

ARCH CAPITAL GROUP LTD.  
Form 10-Q  
August 08, 2007

**UNITED STATES  
SECURITIES AND EXCHANGE COMMISSION**

Washington, D.C. 20549

**FORM 10-Q**

(Mark One)

**x**

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

**For the quarterly period ended June 30, 2007**

**Or**

**o**

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

**For the transition period** to

**Commission file number: 0-26456**

**ARCH CAPITAL GROUP LTD.**

(Exact name of registrant as specified in its charter)

**Bermuda**

(State or other jurisdiction of incorporation  
or organization)

**Not Applicable**

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

**Wessex House, 45 Reid Street**

**Hamilton HM 12, Bermuda**

(Address of principal executive offices)

**(441) 278-9250**

(Zip Code)

Registrant's telephone number, including area code:

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

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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 is a large accelerated filer, an accelerated filer, or a non-accelerated filer. See definition of accelerated filer and large accelerated filer in Rule 12b-2 of the Exchange Act.

Large Accelerated Filer ☒ Accelerated Filer ☐ Non-Accelerated Filer ☐

Indicate by check mark whether the Registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act).

Yes ☐ No ☒

Indicate the number of shares outstanding of each of the issuer's classes of common shares as of the latest practicable date.

<b>Class</b>	<b>Outstanding at July 31, 2007</b>
Common Shares, \$0.01 par value	70,869,221

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ARCH CAPITAL GROUP LTD.

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**Report of Independent Registered Public Accounting Firm**

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

We have reviewed the accompanying consolidated balance sheet of Arch Capital Group Ltd. and its subsidiaries (the Company) as of June 30, 2007, and the related consolidated statements of income for each of the three-month and six-month periods ended June 30, 2007 and 2006, and the consolidated statements of changes in shareholders' equity, comprehensive income and cash flows for each of the six-month periods ended June 30, 2007 and 2006. 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, 2006, and the related consolidated statements of income, changes in shareholders' equity, comprehensive income, and cash flows for the year then ended (not presented herein), and in our report dated February 28, 2007 we expressed an unqualified opinion on those consolidated financial statements. In our opinion, the information set forth in the accompanying consolidated balance sheet information as of December 31, 2006, is fairly stated in all material respects in relation to the consolidated balance sheet from which it has been derived.

/s/ PricewaterhouseCoopers LLP  
New York, New York  
August 8, 2007

**ARCH CAPITAL GROUP LTD. AND SUBSIDIARIES**  
**CONSOLIDATED BALANCE SHEETS**  
(U.S. dollars in thousands, except share data)

	(Unaudited) June 30, 2007	December 31, 2006
<b>Assets</b>		
Investments:		
Fixed maturities available for sale, at fair value (amortized cost: 2007, \$6,972,705; 2006, \$6,858,970)	\$ 6,923,478	\$ 6,876,548
Short-term investments available for sale, at fair value (amortized cost: 2007, \$1,110,053; 2006, \$956,926)	1,114,485	957,698
Short-term investment of funds received under securities lending agreements, at fair value	1,114,959	891,376
Other investments (cost: 2007, \$429,486; 2006, \$282,923)	461,835	307,082
<b>Total investments</b>	<b>9,614,757</b>	<b>9,032,704</b>
Cash	245,143	317,017
Accrued investment income	71,064	68,440
Fixed maturities and short-term investments pledged under securities lending agreements, at fair value	1,085,757	860,803
Premiums receivable	1,041,921	749,961
Funds held by reinsureds	79,335	82,385
Unpaid losses and loss adjustment expenses recoverable	1,545,820	1,552,157
Paid losses and loss adjustment expenses recoverable	131,441	122,149
Prepaid reinsurance premiums	544,137	470,138
Deferred income tax assets, net	70,688	63,606
Deferred acquisition costs, net	309,651	290,999
Receivable for securities sold	54,954	190,168
Other assets	499,100	511,940
<b>Total Assets</b>	<b>\$ 15,293,768</b>	<b>\$ 14,312,467</b>
<b>Liabilities</b>		
Reserve for losses and loss adjustment expenses	\$ 6,782,433	\$ 6,463,041
Unearned premiums	2,001,736	1,791,922
Reinsurance balances payable	382,488	301,679
Senior notes	300,000	300,000
Deposit accounting liabilities	43,559	45,107
Securities lending collateral	1,114,959	891,376
Payable for securities purchased	434,624	418,109
Other liabilities	529,902	510,614
<b>Total Liabilities</b>	<b>11,589,701</b>	<b>10,721,848</b>
<b>Commitments and Contingencies</b>		
<b>Shareholders' Equity</b>		
Non-cumulative preferred shares (\$0.01 par value, 50,000,000 shares authorized)		
- Series A (issued: 2007 and 2006, 8,000,000)	80	80
- Series B (issued: 2007 and 2006, 5,000,000)	50	50
Common shares (\$0.01 par value, 200,000,000 shares authorized, issued: 2007, 71,273,285; 2006, 74,270,466)	713	743
Additional paid-in capital	1,716,295	1,944,304
Retained earnings	1,993,963	1,596,018
Accumulated other comprehensive income (loss), net of deferred income tax	(7,034)	49,424
<b>Total Shareholders' Equity</b>	<b>3,704,067</b>	<b>3,590,619</b>
<b>Total Liabilities and Shareholders' Equity</b>	<b>\$ 15,293,768</b>	<b>\$ 14,312,467</b>

