| U.S. government and government agencies | 373,405 | (1,872) | | | 373,405 | (1,872) |
| Non-U.S. government securities | 338,862 | (16,492) | 10,046 | (1,484) | 348,908 | (17,976) |
| Asset backed securities | 102,740 | (5,676) | 24,569 | (2,903) | 127,309 | (8,579) |
| Total | 2,031,729 | (41,650) | 180,311 | (20,549) | 2,212,040 | (62,199) |
| Equity securities | 81,062 | (12,458) | 28,874 | (9,790) | 109,936 | (22,248) |
| Other investments | 27,754 | (1,014) | 23,252 | (1,748) | 51,006 | (2,762) |
| Short-term investments | 124,398 | (1,330) | | | 124,398 | (1,330) |
| Total | \$ 2,264,943 | \$ (56,452) | \$ 232,437 | \$ (32,087) | \$ 2,497,380 | \$ (88,539) |
| <u>At December 31, 2011</u> | | | | | | |
| Fixed maturities and fixed maturities pledged under securities lending agreements (1): | | | | | | |
| Corporate bonds | \$ 781,635 | \$ (24,977) | \$ 47,687 | \$ (4,945) | \$ 829,322 | \$ (29,922) |
| Mortgage backed securities | 255,101 | (11,988) | 44,606 | (11,238) | 299,707 | (23,226) |
| Municipal bonds | 39,156 | (537) | 14,988 | (349) | 54,144 | (886) |
| Commercial mortgage backed securities | 87,796 | (1,676) | 14,582 | (1,228) | 102,378 | (2,904) |
| U.S. government and government agencies | 7,059 | (3) | | | 7,059 | (3) |
| Non-U.S. government securities | 310,182 | (16,139) | 20,482 | (1,545) | 330,664 | (17,684) |
| Asset backed securities | 260,647 | (8,197) | 7,317 | (1,881) | 267,964 | (10,078) |
| Total | 1,741,576 | (63,517) | 149,662 | (21,186) | 1,891,238 | (84,703) |
| Equity securities | 130,045 | (22,039) | 1,923 | (305) | 131,968 | (22,344) |
| Other investments | 98,605 | (3,053) | 22,443 | (2,557) | 121,048 | (5,610) |
| Short-term investments | 189,100 | (5,292) | | | 189,100 | (5,292) |

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| | | | | | | | | | | | | |
|-------|----|-----------|----|----------|----|---------|----|----------|----|-----------|----|-----------|
| Total | \$ | 2,159,326 | \$ | (93,901) | \$ | 174,028 | \$ | (24,048) | \$ | 2,333,354 | \$ | (117,949) |
|-------|----|-----------|----|----------|----|---------|----|----------|----|-----------|----|-----------|

(1) In securities lending transactions, the Company receives collateral in excess of the fair value of the fixed maturities and short-term investments pledged. For purposes of this table, the Company has excluded the collateral received and reinvested and included the fixed maturities and short-term investments pledged. See Securities Lending Agreements.

Table of Contents**ARCH CAPITAL GROUP LTD. AND SUBSIDIARIES****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)**

At June 30, 2012, on a lot level basis, approximately 790 security lots out of a total of approximately 4,470 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 \$3.5 million. At December 31, 2011, on a lot level basis, approximately 1,150 security lots out of a total of approximately 4,520 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 \$3.0 million.

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

| Maturity | June 30, 2012 | | December 31, 2011 | |
|---------------------------------------|-------------------------|-------------------|-------------------------|-------------------|
| | Estimated Fair Value | Amortized Cost | Estimated Fair Value | Amortized Cost |
| Due in one year or less | \$ 491,380 | \$ 483,860 | \$ 486,986 | \$ 476,734 |
| Due after one year through five years | 3,434,433 | 3,356,501 | 2,850,578 | 2,793,982 |
| Due after five years through 10 years | 2,218,284 | 2,125,636 | 2,532,834 | 2,441,800 |
| Due after 10 years | 284,656 | 273,095 | 345,755 | 326,451 |
| | 6,428,753 | 6,239,092 | 6,216,153 | 6,038,967 |
| Mortgage backed securities | 1,670,108 | 1,664,651 | 1,592,762 | 1,588,355 |
| Commercial mortgage backed securities | 961,326 | 932,053 | 1,046,326 | 1,020,450 |
| Asset backed securities | 570,171 | 561,456 | 576,757 | 572,186 |
| Total | \$ 9,630,358 | \$ 9,397,252 | \$ 9,431,998 | \$ 9,219,958 |

Securities Lending Agreements

The Company operates a securities lending program under which certain of its fixed income portfolio securities are loaned to third parties, primarily major brokerage firms, for short periods of time through a lending agent. The Company maintains legal control over the securities it lends, retains the earnings and cash flows associated with the loaned securities and receives a fee from the borrower for the temporary use of the securities. At June 30, 2012, the fair value and amortized cost of fixed maturities and short-term investments pledged under securities lending agreements were \$74.0 million and \$72.0 million, respectively, compared to \$56.4 million and \$54.5 million at December 31, 2011, respectively. At June 30, 2012, the portfolio of collateral backing the Company's securities lending program included approximately \$6.0 million fair value of sub-prime securities, compared to \$7.3 million at December 31, 2011.

Table of Contents

ARCH CAPITAL GROUP LTD. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)

Fair Value Option

The Company elected to carry certain fixed maturity securities, equity securities and other investments (primarily term loans) at fair value under the fair value option afforded by accounting guidance regarding the fair value option for financial assets and liabilities. Changes in fair value of investments accounted for using the fair value option are included in net realized gains or losses while interest income, dividends received and distributions from fund investments which are not a return of capital are reflected in net investment income. The primary reasons for electing the fair value option were to reflect economic events in earnings on a timely basis and to address practicality and cost-benefit considerations.

The Company also elected to carry the securities and related borrowings under the Federal Reserve Bank of New York's (FRBNY) Term Asset-Backed Securities Loan Facility (TALF) at fair value under the fair value option. The primary reason for electing the fair value option on the TALF investments and TALF borrowings was to mitigate volatility in equity from using different measurement attributes (*i.e.*, TALF investments carried at fair value whereas the related TALF borrowings would be recorded on an accrual basis absent electing the fair value option). Changes in fair value for both the securities and borrowings are included in net realized gains or losses while interest income on the TALF investments is reflected in net investment income and interest expense on the TALF borrowings is reflected in interest expense.

The following table summarizes the Company's assets and liabilities which are accounted for using the fair value option:

| | June 30, 2012 | December 31, 2011 |
|-------------------------------------------------------|------------------|----------------------|
| Fixed maturities | \$ 242,735 | \$ 147,779 |
| Equity securities | 23,118 | 87,403 |
| Other investments (par: \$228,446 and \$138,062) | 230,990 | 131,721 |
| Investments accounted for using the fair value option | 496,843 | 366,903 |
| Securities sold but not yet purchased (1) | (9,206) | (27,178) |
| TALF investments | 307,453 | 387,702 |
| TALF borrowings | (235,818) | (310,486) |
| Net assets accounted for using the fair value option | \$ 559,272 | \$ 416,941 |

(1) Represents the Company's obligation to deliver equity securities that it did not own at the time of sale. Such amounts are included in other liabilities on the Company's consolidated balance sheets.

Table of Contents

ARCH CAPITAL GROUP LTD. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)

Net Investment Income

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

| | Three Months Ended June 30, | | Six Months Ended June 30, | |
|---------------------------|--------------------------------|-----------|------------------------------|------------|
| | 2012 | 2011 | 2012 | 2011 |
| Fixed maturities | \$ 70,290 | \$ 84,420 | \$ 143,739 | \$ 169,564 |
| Term loan investments (1) | 3,557 | 533 | 5,856 | 684 |
| Equity securities | 2,425 | 1,844 | 4,089 | 3,391 |
| Short-term investments | 760 | 505 | 1,132 | 1,183 |
| Other (2) | 2,980 | 5,774 | 6,174 | 12,677 |
| Gross investment income | 80,012 | 93,076 | 160,990 | 187,499 |
| Investment expenses | (6,404) | (6,405) | (13,085) | (12,521) |
| Net investment income | \$ 73,608 | \$ 86,671 | \$ 147,905 | \$ 174,978 |

(1) Included in investments accounted for using the fair value option on the Company's consolidated balance sheets.

(2) Amounts include dividends on investment funds and other items.

Net Realized Gains (Losses)

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

| | Three Months Ended June 30, | | Six Months Ended June 30, | |
|----------------------------------------------------------------------------------------------|--------------------------------|-----------|------------------------------|------------|
| | 2012 | 2011 | 2012 | 2011 |
| Available for sale securities: | | | | |
| Gross gains on investment sales | \$ 67,936 | \$ 71,578 | \$ 115,948 | \$ 143,295 |
| Gross losses on investment sales | (20,757) | (15,917) | (38,693) | (63,667) |
| Change in fair value of assets and liabilities accounted for using the fair value option: | | | | |
| Fixed maturities | (4,810) | (8,483) | 3,407 | (8,393) |
| Equity securities | (3,589) | (6,484) | (202) | (3,050) |

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| | | | | |
|----------------------------|-----------|-----------|-----------|-----------|
| Other investments | (1,744) | 196 | 2,009 | 323 |
| TALF investments | (1,274) | 2,795 | (50) | 4,447 |
| TALF borrowings | (176) | (138) | 895 | (285) |
| Derivative instruments (1) | 277 | 3,176 | (4,392) | (8,144) |
| Other | (996) | (1,513) | 66 | 1,379 |
| Net realized gains | \$ 34,867 | \$ 45,210 | \$ 78,988 | \$ 65,905 |

(1) See Note 9 for information on the Company's derivative instruments.

Table of Contents

ARCH CAPITAL GROUP LTD. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)

Other-Than-Temporary Impairments

The Company performs quarterly reviews of its available for sale investments in order to determine whether declines in fair value below the amortized cost basis were considered other-than-temporary in accordance with applicable guidance. The following table details the OTTI recognized in earnings by asset class:

| | Three Months Ended June 30, | | Six Months Ended June 30, | |
|---------------------------------------------------------------------|--------------------------------|----------|------------------------------|----------|
| | 2012 | 2011 | 2012 | 2011 |
| Fixed maturities: | | | | |
| Corporate bonds | \$ 1,166 | \$ | \$ 1,362 | \$ 359 |
| Mortgage backed securities | 146 | 1,310 | 892 | 2,428 |
| Non-U.S. government securities | 261 | | 261 | |
| Asset backed securities | 106 | | 106 | 10 |
| U.S. government and government agencies | 10 | | 10 | |
| Total | 1,689 | 1,310 | 2,631 | 2,797 |
| Investment of funds received under securities lending agreements | 6 | 374 | 87 | 1,230 |
| Equity securities | 256 | | 256 | 337 |
| Total OTTI recognized in earnings | \$ 1,951 | \$ 1,684 | \$ 2,974 | \$ 4,364 |

A description of the methodology and significant inputs used to measure the amount of OTTI in the 2012 second quarter is as follows:

- **Mortgage backed securities** – the Company utilized underlying data provided by asset managers, cash flow projections and additional information from credit agencies in order to determine an expected recovery value for each security. The analysis includes expected cash flow projections under base case and stress case scenarios which modify the expected default expectations and loss severities and slow down prepayment assumptions. The significant inputs in the models include the expected default rates, delinquency rates and foreclosure costs. The expected recovery values were reduced on a number of mortgage backed securities, primarily as a result of increases in expected default expectations and foreclosure costs. The amortized cost basis of the mortgage backed securities were adjusted down, if required, to the expected recovery value calculated in the OTTI review process;

- **Corporate bonds and other fixed maturities** – the Company reviewed the business prospects, credit ratings, estimated loss given default factors, foreign currency impacts and information received from asset managers and rating agencies for certain corporate bonds. The amortized cost basis of the corporate bonds was adjusted down, if required, to the expected recovery value calculated in the OTTI review process. In addition, the Company recorded OTTI on a portfolio of global corporate bonds, non-U.S. government securities and U.S. Treasuries due to its intent to liquidate such portfolio in the 2012 third quarter;

- Equity securities – the Company utilized information received from asset managers on common stocks, including the business prospects, recent events, industry and market data and other factors. For certain equities which were in an unrealized loss position and where the Company determined that it did not have the intent or ability to hold such securities for a reasonable period of time by which the fair value of the securities would increase and the Company would recover its cost, the cost basis of such securities was adjusted down accordingly;

Table of Contents**ARCH CAPITAL GROUP LTD. AND SUBSIDIARIES****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)**

- Investment of funds received under securities lending agreements – the Company utilized analysis from its securities lending program manager in order to determine an expected recovery value for certain collateral backing the Company’s securities lending program which was invested in sub-prime securities. The analysis provided expected cash flow projections for the securities using similar criteria as described in the mortgage backed securities section above. The amortized cost basis of the investment of funds received under securities lending agreements was adjusted down, if required, to the expected recovery value calculated in the OTTI review process.

The Company believes that the \$23.1 million of OTTI included in accumulated other comprehensive income at June 30, 2012 on the securities which were considered by the Company to be impaired was due to market and sector-related factors (*i.e.*, not credit losses). At June 30, 2012, the Company did not intend to sell these securities, or any other securities which were in an unrealized loss position, and determined that it is more likely than not that the Company will not be required to sell such securities before recovery of their cost basis.

The following table provides a roll forward of the amount related to credit losses recognized in earnings for which a portion of an OTTI was recognized in accumulated other comprehensive income:

| | Three Months Ended June 30, | | Six Months Ended June 30, | |
|-----------------------------------------------------------------------------------------------------------------------------|--------------------------------|-----------|------------------------------|-----------|
| | 2012 | 2011 | 2012 | 2011 |
| Balance at start of period | \$ 67,086 | \$ 84,858 | \$ 66,545 | \$ 86,040 |
| Credit loss impairments recognized on securities not previously impaired | 1,693 | 1,194 | 1,905 | 2,863 |
| Credit loss impairments recognized on securities previously impaired | 258 | 490 | 1,069 | 1,164 |
| Reductions for increases in cash flows expected to be collected that are recognized over the remaining life of the security | | | | |
| Reductions for securities sold during the period | (6,511) | (256) | (6,993) | (3,781) |
| Balance at end of period | \$ 62,526 | \$ 86,286 | \$ 62,526 | \$ 86,286 |

Restricted Assets

The Company is required to maintain assets on deposit, which primarily consist of fixed maturities, with various regulatory authorities to support its insurance and reinsurance operations. The Company’s insurance and reinsurance subsidiaries maintain assets in trust accounts as collateral for insurance and reinsurance transactions with affiliated companies and also have investments in segregated portfolios primarily to provide collateral or guarantees for letters of credit to third parties. See Note 4, Commitments and Contingencies – Letter of Credit and Revolving Credit Facilities, for further details. The following table details the value of the Company’s restricted assets:

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| | June 30, 2012 | December 31, 2011 |
|-----------------------------------------------|------------------|----------------------|
| Assets used for collateral or guarantees: | | |
| Affiliated transactions | \$ 4,426,250 | \$ 4,321,535 |
| Third party agreements | 684,455 | 757,669 |
| Deposits with U.S. regulatory authorities | 288,163 | 288,458 |
| Deposits with non-U.S. regulatory authorities | 223,134 | 169,733 |
| Trust funds | 81,530 | 60,558 |
| Total restricted assets | \$ 5,703,532 | \$ 5,597,953 |

Table of Contents

ARCH CAPITAL GROUP LTD. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)

8. Fair Value

Accounting guidance regarding fair value measurements addresses how companies should measure fair value when they are required to use a fair value measure for recognition or disclosure purposes under GAAP and provides a common definition of fair value to be used throughout GAAP. It defines fair value as the price that would be received to sell an asset or paid to transfer a liability in an orderly fashion between market participants at the measurement date. In addition, it establishes a three-level valuation hierarchy for the disclosure of fair value measurements. The valuation hierarchy is based upon the transparency of inputs to the valuation of an asset or liability as of the measurement date. The level in the hierarchy within which a given fair value measurement falls is determined based on the lowest level input that is significant to the measurement (Level 1 being the highest priority and Level 3 being the lowest priority).

The levels in the hierarchy are defined as follows:

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

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

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

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

The Company determines the existence of an active market based on its judgment as to whether transactions for the financial instrument occur in such market with sufficient frequency and volume to provide reliable pricing information. The independent pricing sources obtain market quotations and actual transaction prices for securities that have quoted prices in active markets. The Company uses quoted values and other data provided by nationally recognized independent pricing sources as inputs into its process for determining fair values of its fixed maturity investments. To validate the techniques or models used by pricing sources, the Company's review process includes, but is not limited to: (i) quantitative analysis (*e.g.*, comparing the quarterly return for each managed portfolio to its target benchmark, with significant differences identified and investigated); (ii) a review of the average number of prices obtained in the pricing process and the range of resulting fair values; (iii) initial and ongoing evaluation of methodologies used by outside parties to calculate fair value including a review of deep dive reports on selected securities which indicated the use of observable inputs in the pricing process; (iv) comparing the fair value estimates to its knowledge of

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the current market; (v) a comparison of the pricing services' fair values to other pricing services' fair values for the same investments; and (vi) back-testing, which includes randomly selecting purchased or sold securities and comparing the executed prices to the fair value estimates from the pricing service. At June 30, 2012, the Company obtained an average of 2.8 quotes per investment, compared to 2.8 quotes at December 31, 2011. Where multiple quotes or prices were obtained, a price source hierarchy was maintained in order to determine which price source provided the fair value (*i.e.*, a price obtained from a pricing service with more seniority in the hierarchy will be used over a less senior one in all cases). The hierarchy prioritizes pricing services based on availability and reliability and assigns the highest priority to index providers. Based on the above review, the Company will challenge any prices for a security or portfolio which are considered not to be representative of fair value. At June 30, 2012 and December 31, 2011, the Company adjusted certain prices (primarily on structured securities) obtained from the pricing services and substituted alternate prices (primarily broker-dealer quotes) for such securities. Such adjustments did not have a material impact on the overall fair value of the Company's investment portfolio.

Table of Contents

ARCH CAPITAL GROUP LTD. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)

The independent pricing sources obtain market quotations and actual transaction prices for securities that have quoted prices in active markets. Each source has its own proprietary method for determining the fair value of securities that are not actively traded. In general, these methods involve the use of matrix pricing in which the independent pricing source uses observable market inputs including, but not limited to, investment yields, credit risks and spreads, benchmarking of like securities, broker-dealer quotes, reported trades and sector groupings to determine a reasonable fair value. In addition, pricing vendors use model processes, such as an Option Adjusted Spread model, to develop prepayment and interest rate scenarios. The Option Adjusted Spread model is commonly used to estimate fair value for securities such as mortgage backed and asset backed securities. In certain circumstances, when fair values are unavailable from these independent pricing sources, quotes are obtained directly from broker-dealers who are active in the corresponding markets. Such quotes are subject to the validation procedures noted above. Of the \$12.41 billion of financial assets and liabilities measured at fair value at June 30, 2012, approximately \$1.39 billion, or 11.2%, were priced using non-binding broker-dealer quotes. Of the \$11.97 billion of financial assets and liabilities measured at fair value at December 31, 2011, approximately \$1.19 billion, or 9.9%, were priced using non-binding broker-dealer quotes.

The Company reviews its securities measured at fair value and discusses the proper classification of such investments with investment advisors and others. The Company determined that Level 1 securities would include highly liquid, recent issue U.S. Treasuries and certain of its short-term investments held in highly liquid money market-type funds where it believes that quoted prices are available in an active market. In addition, the Company determined that exchange-traded equity securities would be included in Level 1.

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

The Company determined that a Euro-denominated corporate bond which consists of an underlying portfolio of fixed income securities for which there is a low level of transparency around inputs to the valuation process should be classified within Level 3 of the valuation hierarchy along with certain other corporate bonds. In addition, the Company determined that certain other investments would be classified within Level 3 of the valuation hierarchy. The Company reviews the classification of its investments each quarter.

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 and reinvested and included the fixed maturities and short-term investments pledged under securities lending agreements, at fair value.

Table of Contents

ARCH CAPITAL GROUP LTD. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)

The following table presents the Company's financial assets and liabilities measured at fair value by level at June 30, 2012:

| | Estimated Fair Value | Quoted Prices in Active Markets for Identical Assets (Level 1) | Fair Value Measurement Using: Significant Other Observable Inputs (Level 2) | Significant Unobservable Inputs (Level 3) |
|----------------------------------------------------------------------------------------|----------------------------|----------------------------------------------------------------------------|--------------------------------------------------------------------------------------------|----------------------------------------------------|
| <u>Assets measured at fair value:</u> | | | | |
| Available for sale securities: | | | | |
| Fixed maturities and fixed maturities pledged under securities lending agreements (1): | | | | |
| Corporate bonds | \$ 2,519,832 | \$ | \$ 2,427,796 | \$ 92,036 |
| Mortgage backed securities | 1,670,108 | | 1,670,108 | |
| Municipal bonds | 1,542,262 | | 1,542,262 | |
| Commercial mortgage backed securities | 961,326 | | 961,326 | |
| U.S. government and government agencies | 1,380,074 | 1,380,074 | | |
| Non-U.S. government securities | 986,585 | | 986,585 | |
| Asset backed securities | 570,171 | | 570,171 | |
| Total | 9,630,358 | 1,380,074 | 8,158,248 | 92,036 |
| Equity securities | 260,864 | 259,648 | 1,216 | |
| Other investments | 381,576 | | 375,190 | 6,386 |
| Short-term investments | 1,087,910 | 925,234 | 162,676 | |
| Fair value option: | | | | |
| Investments accounted for using the fair value option: | | | | |
| Corporate bonds | 194,663 | | 194,663 | |
| Non-U.S. government bonds | 48,072 | | 48,072 | |
| Equity securities | 23,118 | 23,118 | | |
| Other investments | 230,990 | | 230,990 | |
| Total | 496,843 | 23,118 | 473,725 | |
| TALF investments | 307,453 | | 307,453 | |
| Total assets measured at fair value | \$ 12,165,004 | \$ 2,588,074 | \$ 9,478,508 | \$ 98,422 |
| <u>Liabilities measured at fair value:</u> | | | | |
| Fair value option: | | | | |
| TALF borrowings | \$ 235,818 | \$ | \$ 235,818 | \$ |
| Securities sold but not yet purchased (2) | 9,206 | 9,206 | | |
| Total liabilities measured at fair value | \$ 245,024 | \$ 9,206 | \$ 235,818 | \$ |

- (1) In securities lending transactions, the Company receives collateral in excess of the fair value of the fixed maturities and short-term investments pledged. For purposes of this table, the Company has excluded the collateral received and reinvested and included the fixed maturities and short-term investments pledged.
- (2) Represents the Company's obligation to deliver securities that it did not own at the time of sale. Such amounts are included in other liabilities on the Company's consolidated balance sheets.

Table of Contents

ARCH CAPITAL GROUP LTD. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)

The following table presents the Company's financial assets and liabilities measured at fair value by level at December 31, 2011:

| | Estimated Fair Value | Quoted Prices in Active Markets for Identical Assets (Level 1) | Fair Value Measurement Using: Significant Other Observable Inputs (Level 2) | Significant Unobservable Inputs (Level 3) |
|----------------------------------------------------------------------------------------------|----------------------------|----------------------------------------------------------------------------|--------------------------------------------------------------------------------------------|----------------------------------------------------|
| <u>Assets measured at fair value:</u> | | | | |
| Available for sale securities: | | | | |
| Fixed maturities and fixed maturities pledged under securities lending agreements (1): | | | | |
| Corporate bonds | \$ 2,596,118 | \$ | \$ 2,504,027 | \$ 92,091 |
| Mortgage backed securities | 1,592,762 | | 1,592,762 | |
| Municipal bonds | 1,430,565 | | 1,430,565 | |
| Commercial mortgage backed securities | 1,046,326 | | 1,046,326 | |
| U.S. government and government agencies | 1,451,993 | 1,451,993 | | |
| Non-U.S. government securities | 737,477 | | 737,477 | |
| Asset backed securities | 576,757 | | 576,757 | |
| Total | 9,431,998 | 1,451,993 | 7,887,914 | 92,091 |
| Equity securities | 299,584 | 299,528 | 56 | |
| Other investments | 238,111 | | 232,987 | 5,124 |
| Short-term investments | 904,219 | 837,371 | 66,848 | |
| Fair value option: | | | | |
| Investments accounted for using the fair value option: | | | | |
| Corporate bonds | 122,935 | | 122,935 | |
| Non-U.S. government bonds | 24,844 | | 24,844 | |
| Equity securities | 87,403 | 87,403 | | |
| Other investments | 131,721 | | 131,721 | |
| Total | 366,903 | 87,403 | 279,500 | |
| TALF investments | 387,702 | | 387,702 | |
| Total assets measured at fair value | \$ 11,628,517 | \$ 2,676,295 | \$ 8,855,007 | \$ 97,215 |
| <u>Liabilities measured at fair value:</u> | | | | |
| Fair value option: | | | | |
| TALF borrowings | \$ 310,486 | \$ | \$ 310,486 | \$ |
| Securities sold but not yet purchased (2) | 27,178 | 27,178 | | |
| Total liabilities measured at fair value | \$ 337,664 | \$ 27,178 | \$ 310,486 | \$ |

(1) In securities lending transactions, the Company receives collateral in excess of the fair value of the fixed maturities and short-term investments pledged. For purposes of this table, the Company has excluded the collateral received and reinvested and included the fixed

maturities and short-term investments pledged.

(2) Represents the Company's obligation to deliver securities that it did not own at the time of sale. Such amounts are included in other liabilities on the Company's consolidated balance sheets.

Table of Contents

ARCH CAPITAL GROUP LTD. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)

The following table presents a reconciliation of the beginning and ending balances for all investments measured at fair value on a recurring basis using Level 3 inputs for the 2012 second quarter and 2011 second quarter:

| | Fair Value Measurements Using: Significant Unobservable Inputs (Level 3) | | | Total |
|-----------------------------------------------|-----------------------------------------------------------------------------|----------------------|----|----------|
| | Corporate Bonds | Other Investments | | |
| Three Months Ended June 30, 2012 | | | | |
| Balance at beginning of period | \$ 96,655 | \$ 6,215 | \$ | 102,870 |
| Total gains or (losses) (realized/unrealized) | | | | |
| Included in earnings (1) | (548) | | | (548) |
| Included in other comprehensive income | (4,032) | 171 | | (3,861) |
| Purchases, issuances and settlements | | | | |
| Purchases | | | | |
| Issuances | | | | |
| Sales | | | | |
| Settlements | (39) | | | (39) |
| Transfers in and/or out of Level 3 | | | | |
| Balance at end of period | \$ 92,036 | \$ 6,386 | \$ | 98,422 |
| Three Months Ended June 30, 2011 | | | | |
| Balance at beginning of period | \$ 169,045 | \$ 8,201 | \$ | 177,246 |
| Total gains or (losses) (realized/unrealized) | | | | |
| Included in earnings (1) | 7,893 | 1,388 | | 9,281 |
| Included in other comprehensive income | (12,431) | (1,589) | | (14,020) |
| Purchases, issuances and settlements | | | | |
| Purchases | | | | |
| Issuances | | | | |
| Sales | | (71) | | (71) |
| Settlements | (51) | | | (51) |
| Transfers in and/or out of Level 3 | | | | |
| Balance at end of period | \$ 164,456 | \$ 7,929 | \$ | 172,385 |

(1) Gains or losses on corporate bonds and other investments were recorded in net realized gains (losses).

Table of Contents

ARCH CAPITAL GROUP LTD. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)

The following table presents a reconciliation of the beginning and ending balances for all investments measured at fair value on a recurring basis using Level 3 inputs for the six months ended June 30, 2012 and 2011:

| | Fair Value Measurements Using: Significant Unobservable Inputs (Level 3) | | | Total |
|-----------------------------------------------|-----------------------------------------------------------------------------|----------------------|----|---------|
| | Corporate Bonds | Other Investments | | |
| Six Months Ended June 30, 2012 | | | | |
| Balance at beginning of period | \$ 92,091 | \$ 5,124 | \$ | 97,215 |
| Total gains or (losses) (realized/unrealized) | | | | |
| Included in earnings (1) | 1,783 | 81 | | 1,864 |
| Included in other comprehensive income | (1,759) | 1,262 | | (497) |
| Purchases, issuances and settlements | | | | |
| Purchases | | | | |
| Issuances | | | | |
| Sales | | | | |
| Settlements | (79) | (81) | | (160) |
| Transfers in and/or out of Level 3 | | | | |
| Balance at end of period | \$ 92,036 | \$ 6,386 | \$ | 98,422 |
| Six Months Ended June 30, 2011 | | | | |
| Balance at beginning of period | \$ 153,509 | \$ 7,858 | \$ | 161,367 |
| Total gains or (losses) (realized/unrealized) | | | | |
| Included in earnings (1) | 13,664 | 1,709 | | 15,373 |
| Included in other comprehensive income | (2,333) | (972) | | (3,305) |
| Purchases, issuances and settlements | | | | |
| Purchases | | | | |
| Issuances | | | | |
| Sales | | (666) | | (666) |
| Settlements | (384) | | | (384) |
| Transfers in and/or out of Level 3 | | | | |
| Balance at end of period | \$ 164,456 | \$ 7,929 | \$ | 172,385 |

(1) Gains or losses on corporate bonds and other investments were recorded in net realized gains (losses).

The amount of total losses for the 2012 second quarter included in earnings attributable to the change in unrealized gains or losses relating to assets still held at June 30, 2012 was \$0.5 million, while the amount of total gains for the six months ended June 30, 2012 included in earnings attributable to the change in unrealized gains or losses relating to assets still held at June 30, 2012 was \$1.9 million. The amount of total gains for the 2011 second quarter included in earnings attributable to the change in unrealized gains or losses relating to assets still held at June 30, 2011 was \$9.3 million, while the amount of total gains for the six months ended June 30, 2011 included in earnings attributable to the change in unrealized gains or losses relating to assets still held at June 30, 2011 was \$15.1 million.

Financial Instruments Disclosed, But Not Carried, At Fair Value

The Company uses various financial instruments in the normal course of its business. The carrying values of cash, accrued investment income, receivable for securities sold, certain other assets, payable for securities purchased and certain other liabilities approximated their fair values at June 30, 2012, due to their respective

Table of Contents**ARCH CAPITAL GROUP LTD. AND SUBSIDIARIES****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)**

short maturities. As these financial instruments are not actively traded, their respective fair values are classified within Level 2.

At June 30, 2012, the Company's senior notes are carried at their cost of \$300.0 million and have a fair value of \$374.1 million. The fair values of these securities were obtained from a third party pricing service and are based on observable market inputs. As such, the fair values of the senior notes are classified within Level 2.

9. Derivative Instruments

The Company's investment strategy allows for the use of derivative securities. The Company's derivative instruments are recorded on its consolidated balance sheets at fair value. The fair values of those derivatives are based on quoted market prices. All realized and unrealized contract gains and losses are reflected in the Company's results of operations. The Company utilizes exchange traded U.S. Treasury note, Eurodollar and other futures contracts and commodity futures to manage portfolio duration or replicate investment positions in its portfolios. Certain of the Company's corporate bonds are managed in a global bond portfolio which incorporates the use of foreign currency forward contracts which are intended to provide an economic hedge against foreign currency movements on the portfolio's non-U.S. Dollar denominated holdings. The Company routinely utilizes other foreign currency forward contracts, currency options, index futures contracts and other derivatives as part of its total return objective.

In addition, the Company purchases to-be-announced mortgage backed securities (TBAs) as part of its investment strategy. TBAs represent commitments to purchase a future issuance of agency mortgage backed securities. For the period between purchase of a TBA and issuance of the underlying security, the Company's position is accounted for as a derivative. The Company purchases TBAs in both long and short positions to enhance investment performance and as part of its overall investment strategy. The Company did not hold any derivatives which were designated as hedging instruments at June 30, 2012 or December 31, 2011.

The following table summarizes information on the fair values and notional values of the Company's derivative instruments. The fair value of TBAs is included in fixed maturities while the fair value of all other derivatives is included in other investments in the consolidated balance sheets.

| | Asset Derivatives | | Liability Derivatives | |
|------------------------------------|-------------------------|-------------------|-------------------------|-------------------|
| | Estimated Fair Value | Notional Value | Estimated Fair Value | Notional Value |
| <u>At June 30, 2012</u> | | | | |
| Futures contracts | \$ 606 | \$ 100,200 | \$ (1,080) | \$ 385,900 |
| Foreign currency forward contracts | 7,346 | 274,793 | (3,000) | 181,832 |
| TBAs | 272,555 | 255,100 | (320,270) | 295,800 |

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| | | | | | | | | |
|-------|----|---------|--|--------|--|-----------|--|--------|
| Other | | 344 | | 10,235 | | (352) | | 30,381 |
| Total | \$ | 280,851 | | \$ | | (324,702) | | |

At December 31, 2011

| | | | | | | | | |
|------------------------------------|----|--------|----|---------|----|----------|----|---------|
| Futures contracts | \$ | 771 | \$ | 364,035 | \$ | (145) | \$ | 16,275 |
| Foreign currency forward contracts | | 11,937 | | 352,992 | | (6,558) | | 253,733 |
| TBAs | | 23,661 | | 23,000 | | (2,178) | | 2,000 |
| Other | | 4,005 | | 187,613 | | (2,048) | | 309,931 |
| Total | \$ | 40,374 | | \$ | | (10,929) | | |

Table of Contents**ARCH CAPITAL GROUP LTD. AND SUBSIDIARIES****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)**

The following table summarizes net realized gains (losses) recorded on the Company's derivative instruments in the consolidated statements of income:

| Derivatives not designated as hedging instruments | Three Months Ended June 30, | | Six Months Ended June 30, | | |
|------------------------------------------------------|--------------------------------|----------|------------------------------|------------|------|
| | 2012 | 2011 | 2012 | 2011 | 2011 |
| Futures contracts | \$ (2,322) | \$ 4,774 | \$ (4,343) | \$ 3,373 | |
| Foreign currency forward contracts | 938 | (2,467) | (943) | (16,393) | |
| TBA's | 1,419 | 6,896 | 1,742 | 8,502 | |
| Other | 242 | (6,027) | (848) | (3,626) | |
| Total | \$ 277 | \$ 3,176 | \$ (4,392) | \$ (8,144) | |

10. 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 31, 2035. This undertaking does not, however, prevent the imposition of taxes on any person ordinarily resident in Bermuda or any company in respect of its ownership of real property or leasehold interests in Bermuda.

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

The Company's income tax provision resulted in an effective tax rate on income before income taxes of 0.3% and 0.7% for the 2012 second quarter and six months ended June 30, 2012, compared to (2.4)% for the 2011 periods. The Company's effective tax rate, which is based upon the expected annual effective tax rate, may fluctuate from period to period based on the relative mix of income or loss reported by jurisdiction and

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the varying tax rates in each jurisdiction. The Company had a net deferred tax asset of \$99.2 million at June 30, 2012, compared to \$80.7 million at December 31, 2011. In addition, the Company paid \$4.3 million in income taxes, net of recoveries, for the six months ended June 30, 2012, compared to \$6.0 million for the 2011 period.

Table of Contents

ARCH CAPITAL GROUP LTD. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)

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 Company incurs federal excise taxes on certain of its reinsurance transactions, including amounts ceded through intercompany transactions. The Company incurred \$4.0 million of federal excise taxes for the six months ended June 30, 2012, compared to \$5.0 million in the 2011 period. Such amounts are reflected as acquisition expenses in the Company's consolidated statements of income.

11. Legal Proceedings

The Company, in common with the insurance industry in general, is subject to litigation and arbitration in the normal course of its business. As of June 30, 2012, the Company was not a party to any litigation or arbitration which is expected by management to have a material adverse effect on the Company's results of operations and financial condition and liquidity.

Table of Contents

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

The following is a discussion and analysis of our financial condition and results of operations. This should be read in conjunction with our consolidated financial statements included in Item 1 of this report and also our Management's Discussion and Analysis of Financial Condition and Results of Operations contained in our Annual Report on Form 10-K for the year ended December 31, 2011 (2011 Form 10-K). In addition, readers should review Risk Factors set forth in Item 1A of Part I of our 2011 Form 10-K. Tabular amounts are in U.S. Dollars in thousands, except share amounts, unless otherwise noted.

Arch Capital Group Ltd. (ACGL and, together with its subsidiaries, we or us) is a Bermuda public limited liability company with approximately \$5.42 billion in capital at June 30, 2012 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.

Current Outlook

The broad market environment continues to show improvement across the board. From a rate standpoint, almost all lines of business were in positive territory in the 2012 second quarter with rate increases slightly above loss cost trends. In our insurance business, rates were up approximately 4% on a weighted basis. We experienced favorable rate movement on primary lines such as general liability, umbrella liability, auto liability and workers' compensation. Two exceptions to the overall rate trends were in healthcare and surety which experienced moderate rate reductions during the 2012 second quarter. However, even with this improvement in the rate environment, we believe that longer-tail lines still require substantial additional rate improvement to become attractive. In our reinsurance business, rates continued to improve significantly, on a risk adjusted basis, in property and property catastrophe business, with the best increases to date reflected in international, catastrophe exposed businesses. Such improvements were driven, in part, by the impact of the higher level of catastrophic activity in 2010 and 2011. All other lines remained basically unchanged although our reinsurance operations benefited from the underlying rate increases in primary lines noted above. Our underwriting teams continue to execute a disciplined strategy by emphasizing small and medium-sized accounts over large accounts and focusing more on short-tail business.

Our objective is to achieve an average operating return on average equity of 15% or greater over the insurance cycle, which we believe to be an attractive return to our common shareholders given the risks we assume. We continue to look for opportunities to find acceptable books of business to underwrite without sacrificing underwriting discipline and continue to believe that the most attractive area from a pricing point of view remains catastrophe-exposed business. We expect that catastrophe-exposed business will continue to represent a significant proportion of our overall book, which could increase the volatility of our operating results.

The current economic conditions could continue to have a material impact on the frequency and severity of claims and, therefore, could negatively impact our underwriting returns. In addition, volatility in the financial markets could continue to significantly affect our investment returns, reported results and shareholders' equity. We consider the potential impact of economic trends in the estimation process for establishing unpaid losses and loss adjustment expenses and in determining our investment strategies.

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In addition, the impact of the continuing weakness of the U.S., European countries and other key economies, projected budget deficits for the U.S., European countries and other governments and the consequences associated with possible additional downgrades of securities of the U.S., European countries and other governments by credit rating agencies is inherently unpredictable and could have a material adverse effect

Table of Contents

on financial markets and economic conditions in the U.S. and throughout the world. In turn, this could have a material adverse effect on our business, financial condition and results of operations and, in particular, this could have a material adverse effect on the value of securities in our investment portfolio.