See Notes to Consolidated Financial Statements



**ARCH CAPITAL GROUP LTD. AND SUBSIDIARIES**  
**CONSOLIDATED STATEMENTS OF INCOME**  
(U.S. dollars in thousands, except share data)

	(Unaudited) Three Months Ended June 30, 2007		(Unaudited) Six Months Ended June 30, 2007	
		2006		2006
Revenues				
Net premiums written	\$ 757,895	\$ 794,558	\$ 1,629,640	\$ 1,668,277
(Increase) decrease in unearned premiums	(6,483 )	2,892	(132,735 )	(109,226 )
Net premiums earned	751,412	797,450	1,496,905	1,559,051
Net investment income	117,299	90,503	229,988	170,829
Net realized losses	(3,757 )	(32,202 )	(4,738 )	(35,585 )
Fee income	2,091	3,468	4,060	5,273
Other income	265		869	
Total revenues	867,310	859,219	1,727,084	1,699,568
Expenses				
Losses and loss adjustment expenses	425,663	462,255	845,724	930,433
Acquisition expenses	117,277	148,581	237,405	278,253
Other operating expenses	100,505	84,367	191,318	167,344
Interest expense	5,523	5,651	11,046	11,206
Net foreign exchange losses	6,450	1,146	16,192	11,399
Total expenses	655,418	702,000	1,301,685	1,398,635
Income before income taxes	211,892	157,219	425,399	300,933
Income tax expense	6,037	14,332	14,532	25,756
Net income	205,855	142,887	410,867	275,177
Preferred dividends	6,461	5,039	12,922	7,706
Net income available to common shareholders	\$ 199,394	\$ 137,848	\$ 397,945	\$ 267,471
Net income per common share				
Basic	\$ 2.75	\$ 1.88	\$ 5.44	\$ 3.66
Diluted	\$ 2.65	\$ 1.81	\$ 5.24	\$ 3.52
Weighted average common shares and common share equivalents outstanding				
Basic	72,494,823	73,188,101	73,209,439	73,044,473
Diluted	75,254,846	76,155,438	75,947,858	76,014,819

See Notes to Consolidated Financial Statements

**ARCH CAPITAL GROUP LTD. AND SUBSIDIARIES**  
**CONSOLIDATED STATEMENTS OF CHANGES IN SHAREHOLDERS' EQUITY**  
(U.S. dollars in thousands)