Natural Catastrophe Risk

We monitor our natural catastrophe risk globally for all perils and regions, in each case, where we believe there is significant exposure. Our models employ both proprietary and vendor-based systems and include cross-line correlations for property, marine, offshore energy, aviation, workers compensation and personal accident. Currently, we seek to limit our 1-in-250 year return period net probable maximum pre-tax loss from a severe catastrophic event in any geographic zone to approximately 25% of total shareholders' equity. We reserve the right to change this threshold at any time. Based on in-force exposure estimated as of July 1, 2012, our modeled peak zone catastrophe exposure is a windstorm affecting the Gulf of Mexico, with a net probable maximum pre-tax loss of \$878 million, followed by windstorms affecting the Northeastern U.S. and Florida Tri-County with net probable maximum pre-tax losses of \$846 million and \$645 million, respectively. Based on in-force exposure estimated as of April 1, 2012, our modeled peak zone exposure was a windstorm affecting the Gulf of Mexico, with a net probable maximum pre-tax loss of \$860 million, followed by windstorms affecting the Northeastern U.S. and Florida Tri-County with net probable maximum pre-tax losses of \$826 million and \$608 million, respectively. Our exposures to other perils, such as U.S. earthquake and international events, are less than the exposures arising from U.S. windstorms and hurricanes. As of July 1, 2012, our modeled peak zone earthquake exposure (New Madrid earthquake) represented less than 50% of our peak zone catastrophe exposure, and our modeled peak zone international exposure (Japan earthquake) is substantially less than both our peak zone windstorm and earthquake exposures. Net probable maximum pre-tax loss estimates are net of expected reinsurance recoveries, before income tax and before excess reinsurance reinstatement premiums. Loss estimates are reflective of the zone indicated and not the entire portfolio. Since hurricanes and windstorms can affect more than one zone and make multiple landfalls, our loss estimates include clash estimates from other zones.

The loss estimates shown above do not represent our maximum exposures and it is highly likely that our actual incurred losses would vary materially from the modeled estimates. There can be no assurances that we will not suffer a net loss 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. Actual losses may also increase if our reinsurers fail to meet their obligations to us or the reinsurance protections purchased by us are exhausted or are otherwise unavailable. See Risk Factors Risk Relating to Our Industry and Management's Discussion and Analysis of Financial Condition and Results of Operations Natural and Man-Made Catastrophic Events in our 2011 Form 10-K.

Financial Measures

Management uses the following three key financial indicators in evaluating our performance and measuring the overall growth in value generated for ACGL's common shareholders:

Book Value per Common Share

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Book value per common share represents total common shareholders' equity divided by the number of common shares outstanding. Management uses growth in book value per common share as a key measure of the value generated for our common shareholders each period and believes that book value per common share is the key driver of ACGL's share price over time. Book value per common share is impacted by, among other factors, our underwriting results, investment returns and share repurchase activity, which has an accretive or dilutive impact on book value per common share depending on the purchase price.

Table of Contents

Book value per common share was \$34.45 at June 30, 2012, compared to \$33.33 at March 31, 2012 and \$31.76 at December 31, 2011. The 3.4% change for the 2012 second quarter and 8.5% change for the six months ended June 30, 2012 was generated through operating results and total return on investments. We adopted new accounting guidance effective January 1, 2012 concerning the accounting for costs associated with acquiring or renewing insurance contracts. This guidance was adopted retrospectively and has been applied to all prior period financial information. The adoption of the new accounting guidance reduced the reported book value per common share by \$0.27 at December 31, 2011. See Note 3, Recent Accounting Pronouncements, of the notes accompanying our consolidated financial statements for additional information.

Operating Return on Average Common Equity

Operating return on average common equity (Operating ROAE) represents after-tax operating income available to common shareholders divided by the average of beginning and ending common shareholders equity during the period. After-tax operating income available to common shareholders, a non-GAAP measure as defined in the SEC rules, represents net income available to common shareholders, excluding net realized gains or losses, net impairment losses recognized in earnings, equity in net income or loss of investment funds accounted for using the equity method and net foreign exchange gains or losses, net of income taxes. Management uses Operating ROAE as a key measure of the return generated to common shareholders and has set an objective to achieve an average Operating ROAE of 15% or greater over the insurance cycle, which it believes to be an attractive return to common shareholders given the risks we assume. See Comment on Non-GAAP Financial Measures.

Our Operating ROAE was 12.3% for the 2012 second quarter, compared to 5.9% for the 2011 second quarter, and 11.4% for the six months ended June 30, 2012, compared to 3.3% for the 2011 period. The higher Operating ROAE for the 2012 periods primarily resulted from improved underwriting results which reflected a lower level of catastrophic events than in the 2011 periods.

Total Return on Investments

Total return on investments includes net investment income, equity in net income or loss of investment funds accounted for using the equity method, net realized gains and losses and the change in unrealized gains and losses generated by our investment portfolio. Total return is calculated on a pre-tax basis and includes the effect of financial market conditions along with foreign currency fluctuations. Management uses total return on investments as a key measure of the return generated to common shareholders on the capital held in the business, and compares the return generated by our investment portfolio against benchmark returns which we measured our portfolio against during the periods. The benchmark return is a weighted average of the benchmarks assigned to each of our investment managers and vary based on the nature of the portfolios under management.

The benchmark return index is a customized combination of indices intended to approximate a target portfolio by asset mix and average credit quality while also matching the approximate estimated duration and currency mix of our insurance and reinsurance liabilities. Although the estimated duration and average credit quality of this index will move as the duration and rating of its constituent securities change, generally we do not adjust the composition of the benchmark return index. The benchmark return index should not be interpreted as expressing a preference for or aversion to any particular sector or sector weight. The index is intended solely to provide, unlike many master indices that change based on the size of their constituent indices, a relatively stable basket of investable indices.

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Table of Contents

At June 30, 2012, the benchmark return index had an average credit quality of Aa1 by Moody's Investors Service (Moody's), an estimated duration of 3.18 years and included weightings to the following indices:

| | Weighting |
|-------------------------------------------------------------------------|-----------|
| Merrill Lynch Unsubordinated U.S. Treasuries/Agencies, 1-10 Years Index | 30.875% |
| Merrill Lynch U.S. Corporates and All Yankees, 1-10 Years Index | 20.875% |
| Merrill Lynch Mortgage Master Index | 11.875% |
| Barclays Capital CMBS, AAA Index | 10.000% |
| Merrill Lynch Municipals, 1-10 Years Index | 7.125% |
| MSCI World Free Index | 5.000% |
| Merrill Lynch U.S. Treasury Bills, 0-3 Months Index | 4.750% |
| Merrill Lynch U.S. High Yield Master II Constrained Index | 2.375% |
| Barclays Capital U.S. High-Yield Corporate Loan Index | 2.375% |
| Merrill Lynch U.K. Gilts, 1-10 Years Index | 2.375% |
| Merrill Lynch EMU Direct Government 1-10 Years Index | 2.375% |
| Total | 100.000% |

The following table summarizes the pre-tax total return (before investment expenses) of our investment portfolio compared to the benchmark return against which we measured our portfolio during the periods:

| | Arch Portfolio (1) | Benchmark Return |
|----------------------------------------------------|-----------------------|---------------------|
| Pre-tax total return (before investment expenses): | | |
| 2012 second quarter | 0.63% | 0.86% |
| 2011 second quarter | 1.65% | 1.93% |
| | | |
| Six months ended June 30, 2012 | 2.53% | 2.43% |
| Six months ended June 30, 2011 | 3.17% | 2.87% |

(1) Our investment expenses were approximately 0.21% and 0.23% of average invested assets for the 2012 second quarter and 2011 second quarter, respectively, and 0.22% and 0.23% for the six months ended June 30, 2012 and 2011.

For the 2012 second quarter, total return on our portfolio reflected unfavorable returns on equities, reflecting the decline in the S&P 500 index during the period along with underperformance of commodity-related securities. Our portfolio underperformed the benchmark return by 23 basis points for the 2012 second quarter, due in part to an overweighting in certain sector allocations to the benchmark return. Excluding foreign exchange, total return was 1.04% for the 2012 second quarter, compared to 1.54% for the 2011 second quarter, and 2.66% for the six months ended June 30, 2012, compared to 2.69% for the 2011 period.

Comment on Non-GAAP Financial Measures

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Throughout this filing, we present our operations in the way we believe will be the most meaningful and useful to investors, analysts, rating agencies and others who use our financial information in evaluating the performance of our company. This presentation includes the use of after-tax operating income available to common shareholders, which is defined as net income available to common shareholders, excluding net realized gains or losses, net impairment losses recognized in earnings, equity in net income or loss of investment funds accounted for using the equity method and net foreign exchange gains or losses, net of income taxes. The presentation of after-tax operating income available to common shareholders is a non-GAAP financial measure as defined in Regulation G. The reconciliation of such measure to net income available to common shareholders (the most directly comparable GAAP financial measure) in accordance with Regulation G is included under Results of Operations below.

We believe that net realized gains or losses, net impairment losses recognized in earnings, equity in net income or loss of investment funds accounted for using the equity method and net foreign exchange gains or losses in any particular period are not indicative of the performance of, or trends in, our business. Although net realized gains or losses, net impairment losses recognized in earnings, equity in net income or loss of investment

Table of Contents

funds accounted for using the equity method and net foreign exchange gains or losses are an integral part of our operations, the decision to realize investment gains or losses, the recognition of net impairment losses, the recognition of equity in net income or loss of investment funds accounted for using the equity method and the recognition of foreign exchange gains or losses are independent of the insurance underwriting process and result, in large part, from general economic and financial market conditions. Furthermore, certain users of our financial information believe that, for many companies, the timing of the realization of investment gains or losses is largely opportunistic. In addition, net impairment losses recognized in earnings on our investments represent other-than-temporary declines in expected recovery values on securities without actual realization. The use of the equity method on certain of our investments in certain funds that invest in fixed maturity securities is driven by the ownership structure of such funds (either limited partnerships or limited liability companies). In applying the equity method, these investments are initially recorded at cost and are subsequently adjusted based on our proportionate share of the net income or loss of the funds (which include changes in the market value of the underlying securities in the funds). This method of accounting is different from the way we account for our other fixed maturity securities and the timing of the recognition of equity in net income or loss of investment funds accounted for using the equity method may differ from gains or losses in the future upon sale or maturity of such investments. Due to these reasons, we exclude net realized gains or losses, net impairment losses recognized in earnings, equity in net income or loss of investment funds accounted for using the equity method and net foreign exchange gains or losses from the calculation of after-tax operating income available to common shareholders.

We believe that showing net income available to common shareholders exclusive of the items referred to above reflects the underlying fundamentals of our business since we evaluate the performance of and manage our business to produce an underwriting profit. In addition to presenting net income available to common shareholders, we believe that this presentation enables investors and other users of our financial information to analyze our performance in a manner similar to how management analyzes performance. We also believe that this measure follows industry practice and, therefore, allows the users of financial information to compare our performance with our industry peer group. We believe that the equity analysts and certain rating agencies which follow us and the insurance industry as a whole generally exclude these items from their analyses for the same reasons.

RESULTS OF OPERATIONS

The following table summarizes, on an after-tax basis, our consolidated financial data, including a reconciliation of after-tax operating income available to common shareholders to net income available to common shareholders:

| | Three Months Ended June 30, | | Six Months Ended June 30, | |
|--------------------------------------------------------------------------------------------|--------------------------------|-----------|------------------------------|------------|
| | 2012 | 2011 | 2012 | 2011 |
| After-tax operating income available to common shareholders | \$ 141,400 | \$ 59,739 | \$ 255,060 | \$ 67,315 |
| Net realized gains, net of tax | 33,275 | 44,799 | 74,148 | 66,384 |
| Net impairment losses recognized in earnings, net of tax | (1,951) | (1,684) | (2,974) | (4,364) |
| Equity in net income of investment funds accounted for using the equity method, net of tax | 7,787 | 5,973 | 32,613 | 35,646 |
| Net foreign exchange gains (losses), net of tax | 32,108 | (18,685) | 11,567 | (55,827) |
| Net income available to common shareholders | \$ 212,619 | \$ 90,142 | \$ 370,414 | \$ 109,154 |

Table of Contents

The increase in after-tax operating income in the 2012 periods compared to the 2011 periods primarily resulted from improved underwriting results which reflected a lower level of catastrophic loss activity. Our results included losses for current year catastrophic events of \$7.2 million, net of reinsurance and reinstatement premiums, in the 2012 second quarter, compared to \$95.0 million in the 2011 second quarter, and \$30.2 million for the six months ended June 30, 2012, compared to \$273.7 million for the 2011 period.

Segment Information

We classify our businesses into two underwriting segments — insurance and reinsurance — and corporate and other (non-underwriting). Management measures segment performance based on underwriting income or loss. We do not manage our 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.

Insurance Segment

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

| | Three Months Ended June 30, | | | Six Months Ended June 30, | | |
|-------------------------------------|-----------------------------|-------------|----------|---------------------------|--------------|----------|
| | 2012 | 2011 | % Change | 2012 | 2011 | % Change |
| Gross premiums written | \$ 676,090 | \$ 635,005 | 6.5 | \$ 1,364,203 | \$ 1,269,588 | 7.5 |
| Net premiums written | 464,584 | 438,263 | 6.0 | 955,264 | 887,554 | 7.6 |
| Net premiums earned | \$ 446,594 | \$ 410,819 | 8.7 | \$ 888,334 | \$ 818,410 | 8.5 |
| Fee income | 628 | 702 | | 1,158 | 1,480 | |
| Losses and loss adjustment expenses | (290,416) | (301,642) | | (593,580) | (599,365) | |
| Acquisition expenses, net | (76,058) | (66,543) | | (149,928) | (127,958) | |
| Other operating expenses | (76,617) | (77,774) | | (149,987) | (152,403) | |
| Underwriting income (loss) | \$ 4,131 | \$ (34,438) | n/m | \$ (4,003) | \$ (59,836) | n/m |

| Underwriting Ratios | % Point Change | | | % Point Change | | |
|-------------------------------|----------------|--------|----------|----------------|--------|----------|
| | 2012 | 2011 | % Change | 2012 | 2011 | % Change |
| Loss ratio | 65.0% | 73.4% | (8.4) | 66.8% | 73.2% | (6.4) |
| Acquisition expense ratio (1) | 16.9% | 16.0% | 0.9 | 16.7% | 15.5% | 1.2 |
| Other operating expense ratio | 17.2% | 18.9% | (1.7) | 16.9% | 18.6% | (1.7) |
| Combined ratio | 99.1% | 108.3% | (9.2) | 100.4% | 107.3% | (6.9) |

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

Table of Contents

The components of the insurance segment's underwriting results are discussed below.

Premiums Written.

The following table sets forth our insurance segment's net premiums written by major line of business:

| | Three Months Ended June 30, | | | | Six Months Ended June 30, | | | |
|---------------------------------------|-----------------------------|-----|------------|-----|---------------------------|-----|------------|-----|
| | 2012 | | 2011 | | 2012 | | 2011 | |
| | Amount | % | Amount | % | Amount | % | Amount | % |
| Programs | \$ 92,998 | 20 | \$ 81,629 | 19 | \$ 174,614 | 18 | \$ 156,025 | 18 |
| Property, energy, marine and aviation | 86,390 | 19 | 103,296 | 24 | 166,209 | 17 | 179,714 | 20 |
| Professional liability | 65,198 | 14 | 57,906 | 13 | 135,759 | 14 | 117,291 | 13 |
| Executive assurance | 60,205 | 13 | 53,974 | 12 | 128,583 | 13 | 110,042 | 12 |
| Construction | 49,784 | 11 | 42,408 | 10 | 83,437 | 9 | 73,917 | 8 |
| Casualty | 30,638 | 7 | 24,939 | 6 | 57,611 | 6 | 55,073 | 6 |
| Travel and accident | 20,294 | 4 | 19,284 | 4 | 43,130 | 5 | 40,785 | 5 |
| Lenders products | 20,477 | 4 | 21,526 | 5 | 42,892 | 4 | 42,600 | 5 |
| National accounts | 4,961 | 1 | 4,397 | 1 | 40,399 | 4 | 44,588 | 5 |
| Surety | 12,723 | 3 | 9,618 | 2 | 24,857 | 3 | 19,352 | 2 |
| Healthcare | 7,959 | 2 | 8,422 | 2 | 18,594 | 2 | 17,539 | 2 |
| Other (1) | 12,957 | 2 | 10,864 | 2 | 39,179 | 5 | 30,628 | 4 |
| Total | \$ 464,584 | 100 | \$ 438,263 | 100 | \$ 955,264 | 100 | \$ 887,554 | 100 |

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

2012 second quarter versus 2011. Increases in programs, professional liability and construction business were partially offset by a lower level of onshore energy business (included in the property, energy, marine and aviation line). The higher level of program business was primarily due to growth in exposures on existing accounts and rate improvements while the higher level of professional liability business primarily resulted from an increase in international small and medium sized accounts. The increase in construction business was primarily due to activity on an existing account which is not expected to recur, while the reduction in onshore energy premiums reflected lower renewals in reaction to market conditions and a strategic shift towards writing business on an excess basis.

Six months ended June 30, 2012 versus 2011. Increases in programs, executive assurance, professional liability and construction business were partially offset by a lower level of onshore energy business. The higher level of program business was primarily due to growth in exposures on existing accounts and rate improvements. The growth in executive assurance business primarily resulted from small and medium sized accounts in the U.K. and the U.S. while the increase in professional liability premiums primarily reflected new business written in international small and medium sized accounts. The increase in construction business was primarily due to activity on an existing account which is not expected to recur, while the reduction in onshore energy premiums reflected lower renewals in reaction to market conditions and a strategic shift towards writing business on an excess basis.

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Table of Contents

Net Premiums Earned.

The following table sets forth our insurance segment's net premiums earned by major line of business:

| | Three Months Ended June 30, | | | | Six Months Ended June 30, | | | |
|---------------------------------------|-----------------------------|-----|------------|-----|---------------------------|-----|------------|-----|
| | 2012 | | 2011 | | 2012 | | 2011 | |
| | Amount | % | Amount | % | Amount | % | Amount | % |
| Programs | \$ 80,589 | 18 | \$ 71,934 | 18 | \$ 154,587 | 17 | \$ 138,952 | 17 |
| Property, energy, marine and aviation | 77,590 | 17 | 76,644 | 19 | 156,084 | 18 | 150,243 | 18 |
| Professional liability | 68,017 | 15 | 57,767 | 14 | 131,273 | 15 | 125,167 | 15 |
| Executive assurance | 60,856 | 14 | 60,488 | 15 | 119,622 | 14 | 115,058 | 14 |
| Construction | 31,692 | 7 | 27,214 | 7 | 63,500 | 7 | 55,605 | 7 |
| Casualty | 28,102 | 6 | 24,829 | 6 | 57,167 | 6 | 53,256 | 7 |
| Travel and accident | 20,661 | 5 | 19,455 | 5 | 37,374 | 4 | 35,054 | 4 |
| Lenders products | 21,411 | 5 | 19,966 | 5 | 53,564 | 6 | 38,202 | 5 |
| National accounts | 18,415 | 4 | 18,166 | 4 | 37,551 | 4 | 39,328 | 5 |
| Surety | 10,798 | 2 | 9,402 | 2 | 21,358 | 2 | 19,181 | 2 |
| Healthcare | 9,077 | 2 | 9,089 | 2 | 17,975 | 2 | 17,741 | 2 |
| Other (1) | 19,386 | 5 | 15,865 | 3 | 38,279 | 5 | 30,623 | 4 |
| Total | \$ 446,594 | 100 | \$ 410,819 | 100 | \$ 888,334 | 100 | \$ 818,410 | 100 |

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

Net premiums written are primarily earned on a pro rata basis over the terms of the policies for all products, usually 12 months. Net premiums earned reflect changes in net premiums written over the previous five quarters.

Losses and Loss Adjustment Expenses.

The table below shows the components of the insurance segment's loss ratio:

| | Three Months Ended June 30, | | Six Months Ended June 30, | |
|----------------------------------|-----------------------------|--------|---------------------------|--------|
| | 2012 | 2011 | 2012 | 2011 |
| Current year | 68.9% | 75.2% | 68.8% | 76.0% |
| Prior period reserve development | (3.9)% | (1.8)% | (2.0)% | (2.8)% |
| Loss ratio | 65.0% | 73.4% | 66.8% | 73.2% |

Current Year Loss Ratio.

The insurance segment's current year loss ratio was 6.3 points lower in the 2012 second quarter compared to the 2011 second quarter, and 7.2 points lower for the six months ended June 30, 2012 compared to the 2011 period, primarily due to a lower level of catastrophic event activity. The 2012 second quarter loss ratio reflected a de minimis level of catastrophic activity, compared to 8.0 points in the 2011 second quarter, which was related to the severe weather that hit the U.S. during April and May 2011. The level of large non-catastrophic loss activity was similar in both periods.

Table of Contents

Prior Period Reserve Development.

2012 second quarter: The insurance segment's net favorable development of \$17.2 million, or 3.9 points, reflected favorable development in short-tail and medium-tail lines which were partially offset by increases in longer-tail lines. Favorable development in short-tail lines primarily consisted of reductions in property (including special risk other than marine) reserves from the 2010 and 2011 accident years (*i.e.*, the year in which a loss occurred) of \$4.1 million and \$9.8 million, respectively, which was primarily due to a lack of claims activity, and \$1.8 million of favorable development in lenders products reserves from the 2011 accident year. In addition, development in medium-tail lines included favorable development in professional liability reserves from the 2009 accident year of \$10.8 million, partially offset by adverse development in the 2007 accident year of \$6.1 million, along with \$4.4 million of favorable development on healthcare reserves spread across all accident years and \$2.6 million of favorable development on surety reserves, primarily from the 2007 accident year. Adverse development in longer-tail lines included increases in construction reserves of \$1.2 million, \$2.8 million and \$2.9 million in the 2003, 2007 and 2008 accident years and \$7.3 million on executive assurance reserves in the 2011 accident year, primarily due to an increase in loss picks in reaction to recent claims development, partially offset by \$2.5 million of favorable development from the 2010 accident year.

2011 second quarter: The insurance segment's net favorable development of \$7.5 million, or 1.8 points, reflected favorable development in short-tailed lines primarily consisting of reductions in property reserves from the 2008 to 2010 accident years of \$4.3 million, \$3.9 million and \$5.4 million, respectively, partially offset by adverse development of \$2.6 million from the 2006 accident year. The favorable development in property lines was primarily due to a lack of claims activity in the more recent years. In addition, favorable development in professional liability reserves from the 2006 accident year of \$7.5 million was due to better than expected claims emergence, partially offset by adverse development in the 2007 and 2008 accident years of \$1.3 million and \$4.5 million, respectively, mainly due to a few large claims. Such amounts were partially offset by adverse development in casualty reserves from the 2004 and 2010 accident years of \$5.2 million and \$3.1 million, respectively, which was partially offset by favorable development in the 2003 and 2005 accident years of \$2.0 million and \$2.7 million, respectively. In addition, adverse development in alternative markets business from the 2010 accident year of \$3.6 million mainly due to one account, was partially offset by \$2.1 million of favorable development from the 2005 to 2008 accident years due to better than expected claims emergence.

Six months ended June 30, 2012: The insurance segment's net favorable development of \$17.7 million, or 2.0 points, reflected favorable development in short-tail and medium-tail lines which were partially offset by increases in longer-tail lines. Favorable development in short-tail lines primarily consisting of reductions in property reserves from the 2007 to 2011 accident years of \$2.5 million, \$2.2 million, \$4.8 million, \$9.7 million and \$11.7 million, respectively, which was primarily due to a lack of claims activity, and \$3.9 million of favorable development in travel and accident reserves, primarily from the 2010 accident year. In addition, development in medium-tail lines included favorable development in professional liability reserves from the 2009 accident year of \$9.5 million, partially offset by adverse development in the 2011 accident year of \$5.9 million, along with \$7.4 million of favorable development on healthcare reserves spread across all accident years. On program business, favorable development of \$3.2 million consisted of \$6.0 million of favorable development from the 2010 accident year and \$4.5 million net development from earlier accident years, partially offset by \$7.4 million of adverse development from the 2011 accident year. Adverse development in longer-tail lines included an increase in executive assurance reserves in the 2011 accident year of \$9.4 million, primarily due to an increase in loss picks in reaction to recent claims development, and \$5.0 million from the 2009 accident year. In addition, adverse development in specialty casualty reserves from the 2004, 2005 and 2007 accident years of \$4.5 million, \$5.2 million and \$4.5 million, respectively, were partially offset by \$4.0 million of favorable development in the 2006 accident year. Adverse development in construction reserves from the 2007 to 2009 accident years of \$2.5 million, \$5.2 million and \$3.3 million, respectively, was partially offset by \$4.6 million of favorable development in the 2010 accident year.

Six months ended June 30, 2011: The insurance segment's net favorable development of \$22.8 million, or 2.8 points, reflected favorable development in short-tailed lines primarily consisting of reductions in property reserves

Table of Contents

from the 2008 to 2010 accident years of \$7.2 million, \$10.8 million and \$18.5 million, respectively, partially offset by adverse development of \$4.1 million from the 2006 accident year. The 2010 accident year amount included \$8.0 million of favorable development on the 2010 named catastrophic events. The favorable development in property lines was primarily due to a lack of claims emergence in the more recent years. In addition, there was favorable development of \$6.9 million in healthcare reserves, primarily from the 2005 to 2008 accident years. Such amounts were partially offset by adverse development in casualty reserves from the 2004 and 2010 accident years of \$5.3 million and \$9.4 million, respectively and in professional liability reserves from the 2008 to 2010 accident years of \$4.1 million, \$2.1 million and \$3.9 million, respectively, partially offset by favorable development of \$8.5 million from the 2006 accident year. In addition, adverse development in alternative markets business from the 2010 accident year of \$6.8 million was partially offset by \$6.3 million of favorable development from the 2004 to 2009 accident years.

Underwriting Expenses.

2012 second quarter versus 2011: The insurance segment's underwriting expense ratio was 34.1% in the 2012 second quarter, compared to 34.9% in the 2011 second quarter. The acquisition expense ratio was 16.9% in the 2012 second quarter, compared to 16.0% in the 2011 second quarter. The comparison of the 2012 second quarter and 2011 second quarter acquisition expense ratios is influenced by, among other things, the mix and type of business written and earned and the level of ceding commissions. The other operating expense ratio was 17.2% for the 2012 second quarter, compared to 18.9% for the 2011 second quarter, with the lower ratio in the 2012 second quarter reflecting the benefits of continued expense management and the higher level of net premiums earned.

Six months ended June 30, 2012 versus 2011: The insurance segment's underwriting expense ratio was 33.6% for the six months ended June 30, 2012, compared to 34.1% for the 2011 period. The acquisition expense ratio was 16.7% for the six months ended June 30, 2012, compared to 15.5% for the 2011 period. The 2012 second quarter acquisition expense ratio included an increase of 0.5 points related to development in certain prior year loss reserves. The other operating expense ratio was 16.9% for the six months ended June 30, 2012, compared to 18.6% for the 2011 period, with the lower ratio for the six months ended June 30, 2012 reflecting the benefits of continued expense management and the higher level of net premiums earned.

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Table of Contents

Reinsurance Segment

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

| | Three Months Ended June 30, | | | Six Months Ended June 30, | | |
|-------------------------------------|-----------------------------|------------|-----------------------|---------------------------|------------|-----------------------|
| | 2012 | 2011 | % Change | 2012 | 2011 | % Change |
| Gross premiums written | \$ 376,981 | \$ 277,766 | 35.7 | \$ 756,957 | \$ 608,779 | 24.3 |
| Net premiums written | 355,649 | 268,280 | 32.6 | 728,580 | 583,267 | 24.9 |
| Net premiums earned | \$ 280,062 | \$ 232,060 | 20.7 | \$ 518,634 | \$ 458,164 | 13.2 |
| Fee income | 178 | 82 | | 191 | 119 | |
| Losses and loss adjustment expenses | (109,277) | (129,980) | | (201,320) | (326,137) | |
| Acquisition expenses, net | (52,231) | (44,096) | | (97,323) | (91,435) | |
| Other operating expenses | (29,140) | (23,671) | | (55,263) | (44,898) | |
| Underwriting income (loss) | \$ 89,592 | \$ 34,395 | 160.5 | \$ 164,919 | \$ (4,187) | n/m |
| Underwriting Ratios | | | % Point Change | | | % Point Change |
| Loss ratio | 39.0% | 56.0% | (17.0) | 38.8% | 71.2% | (32.4) |
| Acquisition expense ratio | 18.6% | 19.0% | (0.4) | 18.8% | 20.0% | (1.2) |
| Other operating expense ratio | 10.4% | 10.2% | 0.2 | 10.7% | 9.8% | 0.9 |
| Combined ratio | 68.0% | 85.2% | (17.2) | 68.3% | 101.0% | (32.7) |

The components of the reinsurance segment's underwriting results are discussed below.

Premiums Written.

The following table sets forth our reinsurance segment's net premiums written by major line of business:

| | Three Months Ended June 30, | | | | Six Months Ended June 30, | | | |
|---------------------------------------------|-----------------------------|----|------------|----|---------------------------|----|------------|----|
| | 2012 | | 2011 | | 2012 | | 2011 | |
| | Amount | % | Amount | % | Amount | % | Amount | % |
| Property catastrophe | \$ 129,224 | 36 | \$ 108,235 | 40 | \$ 215,798 | 30 | \$ 175,196 | 30 |
| Other specialty (1) | 72,261 | 20 | 43,937 | 17 | 167,723 | 23 | 121,582 | 21 |
| Property excluding property catastrophe (2) | 65,734 | 19 | 53,938 | 20 | 141,227 | 19 | 125,088 | 21 |
| Casualty (3) | 43,702 | 12 | 40,755 | 15 | 127,662 | 18 | 112,116 | 19 |
| Marine and aviation | 18,842 | 5 | 19,978 | 7 | 44,459 | 6 | 44,142 | 8 |
| Other (4) | 25,886 | 8 | 1,437 | 1 | 31,711 | 4 | 5,143 | 1 |

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| | | | | | | | | | | | | |
|----------------|----|---------|-----|----|---------|-----|----|---------|-----|----|---------|-----|
| Total | \$ | 355,649 | 100 | \$ | 268,280 | 100 | \$ | 728,580 | 100 | \$ | 583,267 | 100 |
| Pro rata | \$ | 144,133 | 41 | \$ | 105,036 | 39 | \$ | 268,879 | 37 | \$ | 210,528 | 36 |
| Excess of loss | | 211,516 | 59 | | 163,244 | 61 | | 459,701 | 63 | | 372,739 | 64 |
| Total | \$ | 355,649 | 100 | \$ | 268,280 | 100 | \$ | 728,580 | 100 | \$ | 583,267 | 100 |

-
- (1) Includes U.K. motor, trade credit, surety, workers compensation catastrophe, accident and health and other.
 - (2) Includes facultative business.
 - (3) Includes professional liability, executive assurance and healthcare business.
 - (4) Includes mortgage, life, casualty clash and other.

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Table of Contents

2012 second quarter versus 2011. The growth in net premiums written reflected increases in other specialty, property catastrophe and mortgage business. The growth in other specialty primarily resulted from new business written in U.K. motor while the higher level of property catastrophe primarily resulted from new business and share increases in Florida, Japan and other international risks. The mortgage business primarily resulted from a reinsurance treaty written in the 2012 second quarter which covers newly originated residential mortgages beginning in October 2011. For the 2012 second quarter, such business contributed \$21.6 million of premiums written (included in the other line), of which \$13.5 million related to the period from October 2011 to March 2012.

Six months ended June 30, 2012 versus 2011. The growth in net premiums written reflected increases in all lines of business, primarily in other specialty, property catastrophe and mortgage business as discussed above. Substantial rate improvements in global property catastrophe markets allowed the reinsurance segment to participate in a more meaningful way around the world.

Net Premiums Earned.

The following table sets forth our reinsurance segment's net premiums earned by major line of business:

| | Three Months Ended June 30, | | | | Six Months Ended June 30, | | | |
|------------------------------------------------|-----------------------------|------------|-------------------|------------|---------------------------|------------|-------------------|------------|
| | 2012 | | 2011 | | 2012 | | 2011 | |
| | Amount | % | Amount | % | Amount | % | Amount | % |
| Property catastrophe | \$ 68,992 | 25 | \$ 59,788 | 26 | \$ 130,855 | 25 | \$ 111,430 | 24 |
| Other specialty (1) | 78,207 | 28 | 40,511 | 17 | 124,355 | 24 | 79,480 | 17 |
| Property excluding property catastrophe (2) | 58,720 | 21 | 57,524 | 25 | 120,352 | 23 | 120,530 | 26 |
| Casualty (3) | 48,565 | 17 | 51,493 | 22 | 94,508 | 18 | 99,987 | 22 |
| Marine and aviation | 19,200 | 7 | 21,093 | 9 | 40,649 | 8 | 42,719 | 9 |
| Other (4) | 6,378 | 2 | 1,651 | 1 | 7,915 | 2 | 4,018 | 2 |
| Total | \$ 280,062 | 100 | \$ 232,060 | 100 | \$ 518,634 | 100 | \$ 458,164 | 100 |
| Pro rata | \$ 124,941 | 45 | \$ 103,967 | 45 | \$ 224,866 | 43 | \$ 210,620 | 46 |
| Excess of loss | 155,121 | 55 | 128,093 | 55 | 293,768 | 57 | 247,544 | 54 |
| Total | \$ 280,062 | 100 | \$ 232,060 | 100 | \$ 518,634 | 100 | \$ 458,164 | 100 |

(1) Includes U.K. motor, trade credit, surety, workers' compensation catastrophe, accident and health and other.

(2) Includes facultative business.

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

(4) Includes mortgage, life, casualty clash and other.

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Net premiums written, irrespective of the class of business, are generally earned on a pro rata basis over the terms of the underlying policies or reinsurance contracts. Net premiums earned reflect changes in net premiums written over the previous five quarters, including the mix and type of business written. In April 2012, we completed the acquisition of the credit and surety reinsurance operations of Ariel Reinsurance Company Ltd. based in Zurich, Switzerland. In the transaction, which was accounted for as a business combination under U.S. GAAP, we acquired \$83.1 million of net unearned premiums along with other insurance balances. Under applicable accounting rules for business combinations, the recording of such unearned premiums was not reflected as net premiums written but will result in net premiums earned (primarily over a two year period). Net premiums earned for the 2012 second quarter included \$17.3 million related to the acquired net unearned premiums.

Table of Contents*Losses and Loss Adjustment Expenses.*

The table below shows the components of the reinsurance segment's loss ratio:

| | Three Months Ended June 30, | | Six Months Ended June 30, | |
|----------------------------------|--------------------------------|---------|------------------------------|---------|
| | 2012 | 2011 | 2012 | 2011 |
| Current year | 55.6% | 77.9% | 58.0% | 91.8% |
| Prior period reserve development | (16.6)% | (21.9)% | (19.2)% | (20.6)% |
| Loss ratio | 39.0% | 56.0% | 38.8% | 71.2% |

Current Year Loss Ratio.

The reinsurance segment's current year loss ratio was 22.3 points lower in the 2012 second quarter compared to the 2011 second quarter, and 33.8 points lower for the six months ended June 30, 2012 compared to the 2011 period, primarily due to the lower level of current year catastrophic event activity. The 2012 second quarter loss ratio reflected 2.8 points related to current year catastrophic activity, primarily related to U.S. storm activity, while the 2011 second quarter ratio included 26.8 points of catastrophic activity, which was primarily related to the severe weather that hit the U.S. in April and May 2011. The loss ratio for the six months ended June 30, 2012 reflected 4.9 points related to current year catastrophic activity, compared to 43.6 points of catastrophic activity for the 2011 period. In addition, the loss ratios for the 2012 periods included a higher level of non-catastrophic loss activity than in the 2011 periods.

Prior Period Reserve Development.

2012 second quarter: The reinsurance segment's net favorable development of \$46.6 million, or 16.6 points, reflected favorable development of \$25.7 million on property catastrophe and property other than property catastrophe reserves, including \$3.9 million and \$15.8 million from the 2010 and 2011 underwriting years (*i.e.*, all premiums and losses attributable to contracts having an inception or renewal date within the given twelve-month period), respectively. In addition, there was \$9.9 million of favorable development on casualty reserves, including \$3.0 million, \$3.3 million, \$2.2 million and \$1.7 million for the 2004 to 2007 underwriting years, respectively, partially offset by adverse development in the 2010 and 2011 underwriting years of \$1.9 million and \$1.5 million, respectively, which was due, in part, to increases in loss selections based on the reinsurance segment's view of the insurance environment. The 2012 second quarter loss ratio also benefited from \$7.5 million of favorable development on marine and aviation reserves across most underwriting years and \$3.2 million of favorable development on other specialty business with widespread favorable development partially offset by \$4.5 million adverse development from the 2011 underwriting year. Such amount primarily resulted from increases in loss selections based on the reinsurance segment's view of economic conditions in certain European countries.

2011 second quarter: The reinsurance segment's net favorable development of \$50.8 million, or 21.9 points, reflected \$28.2 million of favorable development in property catastrophe and property other than property catastrophe reserves, including \$16.7 million from the 2010 underwriting year and \$11.5 million from earlier underwriting years. In addition, there was \$14.7 million of favorable development on casualty reserves, including \$5.0 million, \$8.7 million and \$4.8 million for the 2003 to 2005 underwriting years, respectively, and \$6.1 million from the 2008 underwriting year, partially offset by adverse development in the 2009 underwriting year of \$10.9 million which was primarily due to

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development on two contracts. The 2011 second quarter loss ratio also benefited from \$3.2 million of favorable development on other specialty business and \$4.7 million of favorable development from other lines. The reductions in reserves were primarily due to better than expected claims emergence.