	(Unaudited) Six Months Ended June 30, 2007	2006
<b>Non-Cumulative Preferred Shares</b>		
Balance at beginning of period	\$ 130	\$
Preferred shares issued		130
Balance at end of period	130	130
<b>Common Shares</b>		
Balance at beginning of year	743	733
Common shares issued, net	6	6
Purchases of common shares under share repurchase program	(36 )	
Balance at end of period	713	739
<b>Additional Paid-in Capital</b>		
Balance at beginning of year	1,944,304	1,595,440
Cumulative effect of change in accounting for unearned stock grant compensation		(9,646 )
Series A non-cumulative preferred shares issued		193,388
Series B non-cumulative preferred shares issued		120,866
Common shares issued	405	410
Exercise of stock options	13,373	15,572
Common shares retired	(257,162 )	(658 )
Amortization of share-based compensation	14,457	7,510
Other	918	274
Balance at end of period	1,716,295	1,923,156
<b>Deferred Compensation Under Share Award Plan</b>		
Balance at beginning of year		(9,646 )
Cumulative effect of change in accounting for unearned stock grant compensation		9,646
Balance at end of period		
<b>Retained Earnings</b>		
Balance at beginning of year	1,593,907	901,348
Adjustment to adopt SFAS No. 155, <i>Accounting for Certain Hybrid Financial Instruments an amendment of FASB Statements No. 133 and 140</i>	2,111	
Balance at beginning of year, as adjusted	1,596,018	901,348
Dividends declared on preferred shares	(12,922 )	(7,706 )
Net income	410,867	275,177
Balance at end of period	1,993,963	1,168,819
<b>Accumulated Other Comprehensive Income (Loss)</b>		
Balance at beginning of year	51,535	(7,348 )
Adjustment to adopt SFAS No. 155, <i>Accounting for Certain Hybrid Financial Instruments an amendment of FASB Statements No. 133 and 140</i>	(2,111 )	
Balance at beginning of year, as adjusted	49,424	(7,348 )
Change in unrealized appreciation (decline) in value of investments, net of deferred income tax	(67,513 )	(64,272 )
Foreign currency translation adjustments, net of deferred income tax	11,055	(5,444 )
Balance at end of period	(7,034 )	(77,064 )
<b>Total Shareholders' Equity</b>	<b>\$ 3,704,067</b>	<b>\$ 3,015,780</b>

See Notes to Consolidated Financial Statements





ARCH CAPITAL GROUP LTD. AND SUBSIDIARIES

CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME

(U.S. dollars in thousands)

	(Unaudited) Six Months Ended June 30,	
	2007	2006
<b>Comprehensive Income</b>		
Net income	\$ 410,867	\$ 275,177
Other comprehensive loss, net of deferred income tax		
Unrealized decline in value of investments:		
Unrealized holding losses arising during period	(72,486 )	(97,560 )
Reclassification of net realized losses, net of income taxes, included in net income	4,973	33,288
Foreign currency translation adjustments	11,055	(5,444 )
<b>Other comprehensive loss</b>	(56,458 )	(69,716 )
<b>Comprehensive Income</b>	<b>\$ 354,409</b>	<b>\$ 205,461</b>

See Notes to Consolidated Financial Statements

**ARCH CAPITAL GROUP LTD. AND SUBSIDIARIES**  
**CONSOLIDATED STATEMENTS OF CASH FLOWS**  
**(U.S. dollars in thousands)**

	(Unaudited) Six Months Ended June 30, 2007	2006
<b>Operating Activities</b>		
Net income	\$ 410,867	\$ 275,177
Adjustments to reconcile net income to net cash provided by operating activities:		
Net realized losses	4,854	35,673
Other income	(869 )	
Share-based compensation	14,457	7,510
Changes in:		
Reserve for losses and loss adjustment expenses, net of unpaid losses and loss adjustment expenses recoverable	324,793	473,996
Unearned premiums, net of prepaid reinsurance premiums	135,525	117,298
Premiums receivable	(290,437 )	(224,498 )
Deferred acquisition costs, net	(18,702 )	(5,971 )
Funds held by reinsureds	3,050	82,879
Reinsurance balances payable	79,254	105,193
Deferred income tax assets, net	(3,757 )	(5,555 )
Other liabilities	1,737	18,331
Other items, net	16,231	(56,879 )
<b>Net Cash Provided By Operating Activities</b>	677,003	823,154
<b>Investing Activities</b>		
Purchases of fixed maturity investments	(8,933,304 )	(8,196,081 )
Proceeds from sales of fixed maturity investments	8,407,340	7,440,922
Proceeds from redemptions and maturities of fixed maturity investments	305,847	96,360
Purchases of other investments	(185,357 )	(63,813 )
Proceeds from sales of other investments	62,309	6,062
Net purchases of short-term investments	(141,217 )	(279,297 )
Change in securities lending collateral	(223,583 )	131,153
Purchases of furniture, equipment and other	(8,998 )	(8,679 )
<b>Net Cash Used For Investing Activities</b>	(716,963 )	(873,373 )
<b>Financing Activities</b>		
Purchases of common shares under share repurchase program	(254,973 )	
Proceeds from common shares issued, net	7,427	11,212
Proceeds from preferred shares issued, net of issuance costs		314,538
Change in securities lending collateral	223,583	(131,153 )
Excess tax benefits from share-based compensation	3,965	3,143
Preferred dividends paid	(12,922 )	(4,622 )
<b>Net Cash Provided By Financing Activities</b>	(32,920 )	193,118
Effects of exchange rate changes on foreign currency cash	1,006	997
(Decrease) increase in cash	(71,874 )	143,896
Cash beginning of year	317,017	222,477
<b>Cash end of period</b>	<b>\$ 245,143</b>	<b>\$ 366,373</b>
Income taxes paid, net	\$ 1,881	\$ 32,407
Interest paid	\$ 11,025	\$ 11,067

See Notes to Consolidated Financial Statements



**ARCH CAPITAL GROUP LTD. AND SUBSIDIARIES**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

**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, 2006, including the Company's audited consolidated financial statements and related notes and the section entitled Risk Factors.