Six months ended June 30, 2012: The reinsurance segment's net favorable development of \$99.4 million, or 19.2 points, reflected favorable development of \$47.1 million on property catastrophe and property other than

Table of Contents

property catastrophe reserves, including \$10.9 million and \$24.0 million from the 2010 and 2011 underwriting years, respectively. In addition, there was \$30.6 million of favorable development on casualty reserves, including \$11.0 million, \$8.2 million, \$5.9 million, \$6.2 million, \$4.9 million and \$3.4 million for the 2004 to 2009 underwriting years, respectively, partially offset by adverse development in the 2010 and 2011 underwriting years of \$4.5 million and \$2.1 million, respectively, which was due, in part, to increases in loss selections based on the reinsurance segment's view of the insurance environment. The loss ratio for the six months ended June 30, 2012 also benefited from \$8.5 million of favorable development on marine and aviation reserves across most underwriting years and \$12.9 million of favorable development on other specialty business with \$2.6 million, \$3.4 million and \$4.2 million from the 2008 to 2010 underwriting years.

Six months ended June 30, 2011: The reinsurance segment's net favorable development of \$94.2 million, or 20.6 points, reflected \$45.7 million of favorable development in property catastrophe and property other than property catastrophe reserves, including \$31.8 million from the 2010 underwriting year. Such amount included \$13.4 million of favorable development on the 2010 named catastrophic events. In addition, there was \$29.2 million of favorable development on casualty reserves, including \$7.3 million, \$9.5 million, \$13.2 million and \$9.5 million for the 2002 to 2005 underwriting years, respectively, and \$6.9 million from the 2007 underwriting year. Such amounts were partially offset by adverse development in the 2009 and 2010 underwriting years of \$12.8 million and \$4.3 million, respectively, which was primarily due to development on a small number of contracts. The 2011 loss ratio also benefited from \$9.4 million of favorable development on other specialty business, including \$1.9 million and \$3.7 million from the 2008 and 2009 underwriting years, respectively, and \$10.0 million of favorable development from other lines. The reductions in reserves were primarily due to better than expected claims emergence.

Underwriting Expenses.

2012 second quarter versus 2011: The underwriting expense ratio for the reinsurance segment was 29.0% in the 2012 second quarter, compared to 29.2% in the 2011 second quarter. The acquisition expense ratio for the 2012 second quarter was 18.6%, compared to 19.0% for the 2011 second quarter. The comparison of the 2012 second quarter and 2011 second quarter acquisition expense ratios is influenced by, among other things, the mix and type of business written and earned and the level of ceding commissions. The operating expense ratio for the 2012 second quarter was 10.4%, compared to 10.2% in the 2011 second quarter, reflecting an increase in aggregate expenses partially offset by the benefit of the higher level of net premiums earned.

Six months ended June 30, 2012 versus 2011: The underwriting expense ratio for the reinsurance segment was 29.5% for the six months ended June 30, 2012, compared to 29.8% in the 2011 period. The acquisition expense ratio for the six months ended June 30, 2012 was 18.8%, compared to 20.0% for the 2011 period. The operating expense ratio for the six months ended June 30, 2012 was 10.7%, compared to 9.8% for the 2011 period, reflecting an increase in aggregate expenses partially offset by the benefit of the higher level of net premiums earned.

Table of Contents**Other Income or Expense Items**

Net Investment Income. The components of net investment income were derived from the following sources:

| | Three Months Ended June 30, | | Six Months Ended June 30, | |
|---------------------------|--------------------------------|-----------|------------------------------|------------|
| | 2012 | 2011 | 2012 | 2011 |
| Fixed maturities | \$ 70,290 | \$ 84,420 | \$ 143,739 | \$ 169,564 |
| Term loan investments (1) | 3,557 | 533 | 5,856 | 684 |
| Equity securities | 2,425 | 1,844 | 4,089 | 3,391 |
| Short-term investments | 760 | 505 | 1,132 | 1,183 |
| Other (2) | 2,980 | 5,774 | 6,174 | 12,677 |
| Gross investment income | 80,012 | 93,076 | 160,990 | 187,499 |
| Investment expenses | (6,404) | (6,405) | (13,085) | (12,521) |
| Net investment income | \$ 73,608 | \$ 86,671 | \$ 147,905 | \$ 174,978 |

(1) Included in investments accounted for using the fair value option on the consolidated balance sheets.

(2) Amounts include dividends on investment funds and other items. The amount for the six months ended June 30, 2011 includes an initial dividend of \$5.5 million received on an investment fund.

The pre-tax investment income yield, calculated based on amortized cost, was 2.47% for the 2012 second quarter, compared to 2.52% for the 2012 first quarter and 3.06% for the 2011 second quarter. The pre-tax investment income yield was 2.49% for the six months ended June 30, 2012, compared to 3.05% for the 2011 period. The decline in yields in the 2012 periods reflects the effects of lower prevailing interest rates available in the market and our investment strategy which puts a priority on total return. Such effects more than offset the benefit of a higher level of investable assets in the 2012 periods. Yields on future investment income may vary based on financial market conditions, investment allocation decisions and other factors.

Other Income (Loss). We record income or loss from our investments in Aeolus LP and Gulf Reinsurance Limited (joint venture) using the equity method on a three month lag basis based on the availability of their financial statements. We recorded income of \$0.7 million on such investments in the 2012 second quarter, compared to a loss of \$4.3 million in the 2011 second quarter, and a loss of \$7.4 million for the six months ended June 30, 2012, compared to \$0.3 million of income for the 2011 period. The amount recorded for the six months ended June 30, 2012 included a loss of \$8.4 million related to Aeolus LP. As of June 30, 2012, the carrying value of this investment (after taking into account the \$83.1 million in cumulative cash distributions received) was \$10.9 million with no unfunded capital commitments. Aeolus LP operates as an unrated reinsurance platform that provides collateralized property catastrophe protection to insurers and reinsurers on both an ultimate net loss and industry loss warranty basis.

Equity in Net Income of Investment Funds Accounted for Using the Equity Method. We use the equity method on certain investments (which primarily invest in fixed maturity securities) due to the ownership structure of these investment funds, where we do not have a controlling interest and are not the primary beneficiary. In applying the equity method, these investments are initially recorded at cost and are subsequently adjusted based on our proportionate share of the net income or loss of the funds (which include changes in the market value of the underlying

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securities in the funds). Such investments, which are typically structured as limited partnerships, are generally recorded on a one month lag with some investments reported on a three month lag based on the availability of reports from the investment funds. Certain of these funds employ leverage to achieve a higher rate of return on their assets under management. While leverage presents opportunities for increasing the total return of such investments, it may increase losses as well. Fluctuations in the carrying value of the investment funds accounted for using the equity method may increase the volatility of our reported results of operations. Investment funds accounted for using the equity method (excluding our investment in Aeolus LP) totaled \$320.7 million at June 30, 2012, compared to \$345.3 million at December 31, 2011. At June 30, 2012,

Table of Contents

our portfolio included \$340.4 million of investments in bank loan funds, of which \$114.6 million are reflected in the investment funds accounted for using the equity method.

We recorded \$7.8 million of equity in net income related to investment funds accounted for using the equity method in the 2012 second quarter, compared to \$6.0 million of equity in net income for the 2011 second quarter, and \$32.6 million of equity in net income related to investment funds accounted for using the equity method for the six months ended June 30, 2012, compared to \$35.6 million of equity in net income for the 2011 period.

Net Realized Gains or Losses. We recorded net realized gains of \$34.9 million for the 2012 second quarter, compared to net realized gains of \$45.2 million for the 2011 second quarter, and net realized gains of \$79.0 million for the six months ended June 30, 2012, compared to net realized gains of \$65.9 million for the 2011 period. Currently, our portfolio is actively managed to maximize total return within certain guidelines. In assessing returns under this approach, we include net investment income, net realized gains and losses and the change in unrealized gains and losses generated by our investment portfolio. The effect of financial market movements on the investment portfolio will directly impact net realized gains and losses as the portfolio is adjusted and rebalanced. Net realized gains or losses from the sale of fixed maturities primarily resulted from our decisions to reduce credit exposure, to change duration targets, to rebalance our portfolios or due to relative value determinations. In addition, net realized gains or losses include changes in the fair value of assets and liabilities accounted for using the fair value option. See note 7, Investment Information Net Realized Gains (Losses), of the notes accompanying our consolidated financial statements for additional information.

Total return on our portfolio under management for the 2012 second quarter was 0.63%, compared to 1.65% for the 2011 second quarter, and 2.53% for the six months ended June 30, 2012, compared to 3.17% for the 2011 period. Excluding foreign exchange, total return was 1.04% for the 2012 second quarter, compared to 1.54% for the 2011 second quarter, and 2.66% for the six months ended June 30, 2012, compared to 2.69% for the 2011 period. For the 2012 second quarter, total return on our portfolio reflected unfavorable returns on equities, reflecting the decline in the S&P 500 index during the period along with underperformance of commodity-related securities. Total return is calculated on a pre-tax basis.

Net Impairment Losses Recognized in Earnings. On a quarterly basis, we perform reviews of our available for sale investments to determine whether declines in fair value below the cost basis are considered other-than-temporary in accordance with applicable accounting guidance regarding the recognition and presentation of other-than-temporary impairments. The process of determining whether a security is other-than-temporarily impaired requires judgment and involves analyzing many factors. These factors include (i) an analysis of the liquidity, business prospects and overall financial condition of the issuer, (ii) the time period in which there was a significant decline in value, (iii) the significance of the decline, and (iv) the analysis of specific credit events. We evaluate the unrealized losses of our equity securities by issuer and determine if we can forecast a reasonable period of time by which the fair value of the securities would increase and we would recover our cost. If we are unable to forecast a reasonable period of time in which to recover the cost of our equity securities, we record a net impairment loss in earnings equivalent to the entire unrealized loss. For the 2012 second quarter, we recorded \$2.0 million of credit related impairments in earnings, compared to \$1.7 million for the 2011 second quarter. For the six months ended June 30, 2012, we recorded \$3.0 million of credit related impairments in earnings, compared to \$4.4 million for the 2011 period. The OTTI recorded in the 2012 periods resulted, in part, from reductions in estimated recovery values on certain mortgage backed securities following the review of such securities and also included OTTI recorded on a portfolio of global corporate bonds, non-U.S. government securities and U.S. Treasuries due to our intent to liquidate such portfolio in the 2012 third quarter. See note 7, Investment Information Other-Than-Temporary Impairments, of the notes accompanying our consolidated financial statements for additional information.

Table of Contents

Other Expenses. Other expenses, which are included in our other operating expenses and part of corporate and other (non-underwriting), were \$11.9 million for the 2012 second quarter, compared to \$11.4 million for the 2011 second quarter, and \$18.9 million for the six months ended June 30, 2012, compared to \$18.4 million for the 2011 period. 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.

Net Foreign Exchange Gains or Losses. Net foreign exchange gains for the 2012 second quarter of \$31.7 million consisted of net unrealized gains of \$32.4 million and net realized losses of \$0.7 million, compared to net foreign exchange losses for the 2011 second quarter of \$18.4 million which consisted of net unrealized losses of \$18.7 million and net realized gains of \$0.3 million. The 2012 second quarter net foreign exchange gains primarily resulted from the strengthening of the U.S. Dollar against the Euro, British Pound Sterling and other major foreign currencies during the period. Net foreign exchange gains for the six months ended June 30, 2012 of \$11.0 million consisted of net unrealized gains of \$12.2 million and net realized losses of \$1.2 million, compared to net foreign exchange losses for the 2011 period of \$55.3 million which consisted of net unrealized losses of \$55.7 million and net realized gains of \$0.4 million.

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. Historically, we have held 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 or decrease to shareholders' equity and are not included in the consolidated statements of income. As a result of the current financial and economic environment as well as the potential for additional investment returns, we may not match a portion of our projected liabilities in foreign currencies with investments in the same currencies, which could increase our exposure to foreign currency fluctuations and increase the volatility in our shareholders' equity.

CRITICAL ACCOUNTING POLICIES, ESTIMATES AND RECENT ACCOUNTING PRONOUNCEMENTS

Critical accounting policies, estimates and recent accounting pronouncements are discussed in Management's Discussion and Analysis of Financial Condition and Results of Operations contained in our 2011 Form 10-K, updated where applicable in the notes accompanying our consolidated financial statements.

FINANCIAL CONDITION, LIQUIDITY AND CAPITAL RESOURCES

Financial Condition

Investable Assets

The finance and investment committee of our board of directors establishes our investment policies and sets the parameters for creating guidelines for our investment managers. The finance and investment committee reviews the implementation of the investment strategy on a

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regular basis. Our current approach stresses preservation of capital, market liquidity and diversification of risk. 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. 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 and equity portfolios.

Table of Contents

The following table summarizes our invested assets:

| | June 30, 2012 | December 31, 2011 |
|---------------------------------------------------------------------------------|------------------|----------------------|
| Fixed maturities available for sale, at fair value | \$ 9,556,326 | \$ 9,375,604 |
| Fixed maturities, at fair value (1) | 242,735 | 147,779 |
| Fixed maturities pledged under securities lending agreements, at fair value (2) | 74,032 | 56,393 |
| Total fixed maturities | 9,873,093 | 9,579,776 |
| Short-term investments available for sale, at fair value | 1,087,910 | 904,219 |
| Cash | 355,392 | 351,699 |
| Equity securities available for sale, at fair value | 260,864 | 299,584 |
| Equity securities, at fair value (1) | 23,118 | 87,403 |
| Other investments available for sale, at fair value | 381,576 | 238,111 |
| Other investments, at fair value (1) | 230,990 | 131,721 |
| TALF investments, at fair value (3) | 307,453 | 387,702 |
| Investments accounted for using the equity method (4) | 331,601 | 380,507 |
| Total cash and investments | 12,851,997 | 12,360,722 |
| Securities sold but not yet purchased (5) | (9,206) | (27,178) |
| Securities transactions entered into but not settled at the balance sheet date | (106,435) | (17,339) |
| Total investable assets | \$ 12,736,356 | \$ 12,316,205 |

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- (1) Represents securities which are carried at fair value under the fair value option and reflected as investments accounted for using the fair value option on our balance sheet. Changes in the carrying value of such securities are recorded in net realized gains or losses.
 - (2) This table excludes the collateral received and reinvested and includes the fixed maturities and short-term investments pledged under securities lending agreements, at fair value.
 - (3) The Federal Reserve's Term Asset-Backed Securities Loan Facility (TALF) provides secured financing for certain asset-backed securities and legacy commercial mortgage-backed securities. TALF financing is non-recourse to us, 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. We can deliver the collateralized securities to the Federal Reserve in full defeasance of the loan.
 - (4) Changes in the carrying value of investment funds accounted for using the equity method are recorded as equity in net income (loss) of investments funds accounted for using the equity method rather than as an unrealized gain or loss component of accumulated other comprehensive income.
 - (5) Represents our obligation to deliver equity securities that we did not own at the time of sale. Such amounts are included in other liabilities on our balance sheet.

At June 30, 2012, our fixed income portfolio, which includes fixed maturity securities and short-term investments, had average credit quality ratings from Standard & Poor's Rating Services (S&P)/Moody's of AA/Aa2 and an average yield to maturity (imbedded book yield), before investment expenses, of 2.76%. At December 31, 2011, our fixed income portfolio had average credit quality ratings from S&P/Moody's of AA/Aa1 and an average yield to maturity of 2.98%. Our investment portfolio had an average effective duration of 3.01 years at June 30, 2012, compared to 2.99 years at December 31, 2011. At June 30, 2012, approximately \$8.41 billion, or 67%, of our total investments and cash was internally managed, compared to \$7.9 billion, or 66%, at December 31, 2011.

Table of Contents

The following table summarizes our fixed maturities by type:

| | Estimated Fair Value | Gross Unrealized Gains | Gross Unrealized Losses | Cost or Amortized Cost | OTTI Unrealized Losses (2) |
|----------------------------------------------------------------------------------------------|----------------------------|------------------------------|-------------------------------|------------------------------|----------------------------------|
| At June 30, 2012 | | | | | |
| Fixed maturities and fixed maturities pledged under securities lending agreements (1): | | | | | |
| Corporate bonds | \$ 2,714,495 | \$ 92,282 | \$ (11,533) | \$ 2,633,746 | \$ (716) |
| Mortgage backed securities | 1,670,108 | 23,743 | (18,286) | 1,664,651 | (14,772) |
| Municipal bonds | 1,542,262 | 67,946 | (1,541) | 1,475,857 | (65) |
| Commercial mortgage backed securities | 961,326 | 31,685 | (2,412) | 932,053 | (3,259) |
| U.S. government and government agencies | 1,380,074 | 29,797 | (1,872) | 1,352,149 | (207) |
| Non-U.S. government securities | 1,034,657 | 32,558 | (17,976) | 1,020,075 | (157) |
| Asset backed securities | 570,171 | 17,294 | (8,579) | 561,456 | (3,876) |
| Total | \$ 9,873,093 | \$ 295,305 | \$ (62,199) | \$ 9,639,987 | \$ (23,052) |

At December 31, 2011

| | | | | | |
|----------------------------------------------------------------------------------------------|---------------------|-------------------|--------------------|---------------------|--------------------|
| Fixed maturities and fixed maturities pledged under securities lending agreements (1): | | | | | |
| Corporate bonds | \$ 2,719,052 | \$ 79,407 | \$ (29,922) | \$ 2,669,567 | \$ (1,138) |
| Mortgage backed securities | 1,592,762 | 27,633 | (23,226) | 1,588,355 | (20,466) |
| Municipal bonds | 1,430,565 | 77,977 | (886) | 1,353,474 | (105) |
| Commercial mortgage backed securities | 1,046,326 | 28,780 | (2,904) | 1,020,450 | (3,259) |
| U.S. government and government agencies | 1,451,993 | 34,811 | (3) | 1,417,185 | (207) |
| Non-U.S. government securities | 762,321 | 33,486 | (17,684) | 746,519 | |
| Asset backed securities | 576,757 | 14,649 | (10,078) | 572,186 | (3,876) |
| Total | \$ 9,579,776 | \$ 296,743 | \$ (84,703) | \$ 9,367,736 | \$ (29,051) |

(1) In securities lending transactions, we receive collateral in excess of the fair value of the fixed maturities and short-term investments pledged. For purposes of this table, we have excluded the collateral received and reinvested and included the fixed maturities and short-term investments pledged.

(2) Represents the total other-than-temporary impairments (OTTI) recognized in accumulated other comprehensive income (AOCI). It does not include the change in fair value subsequent to the impairment measurement date. At June 30, 2012, the net unrealized loss related to securities for which a non-credit OTTI was recognized in AOCI was \$9.2 million, compared to a net unrealized loss of \$18.0 million at December 31, 2011.

Table of Contents

The following table provides the credit quality distribution of our fixed maturities and fixed maturities pledged under securities lending agreements, excluding TALF investments:

| Rating (1) | June 30, 2012 | | December 31, 2011 | |
|---------------------------------------------|----------------------|------------|----------------------|------------|
| | Estimated Fair Value | % of Total | Estimated Fair Value | % of Total |
| U.S. government and government agencies (2) | \$ 3,043,908 | 30.8 | \$ 3,154,480 | 32.9 |
| AAA | 3,325,996 | 33.7 | 3,229,161 | 33.7 |
| AA | 1,505,032 | 15.2 | 1,425,249 | 14.9 |
| A | 1,028,772 | 10.4 | 884,957 | 9.2 |
| BBB | 428,200 | 4.3 | 412,566 | 4.3 |
| BB | 152,982 | 1.5 | 140,029 | 1.5 |
| B | 175,613 | 1.8 | 165,003 | 1.7 |
| Lower than B | 116,846 | 1.2 | 114,672 | 1.2 |
| Not rated | 95,744 | 1.1 | 53,659 | 0.6 |
| Total | \$ 9,873,093 | 100.0 | \$ 9,579,776 | 100.0 |

(1) For individual fixed maturities, S&P ratings are used. In the absence of an S&P rating, ratings from Moody's are used, followed by ratings from Fitch Ratings.