To facilitate period-to-period comparisons, certain amounts in the 2006 consolidated financial statements have been reclassified to conform to the 2007 presentation. Such reclassifications had no effect on the Company's consolidated net income.

**2. Share Transactions**

*Share Repurchase Program*

On February 28, 2007, ACGL's board of directors authorized the investment of up to \$1 billion in ACGL's common shares through a share repurchase program. Repurchases under the program may be effected from time to time in open market or privately negotiated transactions through February 2009. During the 2007 second quarter and six months ended June 30, 2007, ACGL repurchased approximately 3.0 million and 3.6 million common shares, respectively, for an aggregate purchase price of \$210.5 million and \$255.0 million, respectively. As a result of share repurchase transactions through June 30, 2007, book value per common share was reduced by \$1.10 per share at June 30, 2007 and weighted average shares outstanding for the 2007 second quarter and six months ended June 30, 2007 were reduced by 1.8 million and 1.0 million shares, respectively. The timing and amount of the repurchase transactions under this program will depend on a variety of factors, including market conditions and corporate and regulatory considerations. In connection with the repurchase program, the Warburg Pincus funds waived their rights relating to share repurchases under its shareholders agreement with ACGL for all repurchases of common shares by ACGL under the repurchase program in open market transactions and certain privately negotiated transactions.

### *Non-Cumulative Preferred Shares*

During 2006, ACGL completed two public offerings of non-cumulative preferred shares ( Preferred Shares ). On February 1, 2006, \$200.0 million principal amount of 8.0% series A non-cumulative preferred shares ( Series A Preferred Shares ) were issued with net proceeds of \$193.5 million and, on May 24, 2006, \$125.0 million principal amount of 7.875% series B non-cumulative preferred shares ( Series B Preferred Shares ) were issued with net proceeds of \$120.9 million. The net proceeds of the offerings were used to support the underwriting activities of ACGL's insurance and reinsurance subsidiaries. ACGL has the right to redeem all or a portion of each series of Preferred Shares at a redemption price of \$25.00 per share on or after (1) February 1, 2011 for the Series A Preferred Shares and (2) May 15, 2011 for the Series B Preferred Shares. Dividends on the Preferred Shares are non-cumulative. Consequently, in the event dividends are not declared on the Preferred Shares for any dividend period, holders of Preferred Shares will not be entitled to receive a dividend for such period, and such undeclared dividend will not accrue and will not be payable. Holders of Preferred Shares will be entitled to receive dividend payments only when, as and if declared by ACGL's board of directors or a duly authorized committee of the board of directors. Any such dividends will be payable from the date of original issue on a non-cumulative basis, quarterly in arrears. To the extent declared, these dividends will accumulate, with respect to each dividend period, in an amount per share equal to 8.0% of the \$25.00 liquidation preference per annum for the Series A Preferred Shares and 7.875% of the \$25.00 liquidation preference per annum for the Series B Preferred Shares. At June 30, 2007, the Company had declared an aggregate of \$3.3 million of dividends to be paid (subject to certain conditions) to holders of the Preferred Shares.

### *Share-Based Compensation*

As required by the provisions of Financial Accounting Standards Board ( FASB ) Statement No. 123 (revised 2004), Share-Based Payment ( SFAS No. 123(R) ), the Company recorded after-tax share-based compensation expense related to stock options in the 2007 second quarter of \$2.8 million, or \$0.04 per diluted share, compared to \$1.7 million, or \$0.02 per diluted share, in the 2006 second quarter, and \$4.4 million, or \$0.06 per diluted share, for the six months ended June 30, 2007, compared to \$2.8 million, or \$0.04 per diluted share, for the six months ended June 30, 2006.

During the 2007 second quarter, the Company made a stock grant of 323,630 stock appreciation rights and stock options and 323,480 restricted shares and units to certain employees. The stock appreciation rights and stock options were valued at the grant date using the Black-Scholes option pricing model. The weighted average grant-date fair value of the stock appreciation rights and options and restricted shares and units granted were approximately \$22.50 and \$69.97 per share, respectively. Such value will be amortized over the respective substantive vesting period.

### 3. Debt and Financing Arrangements

#### *Senior Notes*

On May 4, 2004, ACGL completed a public offering of \$300 million principal amount of 7.35% senior notes ( Senior Notes ) due May 1, 2034 and received net proceeds of \$296.4 million. ACGL used \$200 million of the net proceeds to repay all amounts outstanding under a revolving credit agreement. The Senior Notes are ACGL's senior unsecured obligations and rank equally with all of its existing and future senior unsecured indebtedness. Interest payments on the Senior Notes are due on May 1st and November 1st of each year. ACGL may redeem the Senior Notes at any time and from time to time, in whole or in part, at a make-whole redemption price. For the six months ended June 30, 2007 and 2006, interest expense on the Senior Notes was approximately \$11.0 million. The market value of the Senior Notes at June 30, 2007 and December 31, 2006 was \$318.0 million and \$332.0 million, respectively.

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

As of June 30, 2007, the Company had a \$300 million unsecured revolving loan and letter of credit facility and a \$1.0 billion secured letter of credit facility. The \$300 million unsecured revolving loan is also available for the issuance of unsecured letters of credit up to \$100 million for Arch Reinsurance Company ( Arch Re U.S. ). Borrowings of revolving loans may be made by ACGL and Arch Re U.S. at a variable rate based on LIBOR or an alternative base rate at the option of the Company. Secured letters of credit are available for issuance on behalf of the Company's insurance and reinsurance subsidiaries. Issuance of letters of credit and borrowings under the Credit Agreement are subject to the Company's compliance with certain covenants and conditions, including absence of a material adverse change. These covenants require, among other things, that the Company maintain a debt to shareholders' equity ratio of not greater than 0.35 to 1 and shareholders' equity in excess of \$1.95 billion plus 25% of future aggregate net income for each quarterly period (not including any future net losses) beginning after June 30, 2006 and 25% of future aggregate proceeds from the issuance of common or preferred equity and that the Company's principal insurance and reinsurance subsidiaries maintain at least a B++ rating from A.M. Best. In addition, certain of the Company's subsidiaries which are party to the Credit Agreement are required to maintain minimum shareholders' equity levels. The Company was in compliance with all covenants contained in the Credit Agreement at June 30, 2007. The Credit Agreement expires on August 30, 2011.

Including the secured letter of credit portion of the Credit Agreement and another letter of credit facility (together, the LOC Facilities ), the Company has access to letter of credit facilities for up to a total of \$1.45 billion. The principal purpose of the LOC Facilities is to issue, as required, evergreen standby letters of credit in favor of primary insurance or reinsurance counterparties with which the Company has entered into reinsurance arrangements to ensure that such counterparties are permitted to take credit for reinsurance obtained from the Company's reinsurance subsidiaries in United States jurisdictions where such subsidiaries are not licensed or otherwise admitted as an insurer, as required under insurance regulations in the United States, and to comply with requirements of Lloyd's of London in connection with qualifying quota share and other arrangements. The amount of letters of credit issued is driven by, among other things, the timing and payment of catastrophe losses, loss development of existing reserves, the payment pattern of such reserves, the further expansion of the Company's business and the loss experience of such business. When issued, certain letters of credit are secured by a portion of the Company's investment portfolio. In addition, the LOC Facilities also require the maintenance of certain covenants, which the Company was in compliance with at June 30, 2007. At such date, the Company had approximately \$617.0 million in outstanding letters of credit under the LOC Facilities, which were secured by investments totaling \$653.7 million. The other letter of credit facility was amended and restated in December 2006. It is anticipated that the LOC Facilities will be renewed (or replaced) on expiry, but such renewal (or replacement) will be subject to the availability of credit from banks which the Company utilizes. In addition to letters of credit, the Company has and may establish insurance trust accounts in the U.S. and Canada to secure its reinsurance amounts payable as required.