(2) Includes U.S. government-sponsored agency mortgage backed securities and agency commercial mortgage backed securities.

The following table provides information on the severity of the unrealized loss position as a percentage of amortized cost for all fixed maturities and fixed maturities pledged under securities lending agreements which were in an unrealized loss position:

| Severity of Unrealized Loss | June 30, 2012 | | | December 31, 2011 | | |
|-----------------------------|----------------------|-------------------------|------------------------------------|----------------------|-------------------------|------------------------------------|
| | Estimated Fair Value | Gross Unrealized Losses | % of Total Gross Unrealized Losses | Estimated Fair Value | Gross Unrealized Losses | % of Total Gross Unrealized Losses |
| 0-10% | \$ 2,034,205 | \$ (31,543) | 50.7 | \$ 1,692,722 | \$ (44,803) | 52.9 |
| 10-20% | 156,893 | (22,748) | 36.6 | 144,523 | (20,222) | 23.9 |
| 20-30% | 15,600 | (5,189) | 8.3 | 38,749 | (11,709) | 13.8 |
| 30-40% | 5,293 | (2,679) | 4.3 | 14,596 | (7,413) | 8.8 |
| 40-50% | 50 | (40) | 0.1 | 619 | (445) | 0.5 |
| 50-80% | | | | 29 | (111) | 0.1 |
| Total | \$ 2,212,041 | \$ (62,199) | 100.0 | \$ 1,891,238 | \$ (84,703) | 100.0 |

Table of Contents

The following table provides information on the severity of the unrealized loss position as a percentage of amortized cost for non-investment grade fixed maturities and fixed maturities pledged under securities lending agreements which were in an unrealized loss position:

| Severity of Unrealized Loss | June 30, 2012 | | | December 31, 2011 | | |
|-----------------------------|----------------------|-------------------------|------------------------------------|----------------------|-------------------------|------------------------------------|
| | Estimated Fair Value | Gross Unrealized Losses | % of Total Gross Unrealized Losses | Estimated Fair Value | Gross Unrealized Losses | % of Total Gross Unrealized Losses |
| 0-10% | \$ 91,112 | \$ (3,421) | 5.5 | \$ 143,782 | \$ (6,418) | 7.6 |
| 10-20% | 29,018 | (4,721) | 7.6 | 33,926 | (5,484) | 6.5 |
| 20-30% | 14,238 | (4,807) | 7.7 | 26,733 | (8,042) | 9.5 |
| 30-40% | 4,013 | (1,984) | 3.2 | 13,558 | (6,905) | 8.2 |
| 40-50% | 50 | (40) | 0.1 | 619 | (445) | 0.5 |
| 50-80% | | | | 29 | (110) | 0.1 |
| Total | \$ 138,431 | \$ (14,973) | 24.1 | \$ 218,647 | \$ (27,404) | 32.4 |

At June 30, 2012, below-investment grade securities comprised approximately 5.6% of our fixed maturities and fixed maturities pledged under securities lending agreements, compared to 5.0% at December 31, 2011. In accordance with our investment strategy, we invest in high yield fixed income securities which are included in Corporate bonds. Upon issuance, these securities are typically rated below investment grade (i.e., rating assigned by the major rating agencies of BB or less). At June 30, 2012, corporate bonds represented 33% of the total below investment grade securities at fair value, mortgage backed securities represented 51% of the total and 16% were in other classes. At December 31, 2011, corporate bonds represented 46% of the total below investment grade securities at fair value, mortgage backed securities represented 46% of the total and 8% were in other classes. Unrealized losses include the impact of foreign exchange movements on certain securities denominated in foreign currencies and, as such, the amount of securities in an unrealized loss position fluctuates due to foreign currency movements.

We determine estimated recovery values for our fixed maturities and fixed maturities pledged under securities lending agreements following a review of the business prospects, credit ratings, estimated loss given default factors and information received from asset managers and rating agencies for each security. For structured securities, we utilize underlying data, where available, for each security provided by asset managers and additional information from credit agencies in order to determine an expected recovery value for each security. The analysis provided by the asset managers includes expected cash flow projections under base case and stress case scenarios which modify expected default expectations and loss severities and slow down prepayment assumptions. In the tables above, securities at June 30, 2012 which were in an unrealized loss position of greater than 20% of amortized cost were primarily in mortgage backed and asset backed securities where the fair value for the securities was lower than our expected recovery value.

Table of Contents

The following table summarizes our top ten exposures to fixed income corporate issuers by fair value at June 30, 2012, excluding guaranteed amounts and covered bonds:

| | Estimated Fair Value | Credit Rating (1) |
|------------------------------|-------------------------|----------------------|
| General Electric Co. | \$ 45,395 | AA+/A1 |
| Caterpillar Inc. | 33,511 | A/A2 |
| Abbey National Treasury Svcs | 31,810 | A/A2 |
| Wells Fargo & Company | 29,802 | A+/A2 |
| Total SA | 29,402 | AA-/Aa1 |
| Royal Dutch Shell PLC | 28,806 | AA/Aa1 |
| HSBC Holdings PLC | 27,565 | A/Baa1 |
| National Australia Bank Ltd. | 27,279 | AA-/Aa2 |
| Coca-Cola Company | 26,988 | A+/Aa3 |
| Verizon Communications Inc | 25,843 | A-/A3 |
| Total | \$ 306,401 | |

(1) Ratings as assigned by S&P/Moody s.

Our portfolio includes investments, such as mortgage-backed securities, which are subject to prepayment risk. At June 30, 2012, our investments in mortgage-backed securities (MBS), excluding commercial mortgage-backed securities, amounted to approximately \$1.67 billion, or 13.1% of total investable assets, compared to \$1.59 billion, or 12.9%, at December 31, 2011. 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 MBS 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. However, current economic conditions may curtail prepayment activity as refinancing becomes more difficult, thus limiting prepayments on MBS.

Since 2007, the residential mortgage market in the U.S. has experienced a variety of difficulties. During this time, delinquencies and losses with respect to residential mortgage loans generally have increased and may continue to increase, particularly in the sub-prime sector. In addition, during this period, 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 portfolio includes commercial mortgage backed securities (CMBS). At June 30, 2012, CMBS constituted approximately \$961.3 million, or 7.5% of total investable assets, compared to \$1.05 billion, or 8.5%, at December 31, 2011. The commercial real estate market has experienced price deterioration, which could lead to increased delinquencies and defaults on commercial real estate mortgages.

Table of Contents

The following table provides information on our MBS and CMBS at June 30, 2012, excluding amounts guaranteed by the U.S. government and TALF investments:

| | Issuance Year | Amortized Cost | Average Credit Quality | Total | Estimated Fair Value % of Amortized Cost | % of Investable Assets |
|-------------------------|---------------|----------------|------------------------|------------|------------------------------------------|------------------------|
| Non-agency MBS: | 2003 | \$ 2,293 | AAA | \$ 2,326 | 101.4% | 0.0% |
| | 2004 | 13,709 | BBB+ | 12,918 | 94.2% | 0.1% |
| | 2005 | 44,324 | B- | 39,893 | 90.0% | 0.3% |
| | 2006 | 53,445 | BBB- | 49,370 | 92.4% | 0.4% |
| | 2007 | 41,731 | CCC- | 40,173 | 96.3% | 0.3% |
| | 2008 | 6,747 | CCC | 6,613 | 98.0% | 0.1% |
| | 2009(6) | 30,151 | AAA | 32,861 | 109.0% | 0.3% |
| | 2010(6) | 28,899 | AAA | 28,027 | 97.0% | 0.2% |
| | 2012(6) | 82,775 | AAA | 83,027 | 100.3% | 0.7% |
| Total non-agency MBS | | \$ 304,074 | BBB+ | \$ 295,208 | 97.1% | 2.3% |
| Non-agency CMBS: | 1998 | 3,452 | AAA | 3,471 | 100.6% | 0.0% |
| | 2002 | 68 | AAA | 69 | 101.5% | 0.0% |
| | 2004 | 27,556 | AAA | 27,375 | 99.3% | 0.2% |
| | 2005 | 40,271 | AA+ | 40,297 | 100.1% | 0.3% |
| | 2006 | 5,160 | A- | 5,028 | 97.4% | 0.0% |
| | 2007 | 32,415 | A | 34,358 | 106.0% | 0.3% |
| | 2008 | 616 | AAA | 616 | 100.0% | 0.0% |
| | 2010 | 238,680 | AAA | 247,624 | 103.7% | 1.9% |
| | 2011 | 156,477 | AAA | 165,444 | 105.7% | 1.3% |
| | 2012 | 147,183 | AAA | 148,110 | 100.6% | 1.2% |
| Total non-agency CMBS | | \$ 651,878 | AAA | \$ 672,392 | 103.1% | 5.3% |

Additional Statistics:

| | Non-Agency MBS | | Non-Agency CMBS (1) |
|--------------------------------------|----------------|-----------|---------------------|
| | Re-REMICs | All Other | |
| Weighted average loan age (months) | 72 | 69 | 36 |
| Weighted average life (months) (2) | 23 | 48 | 51 |
| Weighted average loan-to-value % (3) | 69.9% | 69.0% | 64.7% |
| Total delinquencies (4) | 19.7% | 21.7% | 3.6% |
| Current credit support % (5) | 43.3% | 14.4% | 28.2% |

- (1) Loans defeased with government/agency obligations represented approximately 1% of the collateral underlying our CMBS holdings.
- (2) The weighted average life for MBS is based on the interest rates in effect at June 30, 2012. The weighted average life for CMBS reflects the average life of the collateral underlying our CMBS holdings.
- (3) The range of loan-to-values is 30% to 86% on MBS and 27% to 105% on CMBS.
- (4) Total delinquencies includes 60 days and over.
- (5) Current credit support % represents the % for a collateralized mortgage obligation (CMO) or CMBS class/tranche from other subordinate classes in the same CMO or CMBS deal.
- (6) Primarily represents Re-REMICs with an average credit quality of AAA from Fitch Ratings.

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Table of Contents

The following table provides information on our asset backed securities (ABS), excluding TALF investments, at June 30, 2012:

| | Amortized Cost | Average Credit Quality | Total | Estimated Fair Value % of Amortized Cost | % of Investable Assets |
|--------------------------|-------------------|------------------------------|-------------------|---------------------------------------------------|------------------------------|
| Sector: | | | | | |
| Credit cards (1) | \$ 175,092 | AA+ | \$ 178,077 | 101.7% | 1.4% |
| Autos (2) | 140,224 | AAA | 139,531 | 99.5% | 1.1% |
| Rate reduction bonds (3) | 80,383 | AAA | 84,014 | 104.5% | 0.7% |
| Equipment (4) | 58,961 | AA- | 60,182 | 102.1% | 0.5% |
| U.K. securitized (5) | 31,874 | AAA | 31,779 | 99.7% | 0.2% |
| Student loans (6) | 6,636 | AAA | 6,773 | 102.1% | 0.1% |
| Other | 55,122 | AA | 55,486 | 100.7% | 0.4% |
| | 548,292 | AA | 555,842 | 101.4% | 4.4% |
| Home equity (7) | \$ 1,676 | AAA | \$ 1,454 | 86.8% | 0.0% |
| | 1,085 | A | 991 | 91.3% | 0.0% |
| | 2,296 | BBB | 2,446 | 106.5% | 0.0% |
| | 3,254 | BB to B | 3,330 | 102.3% | 0.0% |
| | 4,788 | CCC to C | 6,028 | 125.9% | 0.0% |
| | 65 | D | 80 | 123.1% | 0.0% |
| | 13,164 | B+ | 14,329 | 108.8% | 0.1% |
| Total ABS | \$ 561,456 | AA+ | \$ 570,171 | 101.6% | 4.5% |

The effective duration of the total ABS was 1.5 years at June 30, 2012.

- (1) The weighted average credit support % on credit cards is 23.9%.
- (2) The weighted average credit support % on autos is 22.0%.
- (3) The weighted average credit support % on rate reduction bonds is 6.6%.
- (4) The weighted average credit support % on equipment is 5.6%.
- (5) The weighted average credit support % on U.K. securitized is 18.0%.
- (6) The weighted average credit support % on student loans is 22.7%.
- (7) The weighted average credit support % on home equity is 22.8%.

At June 30, 2012, our fixed income portfolio included \$61.0 million par value in sub-prime securities with a fair value of \$40.5 million and average credit quality ratings from S&P/Moody's of A+/B1. At December 31, 2011, our fixed income portfolio included \$40.0 million par value in sub-prime securities with a fair value of \$15.4 million and average credit quality ratings from S&P/Moody's of BB+/Ba2. Such amounts were primarily in the home equity sector of our asset backed securities, with the balance in other ABS, MBS and CMBS sectors. We define sub-prime

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mortgage-backed securities as investments in which the underlying loans primarily exhibit one or more of the following characteristics: low FICO scores, above-prime interest rates, high loan-to-value ratios or high debt-to-income ratios. In addition, the portfolio of collateral backing our securities lending program contained \$6.0 million fair value of sub-prime securities with average credit quality ratings from S&P/Moody s of CCC/Caa2 at June 30, 2012, compared to \$7.3 million fair value with average credit quality ratings from S&P/Moody s of CCC/Caa2 at December 31, 2011.

At June 30, 2012, we held insurance enhanced municipal bonds, net of prerefunded bonds that are escrowed in U.S. government obligations, the fair value of which was \$264.2 million, or 2.1% of our total investable assets. These securities had average credit quality ratings from S&P/Moody s of AA/Aa2 with and without the insurance enhancement. This is due to the fact that, in cases where the claims paying ratings of the guarantors are below investment grade, those ratings have been withdrawn from the bonds by the relevant rating

Table of Contents

agencies, and the insured ratings have been equated to the underlying ratings. The ratings were obtained from the individual rating agencies and were assigned a numerical amount with 1 being the highest rating. The average ratings were calculated using the weighted average fair values of the individual bonds. The average ratings with and without the insurance enhancement are substantially the same at June 30, 2012. Guarantors of our insurance enhanced municipal bonds, net of prerefunded bonds that are escrowed in U.S. government obligations, included Assured Guaranty Ltd. (\$95.6 million), National Public Finance Guarantee (\$87.1 million), the Texas Permanent School Fund (\$48.7 million) and Financial Guaranty Insurance Company (\$32.8 million). We do not have a significant exposure to insurance enhanced asset-backed or mortgage-backed securities. We do not have any significant investments in companies which guarantee securities at June 30, 2012.

The following table provides information on the fair value of our Eurozone investments at June 30, 2012:

| Country (1) | Sovereign (2) | Financial Corporates | Other Corporates | Covered Bonds (3) | Bank Loans (4) | Equities and Other | Total |
|-------------------|---------------|----------------------|------------------|-------------------|----------------|--------------------|------------|
| Germany | \$ 159,511 | \$ 1,271 | \$ 22,482 | \$ | \$ 22,726 | \$ 1,536 | \$ 207,526 |
| Netherlands | 7,382 | 31,873 | 30,925 | 30,710 | 6,692 | 16,053 | 123,635 |
| France | | 992 | 32,519 | 40,345 | 4,308 | 8,639 | 86,803 |
| Finland | 105,015 | 247 | | | | | 105,262 |
| Supranational (5) | 45,426 | | | | | | 45,426 |
| Spain | | | 687 | 12,240 | 4,998 | 213 | 18,138 |
| Luxembourg | | | 4,237 | | 2,335 | 23 | 6,595 |
| Italy | 5,986 | | 3,417 | | 959 | 114 | 10,476 |
| Belgium | 3,905 | | 7,049 | | | | 10,954 |
| Ireland | | 633 | | | | 1,682 | 2,315 |
| Portugal | | | 627 | | | | 627 |
| Total | \$ 327,225 | \$ 35,016 | \$ 101,943 | \$ 83,295 | \$ 42,018 | \$ 28,260 | \$ 617,757 |

(1) The country allocations set forth in the table are based on various assumptions made by us in assessing the country in which the underlying credit risk resides, including a review of the jurisdiction of organization, business operations and other factors. Based on such analysis, we do not believe that we have any Eurozone investments from Austria, Cyprus, Estonia, Greece, Malta, Slovakia or Slovenia at June 30, 2012.

(2) Sovereign includes securities issued and/or guaranteed by Eurozone governments.

(3) Securities issued by Eurozone banks where the security is backed by a separate group of loans.

(4) Included in corporate bonds.

(5) Includes World Bank, European Investment Bank, International Finance Corp. and European Bank for Reconstruction and Development.

At June 30, 2012, our equity portfolio included \$274.8 million fair value of equity securities, compared to \$359.8 million at December 31, 2011, net of securities sold but not purchased. Our equity portfolio primarily consists of publicly traded common stocks in the natural resources, energy and consumer staples sectors. Certain of our equity managers use leverage to achieve a higher rate of return on their assets under management. While leverage presents opportunities for increasing the total return of such investments, it may increase losses as well. Accordingly, any event that adversely affects the value of the underlying holdings would be magnified to the extent leverage is used and our potential losses would be magnified.

Table of Contents

The following table provides information on the severity of the unrealized loss position as a percentage of cost for all equity securities classified as available for sale which were in an unrealized loss position:

| Severity of Unrealized Loss | June 30, 2012 | | | December 31, 2011 | | |
|-----------------------------|----------------------|-------------------------|------------------------------------|----------------------|-------------------------|------------------------------------|
| | Estimated Fair Value | Gross Unrealized Losses | % of Total Gross Unrealized Losses | Estimated Fair Value | Gross Unrealized Losses | % of Total Gross Unrealized Losses |
| 0-10% | \$ 55,997 | \$ (1,899) | 8.5 | \$ 74,813 | \$ (3,651) | 16.3 |
| 10-20% | 25,874 | (4,177) | 18.8 | 26,791 | (4,457) | 19.9 |
| 20-30% | 12,639 | (4,030) | 18.1 | 21,457 | (7,827) | 35.0 |
| 30-40% | 3,628 | (1,959) | 8.8 | 5,070 | (2,645) | 11.9 |
| 40-50% | 11,524 | (9,528) | 42.8 | 2,345 | (1,984) | 8.9 |
| 50-70% | 522 | (655) | 3.0 | 1,492 | (1,780) | 8.0 |
| Total | \$ 110,184 | \$ (22,248) | 100.0 | \$ 131,968 | \$ (22,344) | 100.0 |

On a quarterly basis, we evaluate the unrealized losses of our equity securities by issuer and forecast a reasonable period of time by which the fair value of the securities would increase and we would recover the cost basis. A substantial portion of the equity securities with unrealized losses were less than 30% under their cost basis at June 30, 2012. For equity securities with a higher level of unrealized losses, available positive and negative evidence is reviewed to determine whether an other-than-temporary impairment should be recorded. At June 30, 2012, we believe that a reasonable period of time exists to allow for recovery of the cost basis of our equity securities.