#### 4. Segment Information

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

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

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

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

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



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

(U.S. dollars in thousands)	(Unaudited) Three Months Ended June 30, 2007					
	Insurance		Reinsurance		Total	
Gross premiums written(1)	\$ 684,725		\$ 427,348		\$ 1,102,210	
Net premiums written(1)	451,828		306,067		757,895	
Net premiums earned(1)	\$ 432,560		\$ 318,852		\$ 751,412	
Fee income	1,276		815		2,091	
Losses and loss adjustment expenses	(272,658 )		(153,005 )		(425,663 )	
Acquisition expenses, net	(47,532 )		(69,745 )		(117,277 )	
Other operating expenses	(70,269 )		(19,999 )		(90,268 )	
Underwriting income	\$ 43,377		\$ 76,918		120,295	
Net investment income					117,299	
Net realized losses					(3,757 )	
Other income					265	
Other expenses					(10,237 )	
Interest expense					(5,523 )	
Net foreign exchange losses					(6,450 )	
Income before income taxes					211,892	
Income tax expense					(6,037 )	
Net income					205,855	
Preferred dividends					(6,461 )	
Net income available to common shareholders					\$ 199,394	
Underwriting Ratios						
Loss ratio	63.0	%	48.0	%	56.6	%
Acquisition expense ratio(2)	10.8	%	21.9	%	15.5	%
Other operating expense ratio	16.2	%	6.3	%	12.0	%
Combined ratio	90.0	%	76.2	%	84.1	%

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

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

(U.S. dollars in thousands)	(Unaudited) Three Months Ended June 30, 2006					
	Insurance		Reinsurance		Total	
Gross premiums written (1)	\$	647,817	\$	499,241	\$	1,136,274
Net premiums written (1)		409,302		385,256		794,558
Net premiums earned (1)	\$	385,877	\$	411,573	\$	797,450
Fee income		1,253		2,215		3,468
Losses and loss adjustment expenses	(251,172	)	(211,083	)	(462,255	)
Acquisition expenses, net	(41,275	)	(107,306	)	(148,581	)
Other operating expenses	(63,689	)	(14,179	)	(77,868	)
Underwriting income	\$	30,994	\$	81,220		112,214
Net investment income						90,503
Net realized losses						(32,202)
Other income						
Other expenses						(6,499)
Interest expense						(5,651)
Net foreign exchange losses						(1,146)
Income before income taxes						157,219
Income tax expense						(14,332)
Net income						142,887
Preferred dividends						(5,039)
Net income available to common shareholders					\$	137,848
Underwriting Ratios						
Loss ratio	65.1	%	51.3	%	58.0	%
Acquisition expense ratio (2)	10.5	%	26.1	%	18.5	%
Other operating expense ratio	16.5	%	3.4	%	9.8	%
Combined ratio	92.1	%	80.8	%	86.3	%

(1) Certain amounts included in the gross premiums written of each segment are related to intersegment transactions. Accordingly, the sum of gross premiums written for each segment does not agree to the total gross premiums written as shown in the table above due to the elimination of intersegment transactions in the total. The insurance segment and reinsurance segment results include nil and \$10.9 million, respectively, of gross and net premiums written and \$0.5 million and \$12.3 million, respectively, of net premiums earned assumed through intersegment transactions.

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

(U.S. dollars in thousands)	(Unaudited) Six Months Ended June 30, 2007		Insurance	Reinsurance	Total	
Gross premiums written (1)	\$	1,345,935		\$ 986,002	\$ 2,312,824	
Net premiums written (1)		880,172		749,468	1,629,640	
Net premiums earned (1)	\$	846,407		\$ 650,498	\$ 1,496,905	
Fee income		2,701		1,359	4,060	
Losses and loss adjustment expenses	(531,980	)	(313,744	)	(845,724 )	
Acquisition expenses, net	(94,227	)	(143,178	)	(237,405 )	
Other operating expenses	(139,163	)	(33,780	)	(172,943 )	
Underwriting income	\$	83,738		\$ 161,155	244,893	
Net investment income					229,988	
Net realized losses					(4,738 )	
Other income					869	
Other expenses					(18,375 )	
Interest expense					(11,046 )	
Net foreign exchange losses					(16,192 )	
Income before income taxes					425,399	
Income tax expense					(14,532 )	
Net income					410,867	
Preferred dividends					(12,922 )	
Net income available to common shareholders					\$ 397,945	
Underwriting Ratios						
Loss ratio	62.9	%	48.2	%	56.5	%
Acquisition expense ratio (2)	10.9	%	22.0	%	15.8	%
Other operating expense ratio	16.4	%	5.2	%	11.6	%
Combined ratio	90.2	%	75.4	%	83.9	%

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

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

(U.S. dollars in thousands)	(Unaudited) Six Months Ended June 30, 2006		Insurance	Reinsurance	Total	
Gross premiums written (1)	\$	1,263,301	\$	1,063,909	\$ 2,304,088	
Net premiums written (1)		806,556		861,721	1,668,277	
Net premiums earned (1)	\$	766,131	\$	792,920	\$ 1,559,051	
Fee income		2,657		2,616	5,273	
Losses and loss adjustment expenses		(499,174 )		(431,259 )	(930,433 )	
Acquisition expenses, net		(79,160 )		(199,093 )	(278,253 )	
Other operating expenses		(125,765 )		(27,431 )	(153,196 )	
Underwriting income	\$	64,689	\$	137,753	202,442	
Net investment income					170,829	
Net realized losses					(35,585 )	
Other income						
Other expenses					(14,148 )	
Interest expense					(11,206 )	
Net foreign exchange losses					(11,399 )	
Income before income taxes					300,933	
Income tax expense					(25,756 )	
Net income					275,177	
Preferred dividends					(7,706 )	
Net income available to common shareholders					\$ 267,471	
Underwriting Ratios						
Loss ratio	65.2	%	54.4	%	59.7	%
Acquisition expense ratio (2)	10.1	%	25.1	%	17.7	%
Other operating expense ratio	16.4	%	3.5	%	9.8	%
Combined ratio	91.7	%	83.0	%	87.2	%

(1) Certain amounts included in the gross premiums written of each segment are related to intersegment transactions. Accordingly, the sum of gross premiums written for each segment does not agree to the total gross premiums written as shown in the table above due to the elimination of intersegment transactions in the total. The insurance segment and reinsurance segment results include \$0.8 million and \$22.4 million, respectively, of gross and net premiums written and \$1.4 million and \$25.1 million, respectively, of net premiums earned assumed through intersegment transactions.

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

Set forth below is summary information regarding net premiums written and earned by major line of business and net premiums written by client location for the insurance segment:

INSURANCE SEGMENT (U.S. dollars in thousands)	(Unaudited) Three Months Ended June 30, 2007		2006	
	Amount	% of Total	Amount	% of Total
<b>Net premiums written (1)</b>				
Property, marine and aviation	\$ 104,705	23.2	\$ 74,712	18.2
Professional liability	81,603	18.1	63,555	15.5
Construction, surety and national accounts	68,482	15.1	66,717	16.3
Programs	59,154	13.1	56,512	13.8
Casualty	57,240	12.7	66,643	16.3
Executive assurance	47,904	10.6	53,841	13.2
Healthcare	12,383	2.7	14,199	3.5
Other	20,357 (2)	4.5	13,123	3.2
Total	\$ 451,828	100.0	\$ 409,302	100.0
<b>Net premiums earned (1)</b>				
Property, marine and aviation	\$ 92,387	21.4	\$ 54,783	14.2
Professional liability	82,142	19.0	65,639	17.0
Construction, surety and national accounts	67,562	15.6	67,967	17.6
Programs	57,036	13.2	57,478	14.9
Casualty	52,570	12.1	61,121	15.9
Executive assurance	47,408	11.0	49,707	12.9
Healthcare	17,107	3.9	17,869	4.6
Other	16,348 (2)	3.8	11,313	2.9
Total	\$ 432,560	100.0	\$ 385,877	100.0
<b>Net premiums written by client location (1)</b>				
United States	\$ 361,733	80.1	\$ 343,923	84.0
Europe	60,968	13.5	39,886	9.8
Other	29,127	6.4	25,493	6.2
Total	\$ 451,828	100.0	\$ 409,302	100.0

(1) Insurance segment results include premiums written and earned assumed through intersegment transactions of \$0.3 million for the 2007 second quarter and nil and \$0.5 million, respectively, for the 2006 second quarter. Insurance segment results exclude premiums written and earned ceded through intersegment transactions of \$9.6 million and \$10.8 million, respectively, for the 2007 second quarter and \$10.9 million and \$12.3 million, respectively, for the 2006 second quarter.