Other investments totaled \$612.6 million at June 30, 2012, compared to \$369.8 million at December 31, 2011. Investment funds accounted for using the equity method (excluding our investment in Aeolus LP) totaled \$320.7 million at June 30, 2012, compared to \$345.3 million at December 31, 2011. Certain of our investment managers may use leverage to achieve a higher rate of return on their assets under management, primarily those included in other investments available for sale, at fair value, investments accounted for using the fair value option and investments accounted for using the equity method on our balance sheet. While leverage presents opportunities for increasing the total return of such investments, it may increase losses as well. Accordingly, any event that adversely affects the value of the underlying holdings would be magnified to the extent leverage is used and our potential losses would be magnified. In addition, the structures used to generate leverage may lead to such investments being required to meet covenants based on market valuations and asset coverage. Market valuation declines could force the sale of investments into a depressed market, which may result in significant additional losses. Alternatively, the levered investments may attempt to deleverage by raising additional equity or potentially changing the terms of the established financing arrangements. We may choose to participate in the additional funding of such investments.

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. See note 9, Derivative Instruments, of the notes accompanying our consolidated financial statements for additional disclosures concerning derivatives.

Accounting guidance regarding fair value measurements addresses how companies should measure fair value when they are required to use a fair value measure for recognition or disclosure purposes under GAAP and provides a common definition of fair value to be used throughout GAAP. See note 8, Fair Value of the notes accompanying our consolidated financial statements for a summary of our financial assets and liabilities measured at fair value at June 30, 2012 and December 31, 2011 by level.

Table of Contents**Premiums Receivable and Reinsurance Recoverables**

At June 30, 2012, 74.9% of premiums receivable of \$834.1 million represented amounts not yet due, while amounts in excess of 90 days overdue were 4.4% of the total. At December 31, 2011, 72.6% of premiums receivable of \$501.6 million represented amounts not yet due, while amounts in excess of 90 days overdue were 4.8% of the total. Approximately 2.1% of the \$68.2 million of paid losses and loss adjustment expenses recoverable were in excess of 90 days overdue at June 30, 2012, compared to 2.3% of the \$33.5 million of paid losses and loss adjustment expenses recoverable at December 31, 2011. At June 30, 2012 and December 31, 2011, our reserves for doubtful accounts were approximately \$13.4 million and \$14.2 million, respectively.

At June 30, 2012, approximately 87.7% of reinsurance recoverables on paid and unpaid losses (not including prepaid reinsurance premiums) of \$1.85 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 5.0% of our total shareholders' equity. At December 31, 2011, approximately 90.1% of reinsurance recoverables on paid and unpaid losses (not including prepaid reinsurance premiums) of \$1.85 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 5.4% of our total shareholders' equity.

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

| | Three Months Ended June 30, | | Six Months Ended June 30, | |
|--------------------------------------------|--------------------------------|------------|------------------------------|--------------|
| | 2012 | 2011 | 2012 | 2011 |
| Premiums Written | | | | |
| Direct | \$ 695,743 | \$ 626,978 | \$ 1,405,475 | \$ 1,254,152 |
| Assumed | 356,070 | 284,961 | 712,994 | 622,353 |
| Ceded | (231,580) | (205,396) | (434,625) | (405,684) |
| Net | \$ 820,233 | \$ 706,543 | \$ 1,683,844 | \$ 1,470,821 |
| Premiums Earned | | | | |
| Direct | \$ 633,341 | \$ 587,725 | \$ 1,247,352 | \$ 1,160,731 |
| Assumed | 290,680 | 249,045 | 550,536 | 494,180 |
| Ceded | (197,365) | (193,891) | (390,920) | (378,337) |
| Net | \$ 726,656 | \$ 642,879 | \$ 1,406,968 | \$ 1,276,574 |
| Losses and Loss Adjustment Expenses | | | | |
| Direct | \$ 386,050 | \$ 454,528 | \$ 739,832 | \$ 848,112 |
| Assumed | 103,367 | 144,009 | 212,784 | 387,817 |
| Ceded | (89,724) | (166,915) | (157,716) | (310,427) |
| Net | \$ 399,693 | \$ 431,622 | \$ 794,900 | \$ 925,502 |

Reserves for Losses and Loss Adjustment Expenses

We establish reserves for losses and loss adjustment expenses (Loss Reserves) 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. Estimating Loss

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Reserves is inherently difficult, which is exacerbated by the fact that we are a relatively new company with relatively limited historical experience upon which to base such estimates. 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.

Table of Contents

At June 30, 2012 and December 31, 2011, our Loss Reserves, net of unpaid losses and loss adjustment expenses recoverable, by type and by operating segment were as follows:

| | June 30, 2012 | December 31, 2011 |
|--------------------------|------------------|----------------------|
| Insurance: | | |
| Case reserves | \$ 1,392,011 | \$ 1,311,740 |
| IBNR reserves | 2,828,749 | 2,783,091 |
| Total net reserves | \$ 4,220,760 | \$ 4,094,831 |
| Reinsurance: | | |
| Case reserves | \$ 738,831 | \$ 721,032 |
| Additional case reserves | 164,323 | 178,640 |
| IBNR reserves | 1,641,425 | 1,643,660 |
| Total net reserves | \$ 2,544,579 | \$ 2,543,332 |
| Total: | | |
| Case reserves | \$ 2,130,842 | \$ 2,032,772 |
| Additional case reserves | 164,323 | 178,640 |
| IBNR reserves | 4,470,174 | 4,426,751 |
| Total net reserves | \$ 6,765,339 | \$ 6,638,163 |

At June 30, 2012 and December 31, 2011, the insurance segment's Loss Reserves by major line of business, net of unpaid losses and loss adjustment expenses recoverable, were as follows:

| | June 30, 2012 | December 31, 2011 |
|---------------------------------------|------------------|----------------------|
| Casualty | \$ 660,652 | \$ 655,017 |
| Executive assurance | 670,773 | 636,692 |
| Professional liability | 636,353 | 631,991 |
| Property, energy, marine and aviation | 576,412 | 590,098 |
| Programs | 557,349 | 541,113 |
| Construction | 425,665 | 403,109 |
| National accounts | 189,972 | 169,906 |
| Healthcare | 137,339 | 139,825 |
| Surety | 82,022 | 70,680 |
| Travel and accident | 34,618 | 37,645 |
| Lenders products | 24,619 | 12,332 |
| Other | 224,986 | 206,423 |
| Total net reserves | \$ 4,220,760 | \$ 4,094,831 |

Table of Contents

At June 30, 2012 and December 31, 2011, the reinsurance segment's Loss Reserves by major line of business, net of unpaid losses and loss adjustment expenses recoverable, were as follows:

| | June 30, 2012 | December 31, 2011 |
|-----------------------------------------|--------------------------|------------------------------|
| Casualty | \$ 1,574,427 | \$ 1,600,887 |
| Property excluding property catastrophe | 301,728 | 336,425 |
| Property catastrophe | 231,214 | 237,804 |
| Marine and aviation | 157,367 | 166,294 |
| Other specialty | 228,550 | 153,455 |
| Other | 51,293 | 48,467 |
| Total net reserves | \$ 2,544,579 | \$ 2,543,332 |

Shareholders' Equity

Our shareholders' equity was \$5.02 billion at June 30, 2012, compared to \$4.59 billion at December 31, 2011. The increase for the six months ended June 30, 2012 was primarily attributable to positive underwriting and investment returns.

Book Value per Common Share

The following table presents the calculation of book value per common share at June 30, 2012 and December 31, 2011:

| (U.S. dollars in thousands, except share data) | June 30, 2012 | December 31, 2011 |
|-------------------------------------------------------|--------------------------|------------------------------|
| Calculation of book value per common share: | | |
| Total shareholders' equity | \$ 5,020,316 | \$ 4,592,074 |
| Less preferred shareholders' equity | (325,000) | (325,000) |
| Common shareholders' equity | \$ 4,695,316 | \$ 4,267,074 |
| Common shares outstanding (1) | 136,291,652 | 134,358,345 |
| Book value per common share | \$ 34.45 | \$ 31.76 |

(1) Excludes the effects of 8,043,017 and 8,706,441 stock options and 323,303 and 298,425 restricted stock units outstanding at June 30, 2012 and December 31, 2011, respectively.

Liquidity and Capital Resources

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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 non-cumulative preferred shares and common shares. ACGL's readily available cash, short-term investments and marketable securities, excluding amounts held by our regulated insurance and reinsurance subsidiaries, totaled \$5.1 million at June 30, 2012, compared to \$14.4 million at December 31, 2011. During the six months ended June 30, 2012, ACGL received dividends of \$48.0 million from Arch Reinsurance Ltd. (Arch Re Bermuda), our Bermuda-based reinsurer and insurer.

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 an enhanced capital requirement which must equal or exceed its minimum solvency margin (*i.e.*, the amount by which the value of its general business assets must exceed its

Table of Contents

general business liabilities) equal to the greatest of (1) \$100.0 million, (2) 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 (3) 15% of net discounted aggregated losses and loss expense provisions 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 enhanced capital requirement, 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 (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. Arch Re Bermuda is required to meet enhanced capital requirements and a target capital level (defined as 120% of the enhanced capital requirements) as calculated using a new risk based capital model called the Bermuda Solvency Capital Requirement (BSCR) model. At December 31, 2011, as determined under Bermuda law, Arch Re Bermuda had statutory capital of \$2.28 billion and statutory capital and surplus of \$4.56 billion, which amounts were in compliance with Arch Re Bermuda's enhanced capital requirement at such date. Such amounts include ownership interests in U.S. insurance and reinsurance subsidiaries. Accordingly, Arch Re Bermuda can pay approximately \$1.09 billion to ACGL during the remainder of 2012 without providing an affidavit to the BMA, as discussed above. In addition to meeting applicable regulatory standards, the ability of our insurance and reinsurance subsidiaries to pay dividends to intermediate parent companies owned by Arch Re Bermuda 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 maintain assets in trust accounts as collateral for insurance and reinsurance transactions with affiliated companies and also have investments in segregated portfolios primarily to provide collateral or guarantees for letters of credit to third parties. At June 30, 2012 and December 31, 2011, such amounts approximated \$5.70 billion and \$5.60 billion, respectively.

Our non-U.S. operations account for a significant percentage of our net premiums written. In the current market environment, the business written in our non-U.S. operations has been more profitable than the business written in our U.S. operations, which has significantly increased the non-U.S. group's contribution to our overall pre-tax income. Additionally, a significant component of our pre-tax income is generated through our investment performance, especially in this competitive insurance and reinsurance market. We hold a substantial amount of our investable assets in our non-U.S. operations and, accordingly, a large portion of our investment income is produced in our non-U.S. operations. In addition, ACGL, through its subsidiaries, provides financial support to certain of its insurance subsidiaries and affiliates, through certain reinsurance arrangements beneficial to the ratings of such subsidiaries. Our U.S.-based insurance and reinsurance groups enter into separate reinsurance arrangements with Arch Re Bermuda covering individual lines of business. For the 2011 calendar year, the U.S. groups ceded business to Arch Re Bermuda at an aggregate net cession rate (i.e., net of third party reinsurance) of approximately 51%.

Except as described in the above paragraph, 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.

Table of Contents

The following table summarizes our consolidated cash flows from operating, investing and financing activities:

| | Six Months Ended June 30, | |
|-----------------------------------------------------------|------------------------------|------------|
| | 2012 | 2011 |
| Total cash provided by (used for): | | |
| Operating activities | \$ 397,268 | \$ 446,547 |
| Investing activities | (315,321) | (199,138) |
| Financing activities | (78,747) | (205,551) |
| Effects of exchange rate changes on foreign currency cash | 493 | 6,403 |
| Increase in cash | \$ 3,693 | \$ 48,261 |

- Cash provided by operating activities for the six months ended June 30, 2012 was lower than in the 2011 period. Paid losses were higher for the 2012 period, including outflows on catastrophic events from 2010 and 2011 and the maturation of our reserves. In addition, receipts from interest and dividend income were lower for the 2012 period due, in part, to changes in investment mix, timing and portfolio yields. The 2012 period also reflected a higher level of cash outflows for operating expenses, primarily due to the timing of certain incentive compensation items. Such amounts were partially offset by a higher level of premium receipts.
- Cash used for investing activities for the six months ended June 30, 2012 was higher than in the 2011 period. The 2012 period included a higher level of purchases and sales of fixed maturity investments than in the 2011 period, an increase in funding for other investments (funding of existing and new investments) and a lower level of securities on loan through our securities lending program, compared to a higher level of securities lending activity in the 2011 period. In addition, during the 2012 period, we sold four individual TALF investments and the related TALF borrowings were extinguished accordingly.
- Cash used for financing activities for the six months ended June 30, 2012 was lower than in the 2011 period. The 2011 period reflected \$266.7 million of share repurchases under our share repurchase program while the 2012 period did not include any repurchase activity. During the 2012 second quarter, we issued \$325 million liquidation value of Series C non-cumulative preferred shares and repurchased all existing Series A and B non-cumulative preferred shares. In addition, as noted above, the 2012 period cash flows reflected a lower financing inflow for securities on loan through our securities lending program than in the 2011 period. In addition, the 2012 period reflected the repayment of \$73.8 million of TALF borrowings.

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

Table of Contents

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.

Our investments in certain securities, including certain fixed income and structured securities, investments in funds accounted for using the equity method, other investments and our investment in Gulf Reinsurance Limited (joint venture) may be illiquid due to contractual provisions or investment market conditions. If we require significant amounts of cash on short notice in excess of anticipated cash requirements, then we may have difficulty selling these investments in a timely manner or may be forced to sell or terminate them at unfavorable values.

On a consolidated basis, our aggregate investable assets totaled \$12.74 billion at June 30, 2012, compared to \$12.32 billion at December 31, 2011. The primary goals of our asset liability management process are to satisfy the insurance liabilities, manage the interest rate risk embedded in those insurance liabilities and maintain sufficient liquidity to cover fluctuations in projected liability cash flows, including debt service obligations. Generally, the expected principal and interest payments produced by our fixed income portfolio adequately fund the estimated runoff of our insurance reserves. Although this is not an exact cash flow match in each period, the substantial degree by which the fair value of the fixed income portfolio exceeds the expected present value of the net insurance liabilities, as well as the positive cash flow from newly sold policies and the large amount of high quality liquid bonds, provide assurance of our ability to fund the payment of claims and to service our outstanding debt without having to sell securities at distressed prices or access credit facilities. Our unfunded investment commitments totaled approximately \$537.0 million at June 30, 2012.

In August 2011, S&P downgraded the United States credit rating from AAA to AA+ with a negative outlook and warned it could lower the credit rating to AA within the next two years if it sees less reduction in spending than agreed to, higher interest rates, or new fiscal pressures during the period that result in a higher general government debt trajectory. In addition, both Moody's Investors Service and Fitch Ratings have announced the possibility of a downgrade to the United States credit rating. The impact of the continuing weakness of the U.S., European countries and other key economies, projected budget deficits for the U.S., European countries and other governments and the consequences associated with possible additional downgrades of securities of the U.S., European countries and other governments by credit rating agencies is inherently unpredictable and could have a material adverse effect on financial markets and economic conditions in the U.S. and throughout the world. In turn, this could have a material adverse effect on our business, financial condition and results of operations and, in particular, this could have a material adverse effect on the value and liquidity of securities in our investment portfolio. Our investment portfolio as of June 30, 2012 included \$1.38 billion of obligations of the U.S. government and government agencies at fair value and \$1.54 billion of municipal bonds at fair value. Please refer to Item 1A Risk Factors of our Annual Report on Form 10-K for the year ended December 31, 2011 for a discussion of other risks relating to our business and investment portfolio.

We expect that our liquidity needs, including our anticipated insurance obligations and operating and capital expenditure needs, for the next twelve months, at a minimum, will be met by funds generated from underwriting activities and investment income, as well as by our balance of cash, short-term investments, proceeds on the sale or maturity of our investments, and our credit facilities.

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

Table of Contents

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.

The board of directors of ACGL has authorized the investment in ACGL's common shares through a share repurchase program. Authorizations have consisted of a \$1.0 billion authorization in February 2007, a \$500.0 million authorization in May 2008, a \$1.0 billion authorization in November 2009 and a \$1.0 billion authorization in February 2011. Since the inception of the share repurchase program through June 30, 2012, ACGL has repurchased 104.8 million common shares for an aggregate purchase price of \$2.56 billion. At June 30, 2012, \$942.0 million of share repurchases were available under the program. Repurchases under the program may be effected from time to time in open market or privately negotiated transactions through December 2012. 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. We will continue to monitor our share price and, depending upon results of operations, market conditions and the development of the economy, as well as other factors, we will consider share repurchases on an opportunistic basis.

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. We can provide no assurance that, if needed, we would be able to obtain additional funds through financing on satisfactory terms or at all. Adverse developments in the financial markets, such as disruptions, uncertainty or volatility in the capital and credit markets, may result in realized and unrealized capital losses that could have a material adverse effect on our results of operations, financial position and our businesses, and may also limit our access to capital required to operate our business.

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, 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 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. As noted above, 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

Table of Contents

shareholders could result, and, in any case, such securities may have rights, preferences and privileges that are senior to those of our outstanding securities.

We purchased asset-backed and commercial mortgage-backed securities under the FRBNY's TALF program. As of June 30, 2012, we had \$307.5 million of securities under TALF which are reflected as TALF investments, at fair value and \$235.8 million of secured financing from the FRBNY which is reflected as TALF borrowings, at fair value. As of December 31, 2011, we had \$387.7 million of TALF investments, at fair value and \$310.5 million of TALF borrowings, at fair value. During the six months ended June 30, 2012, we sold certain TALF investments and the related TALF borrowings were extinguished accordingly.

In August 2011, we entered into a three-year agreement for a \$300 million unsecured revolving loan and letter of credit facility and a \$500 million secured letter of credit facility. Under the terms of the agreement, Arch Reinsurance Company (Arch Re U.S.) and Arch Re Bermuda are limited to issuing \$100 million of unsecured letters of credit as part of the unsecured revolving loan. In addition, we have access to secured letter of credit facilities of approximately \$81 million, which are available on a limited basis and for limited purposes. Refer to note 4, Commitments and Contingencies Letter of Credit and Revolving Credit Facilities, of the notes accompanying our consolidated financial statements for a discussion of our available facilities, applicable covenants on such facilities and available capacity.

In March 2012, ACGL and Arch Capital Group (U.S.) Inc. 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 April 2012, ACGL completed the underwritten public offering of \$325 million of its 6.75% Series C non-cumulative preferred shares. The net proceeds from the offering of approximately \$316 million and other available funds were used to redeem all of ACGL's \$200 million of 8.0% Series A preferred shares and \$125 million of 7.875% Series B preferred shares. The preferred shares were redeemed at a redemption price equal to \$25.00 per share, plus all declared and unpaid dividends to (but excluding) the redemption date. Except in specified circumstances relating to certain tax or corporate events, the Series C non-cumulative preferred shares are not redeemable prior to April 2, 2017. Dividends on the Series C preferred shares are non-cumulative. Consequently, in the event dividends are not declared on the Series C 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 Series C 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 ACGL's board of directors. Any such dividends will be payable from the date of original issue on a non-cumulative basis, quarterly in arrears on the last day of each period. To the extent declared, these dividends will accumulate, with respect to each dividend period, in an amount per share equal to 6.75% of the \$25.00 liquidation preference per annum.

At June 30, 2012, ACGL's capital of \$5.42 billion consisted of \$300.0 million of senior notes, representing 5.5% of the total, \$100.0 million of revolving credit agreement borrowings due in August 2014, representing 1.8% of the total, \$325.0 million of preferred shares, representing 6.0% of the total, and common shareholders' equity of \$4.70 billion, representing the balance. At December 31, 2011, ACGL's capital of \$4.99 billion consisted of \$300.0 million of senior notes, representing 6.0% of the total, \$100.0 million of revolving credit agreement borrowings due in August 2014, representing 2.0% of the total, \$325.0 million of preferred shares, representing 6.5% of the total, and common shareholders' equity of \$4.27 billion, representing the balance. The

Table of Contents

increase in capital during the six months ended June 30, 2012 was primarily attributable to positive underwriting and investment returns.

Off-Balance Sheet Arrangements

Off-balance sheet arrangements are discussed in Management's Discussion and Analysis of Financial Condition and Results of Operations contained in our 2011 Form 10-K.

Market Sensitive Instruments and Risk Management

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 June 30, 2012. Market risk represents the risk of changes in the fair value of a financial instrument and is comprised of several components, including liquidity, basis and price risks. An analysis of material changes in market risk exposures at June 30, 2012 that affect the quantitative and qualitative disclosures presented in our 2011 Form 10-K (see section captioned Management's Discussion and Analysis of Financial Condition and Results of Operations Market Sensitive Instruments and Risk Management) were as follows:

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 fair 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 fair value of our interest rate sensitive securities falls, and the converse is also true. 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. Furthermore, in recent months interest rate movements in many credit sectors have exhibited a much lower correlation to changes in U.S. Treasury yields. Accordingly, the actual effect of interest rate movements may differ materially from the amounts set forth in the following tables.

The following table summarizes the effect that an immediate, parallel shift in the interest rate yield curve would have had on the portfolio at June 30, 2012 and December 31, 2011:

| (U.S. dollars in millions) | Interest Rate Shift in Basis Points | | | | |
|------------------------------------|-------------------------------------|-------------|-------------|-------------|-------------|
| | -100 | -50 | - | 50 | 100 |
| <u>At June 30, 2012</u> | | | | | |
| Total fair value | \$ 12,007.9 | \$ 11,856.6 | \$ 11,713.8 | \$ 11,514.5 | \$ 11,341.8 |
| Change from base | 2.51% | 1.22% | | (1.70)% | (3.18)% |
| Change in unrealized value | \$ 294.1 | \$ 142.8 | \$ | \$ (199.3) | \$ (372.0) |
| <u>At December 31, 2011</u> | | | | | |

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| | | | | | | | | | | |
|----------------------------|----|----------|----|----------|----|----------|----|----------|----|----------|
| Total fair value | \$ | 11,320.9 | \$ | 11,215.5 | \$ | 11,067.5 | \$ | 10,905.6 | \$ | 10,743.4 |
| Change from base | | 2.29% | | 1.34% | | | | (1.46)% | | (2.93)% |
| Change in unrealized value | \$ | 253.4 | \$ | 148.0 | \$ | | \$ | (161.9) | \$ | (324.1) |

In addition, we consider the effect of credit spread movements on the fair value of our fixed maturities, fixed maturities pledged under securities lending agreements, short-term investments and certain of our other investments and investment funds accounted for using the equity method which invest in fixed income securities and the corresponding change in unrealized appreciation. As credit spreads widen, the fair value of our fixed income securities falls, and the converse is also true.

Table of Contents

The following table summarizes the effect that an immediate, parallel shift in credit spreads in a static interest rate environment would have had on the portfolio at June 30, 2012 and December 31, 2011:

| (U.S. dollars in millions) | Credit Spread Shift in Basis Points | | | | |
|-----------------------------|-------------------------------------|-------------|-------------|-------------|-------------|
| | -100 | -50 | - | 50 | 100 |
| At June 30, 2012 | | | | | |
| Total fair value | \$ 11,942.7 | \$ 11,836.4 | \$ 11,713.8 | \$ 11,597.0 | \$ 11,481.1 |
| Change from base | 1.95% | 1.05% | | (1.00)% | (1.99)% |
| Change in unrealized value | \$ 228.9 | \$ 122.6 | \$ | \$ (116.8) | \$ (232.7) |
| At December 31, 2011 | | | | | |
| Total fair value | \$ 11,297.6 | \$ 11,189.3 | \$ 11,067.5 | \$ 10,952.5 | \$ 10,836.4 |
| Change from base | 2.08% | 1.10% | | (1.04)% | (2.09)% |
| Change in unrealized value | \$ 230.1 | \$ 121.8 | \$ | \$ (115.0) | \$ (231.1) |

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 June 30, 2012, our portfolio's VaR was estimated to be 2.92%, compared to an estimated 3.23% at December 31, 2011.

Equity Securities, Privately Held Securities and Other Investments. Our investment portfolio includes an allocation to equity securities, privately held securities and certain other investments. At June 30, 2012 and December 31, 2011, the fair value of our investments in equity securities, privately held securities and certain other investments totaled \$446.9 million and \$508.5 million, respectively. These securities are exposed to price risk, which is the potential loss arising from decreases in fair value. An immediate hypothetical 10% decline in the value of each position would reduce the fair value of such investments by approximately \$44.7 million and \$50.8 million at June 30, 2012 and December 31, 2011, respectively, and would have decreased book value per common share by approximately \$0.33 and \$0.38, respectively. An immediate hypothetical 10% increase in the value of each position would increase the fair value of such investments by approximately \$44.7 million and \$50.8 million at June 30, 2012 and December 31, 2011, respectively, and would have increased book value per common share by approximately \$0.33 and \$0.38, respectively.

Investment-Related Derivatives. 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. See note 9, Derivative Instruments, of the notes accompanying our consolidated financial statements for additional disclosures concerning derivatives. At June 30, 2012, the notional value of the net long position of derivative instruments (excluding to-be-announced mortgage backed securities which are included in the fixed income securities analysis above and foreign currency forward contracts which are included in the foreign currency exchange risk analysis below) was \$526.7 million, compared to \$877.9 million at December 31, 2011. A 100 basis point depreciation of the underlying exposure to these derivative instruments at June 30, 2012 and December 31, 2011 would have resulted in a reduction in net income of approximately \$5.3 million and \$8.8 million, respectively, and would have decreased book value per common share by \$0.04 and \$0.07, respectively. A 100 basis point appreciation of the underlying exposure to these derivative instruments at June 30, 2012 and December 31, 2011 would have resulted in an increase in net income of approximately \$5.3 million and \$8.8 million, respectively, and would have increased book value per common share by \$0.04 and \$0.07, respectively.

Table of Contents

For further discussion on investment activity, please refer to Financial Condition, Liquidity and Capital Resources Financial Condition Investable Assets.

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. Through our subsidiaries and branches located in various foreign countries, we conduct our insurance and reinsurance operations in a variety of local currencies other than the U.S. Dollar. We generally hold investments in foreign currencies which are intended to mitigate our exposure to foreign currency fluctuations in our net insurance liabilities. We may also utilize foreign currency forward contracts and currency options as part of our investment strategy. See Note 9, Derivative Instruments, of the notes accompanying our consolidated financial statements for additional information.

The following table provides a summary of our net foreign currency exchange exposures, as well as foreign currency derivatives in place to manage these exposures, at June 30, 2012 and December 31, 2011:

| (U.S. dollars in thousands, except per share data) | June 30, 2012 | December 31, 2011 |
|-------------------------------------------------------------------------------------------------------------------------|------------------|----------------------|
| Assets, net of insurance liabilities, denominated in foreign currencies, excluding shareholders' equity and derivatives | \$ 125,402 | \$ 143,731 |
| Shareholders' equity denominated in foreign currencies (1) | 249,109 | 247,135 |
| Net foreign currency forward contracts outstanding (2) | (59,635) | (16,569) |
| Net exposures denominated in foreign currencies | \$ 314,876 | \$ 374,327 |
| Pre-tax impact of a hypothetical 10% appreciation of the U.S. Dollar against foreign currencies: | | |
| Shareholders' equity | \$ (31,488) | \$ (37,433) |
| Book value per common share | \$ (0.23) | \$ (0.28) |
| Pre-tax impact of a hypothetical 10% decline of the U.S. Dollar against foreign currencies: | | |
| Shareholders' equity | \$ 31,488 | \$ 37,433 |
| Book value per common share | \$ 0.23 | \$ 0.28 |

(1) Represents capital contributions held in the foreign currencies of our operating units.

(2) Notional value of the outstanding foreign currency forward contracts in U.S. Dollars.

As a result of the current financial and economic environment as well as the potential for additional investment returns, we may not match a portion of our projected liabilities in foreign currencies with investments in the same currencies, which would increase our exposure to foreign currency fluctuations and increase the volatility in our results of operations. 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.

Cautionary Note Regarding Forward-Looking Statements

The Private Securities Litigation Reform Act of 1995 (PSLRA) provides a safe harbor for forward-looking statements. This release or any other written or oral statements made by or on behalf of us may include forward-looking statements, which reflect our current views with respect to future events and financial performance. All statements other than statements of historical fact included in or incorporated by reference in this release are forward-looking statements. Forward-looking statements, for purposes of the PSLRA or otherwise, can generally be identified by the use of forward-looking terminology such as may, will,

Table of Contents

expect, intend, estimate, anticipate, believe or continue and similar statements of a future or forward-looking nature or their negative or variations or similar terminology.

Forward-looking statements involve our current assessment of risks and uncertainties. Actual events and results may differ materially from those expressed or implied in these statements. Important factors that could cause actual events or results to differ materially from those indicated in such statements are discussed below and elsewhere in this release and in our periodic reports filed with the Securities and Exchange Commission (the SEC), and include:

- our ability to successfully implement its business strategy during soft as well as hard markets;
- acceptance of our business strategy, security and financial condition by rating agencies and regulators, as well as by brokers and our insureds and reinsureds;
- our ability to maintain or improve our ratings, which may be affected by our ability to raise additional equity or debt financings, by ratings agencies existing or new policies and practices, as well as other factors described herein;
- general economic and market conditions (including inflation, interest rates, foreign currency exchange rates, prevailing credit terms and the depth and duration of a recession) and conditions specific to the reinsurance and insurance markets (including the length and magnitude of the current soft market) in which we operate;
- competition, including increased competition, on the basis of pricing, capacity, coverage terms or other factors;
- developments in the world's financial and capital markets and our access to such markets;
- our ability to successfully enhance, integrate and maintain operating procedures (including information technology) to effectively support our current and new business;
- the loss of key personnel;
- the integration of businesses we have acquired or may acquire into our existing operations;

- accuracy of those estimates and judgments utilized in the preparation of our financial statements, including those related to revenue recognition, insurance and other reserves, reinsurance recoverables, investment valuations, intangible assets, bad debts, income taxes, contingencies and litigation, and any determination to use the deposit method of accounting, which 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 relatively limited historical information has been reported to us through June 30, 2012;
- greater than expected loss ratios on business written by us and adverse development on claim and/or claim expense liabilities related to business written by our insurance and reinsurance subsidiaries;
- severity and/or frequency of losses;
- claims for natural or man-made catastrophic events in our insurance or reinsurance business could cause large losses and substantial volatility in our results of operations;
- acts of terrorism, political unrest and other hostilities or other unforecasted and unpredictable events;
- availability to us of reinsurance to manage our gross and net exposures and the cost of such reinsurance;
- the failure of reinsurers, managing general agents, third party administrators or others to meet their obligations to us;
- the timing of loss payments being faster or the receipt of reinsurance recoverables being slower than anticipated by us;
- our investment performance, including legislative or regulatory developments that may adversely affect the fair value of our investments;

Table of Contents

- the impact of the continued weakness of the U.S., European countries or other key economies, projected budget deficits for the U.S., European countries and other governments and the consequences associated with possible additional downgrades of securities of the U.S., European countries and other governments by credit rating agencies, and the resulting effect on the value of securities in our investment portfolio as well as the uncertainty in the market generally;
- losses relating to aviation business and business produced by a certain managing underwriting agency for which we may be liable to the purchaser of its prior reinsurance business or to others in connection with the May 5, 2000 asset sale described in our periodic reports filed with the SEC;
- changes in accounting principles or policies or in our application of such accounting principles or policies;
- changes in the political environment of certain countries in which we operates, underwrites business or invests;
- statutory or regulatory developments, including as to tax policy matters and insurance and other regulatory matters such as the adoption of proposed legislation that would affect Bermuda-headquartered companies and/or Bermuda-based insurers or reinsurers and/or changes in regulations or tax laws applicable to us, our subsidiaries, brokers or customers; and
- the other matters set forth under Item 1A Risk Factors , Item 7 Management 's Discussion and Analysis of Financial Condition and Results of Operations and other sections of our Annual Report on Form 10-K, as well as the other factors set forth in our other documents on file with the SEC, and management 's response to any of the aforementioned factors.

All subsequent written and oral forward-looking statements attributable to us or persons acting on our behalf are expressly qualified in their entirety by these cautionary statements. The foregoing review of important factors should not be construed as exhaustive and should be read in conjunction with other cautionary statements that are included herein or elsewhere. We undertake no obligation to publicly update or revise any forward-looking statement, whether as a result of new information, future events or otherwise.

Other Financial Information

The consolidated financial statements as of June 30, 2012 and for the three month periods ended June 30, 2012 and 2011 have been reviewed by PricewaterhouseCoopers LLP, an independent registered public accounting firm. Their report (dated August 8, 2012) is included on page 2. The report of PricewaterhouseCoopers LLP states that they did not audit and they do not express an opinion on that unaudited financial information. Accordingly, the degree of reliance on their report on such information should be restricted in light of the limited nature of the review procedures applied. PricewaterhouseCoopers LLP is not subject to the liability provisions of Section 11 of the Securities Act of 1933 for their report on the unaudited financial information because that report is not a report or a part of the registration statement prepared or certified by PricewaterhouseCoopers LLP within the meaning of Sections 7 and 11 of the Securities Act of 1933.

Table of Contents

ITEM 3. 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 Operations," which information is hereby incorporated by reference.

ITEM 4. CONTROLS AND PROCEDURES

Evaluation of Disclosure Controls and Procedures

In connection with the filing of this Form 10-Q, our management, including the Chief Executive Officer and Chief Financial Officer, conducted an evaluation of the effectiveness of disclosure controls and procedures pursuant to applicable Exchange Act Rules as of the end of the period covered by this report. Based on that evaluation, the Chief Executive Officer and Chief Financial Officer concluded that the disclosure controls and procedures were effective as of the end of and during the period covered by this report with respect to information being recorded, processed, summarized and reported within time periods specified in the SEC's rules and forms and with respect to timely communication to them and other members of management responsible for preparing periodic reports of all material information required to be disclosed in this report as it relates to ACGL and its consolidated subsidiaries.

We continue to enhance our operating procedures and internal controls 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.

Table of Contents**Changes in Internal Controls Over Financial Reporting**

There have been no changes in internal control over financial reporting that occurred during the fiscal quarter ended June 30, 2012 that have materially affected, or are reasonably likely to materially affect, internal control over financial reporting.

PART II. OTHER INFORMATION***Item 1. 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 June 30, 2012, we were not a party to any litigation or arbitration which is expected by management to have a material adverse effect on our results of operations and financial condition and liquidity.

Item 2. Unregistered Sales of Equity Securities and Use of Proceeds

The following table summarizes our purchases of our common shares for the 2012 second quarter:

| (U.S. dollars in thousands, except share data) Period | Issuer Purchases of Equity Securities | | | Total Number of Shares Purchased as Part of Publicly Announced Plans or Programs (2) | Approximate Dollar Value of Shares that May Yet be Purchased Under the Plan or Programs |
|-------------------------------------------------------------|--------------------------------------------|---------------------------------|--|--------------------------------------------------------------------------------------------------|-----------------------------------------------------------------------------------------------------|
| | Total Number of Shares Purchased (1) | Average Price Paid per Share | | | |
| 4/1/2012-4/30/2012 | 2,159 | \$ 38.90 | | | \$ 941,967 |
| 5/1/2012-5/31/2012 | 156,362 | 39.10 | | | \$ 941,967 |
| 6/1/2012-6/30/2012 | 13,634 | 37.71 | | | \$ 941,967 |
| Total | 172,155 | \$ 38.99 | | | \$ 941,967 |

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

(2) The board of directors of ACGL has authorized the investment 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 December 2012. Since the inception of the share repurchase program, ACGL has repurchased approximately 104.8 million common shares for an aggregate purchase price of \$2.56 billion. 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.

Item 5. Other Information

In accordance with Section 10a(i)(2) of the Securities Exchange Act of 1934, as amended, we are responsible for disclosing non-audit services to be provided by our independent auditor, PricewaterhouseCoopers LLP, which are approved by the Audit Committee of our board of directors. During the 2012 second quarter, the Audit Committee approved engagements of PricewaterhouseCoopers LLP for permitted non-audit services, substantially all of which consisted of tax services, tax consulting and tax compliance.

Table of Contents

Item 6. Exhibits

| Exhibit No. | Description |
|-------------|--------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|
| 10.1 | Restricted Share Agreements with Arch Capital Group Ltd. substantially in the form signed by the Non-Employee Directors of Arch Capital Group Ltd. for May 9, 2012 grants |
| 10.2 | Employment Agreement, dated as of July 25, 2012, between Arch Capital Group Ltd. and Mark D. Lyons (a) |
| 10.3 | Employment Agreement, dated as of June 5, 2009, between Arch Insurance Group Inc. and David McElroy |
| 10.4 | Amendment, dated as of July 25, 2012, to the Employment Agreement, dated as of June 5, 2009, between Arch Insurance Group Inc. and David McElroy |
| 10.5 | Resignation Letter of John Hele, dated July 24, 2012 (a) |
| 15 | Accountants Awareness Letter (regarding unaudited interim financial information) |
| 31.1 | Certification of Chief Executive Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002 |
| 31.2 | Certification of Chief Financial Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002 |
| 32.1 | Certification of Chief Executive Officer pursuant to Section 906 of the Sarbanes-Oxley Act of 2002 |
| 32.2 | Certification of Chief Financial Officer pursuant to Section 906 of the Sarbanes-Oxley Act of 2002 |
| 101 | The following financial information from Arch Capital Group Ltd. s Quarterly Report for the quarter ended June 30, 2012 formatted in XBRL: (i) Consolidated Balance Sheets at June 30, 2012 and December 31, 2011; (ii) Consolidated Statements of Income for the three and six month periods ended June 30, 2012 and 2011; (iii) Consolidated Statements of Comprehensive Income for the six month periods ended June 30, 2012 and 2011; (iv) Consolidated Statements of Changes in Shareholders Equity for the six month periods ended June 30, 2012 and 2011; (v) Consolidated Statements of Cash Flows for the six month periods ended June 30, 2012 and 2011; and (vi) Notes to Consolidated Financial Statements.* |

(a) Filed as an exhibit to our Report on Form 8-K, as filed with the SEC on July 30, 2012, and incorporated by reference.

* This exhibit will not be deemed filed for the purposes of Section 18 of the Securities Exchange Act of 1934 (15 U.S.C. 78r) , or otherwise subject to the liability of that section. Such exhibit will not be deemed to be incorporated by reference into any filing under the Securities Act or Securities Exchange Act, except to the extent that Arch Capital Group Ltd. specifically incorporates it by reference.

Table of Contents

SIGNATURES

Pursuant to the requirements 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)**

Date: August 8, 2012

/s/ Constantine Iordanou
Constantine Iordanou
President and Chief Executive Officer (Principal Executive Officer)
and Chairman of the Board of Directors

Date: August 8, 2012

/s/ John C.R. Hele
John C.R. Hele
Executive Vice President, Chief Financial Officer and Treasurer
(Principal Financial and Accounting Officer)

Table of Contents

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