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

(Unaudited)  
Six Months Ended  
June 30,  
2007

**INSURANCE SEGMENT**  
(U.S. dollars in thousands)

**2006**  
**% of**  
**Amount** **Total**

**Net premiums written (1)**

Property, marine and aviation	\$ 189,568	21.5	\$ 143,358	17.8
Professional liability	152,006	17.3	126,009	15.6
Construction, surety and national accounts	147,711	16.8	147,346	18.3
Programs	117,478	13.3	117,046	14.5
Casualty	100,330	11.4	117,393	14.6
Executive assurance	91,995	10.4	99,432	12.3
Healthcare	33,914	3.9	32,314	4.0
Other	47,170 (2)	5.4	23,658	2.9
<b>Total</b>	<b>\$ 880,172</b>	<b>100.0</b>	<b>\$ 806,556</b>	<b>100.0</b>

**Net premiums earned (1)**

Property, marine and aviation	\$ 174,191	20.6	\$ 117,751	15.4
Professional liability	159,272	18.8	119,684	15.6
Construction, surety and national accounts	134,666	15.9	134,670	17.6
Programs	113,245	13.4	114,867	15.0
Casualty	104,112	12.3	123,929	16.2
Executive assurance	92,786	10.9	99,783	13.0
Healthcare	36,951	4.4	34,546	4.5
Other	31,184 (2)	3.7	20,901	2.7
<b>Total</b>	<b>\$ 846,407</b>	<b>100.0</b>	<b>\$ 766,131</b>	<b>100.0</b>

**Net premiums written by client location (1)**

United States	\$ 681,738	77.5	\$ 668,388	82.9
Europe	135,903	15.4	87,466	10.8
Other	62,531	7.1	50,702	6.3
<b>Total</b>	<b>\$ 880,172</b>	<b>100.0</b>	<b>\$ 806,556</b>	<b>100.0</b>

(1) Insurance segment results include premiums written and earned assumed through intersegment transactions of \$0.8 million for the six months ended June 30, 2007 and \$0.8 million and \$1.4 million, respectively, for the six months ended June 30, 2006. Insurance segment results exclude premiums written and earned ceded through intersegment transactions of \$18.3 million and \$21.4 million, respectively, for the six months ended June 30, 2007 and \$22.4 million and \$25.1 million, respectively, for the six months ended June 30, 2006.

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

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

REINSURANCE SEGMENT (U.S. dollars in thousands)	(Unaudited) Three Months Ended June 30, 2007		2006	
	Amount	% of Total	Amount	% of Total
<b>Net premiums written (1)</b>				
Casualty (2)	\$ 110,106	36.0	\$ 176,116	45.7
Property catastrophe	77,514	25.3	33,786	8.8
Property excluding property catastrophe	69,353	22.7	88,785	23.0
Other specialty	27,971	9.1	64,493	16.7
Marine and aviation	19,812	6.5	20,626	5.4
Other	1,311	0.4	1,450	0.4
Total	\$ 306,067	100.0	\$ 385,256	100.0
<b>Net premiums earned (1)</b>				
Casualty (2)	\$ 131,112	41.1	\$ 183,474	44.6
Property catastrophe	38,151	12.0	49,481	12.0
Property excluding property catastrophe	64,737	20.3	81,668	19.8
Other specialty	52,582	16.5	70,970	17.2
Marine and aviation	30,021	9.4	23,701	5.8
Other	2,249	0.7	2,279	0.6
Total	\$ 318,852	100.0	\$ 411,573	100.0
<b>Net premiums written (1)</b>				
Pro rata	\$ 184,972	60.4	\$ 288,439	74.9
Excess of loss	121,095	39.6	96,817	25.1
Total	\$ 306,067	100.0	\$ 385,256	100.0
<b>Net premiums earned (1)</b>				
Pro rata	\$ 228,815	71.8	\$ 321,438	78.1
Excess of loss	90,037	28.2	90,135	21.9
Total	\$ 318,852	100.0	\$ 411,573	100.0
<b>Net premiums written by client location (1)</b>				
United States	\$ 206,456	67.5	\$ 228,677	59.4
Europe	37,710	12.3	111,663	29.0
Bermuda	47,851	15.6	23,843	6.2
Other	14,050	4.6	21,073	5.4
Total	\$ 306,067	100.0	\$ 385,256	100.0

(1) Reinsurance segment results include premiums written and earned assumed through intersegment transactions of \$9.6 million and \$10.8 million, respectively, for the 2007 second quarter and \$10.9 million and \$12.3 million, respectively, for the 2006 second quarter. Reinsurance segment results exclude premiums written and earned ceded through intersegment transactions of \$0.3 million for the 2007 second quarter and nil and \$0.5 million, respectively, for the 2006 second quarter.

(2) Includes professional liability and executive assurance business.





REINSURANCE SEGMENT (U.S. dollars in thousands)	(Unaudited) Six Months Ended June 30, 2007		2006	
	Amount	% of Total	Amount	% of Total
<b>Net premiums written (1)</b>				
Casualty (2)	\$ 254,582	34.0	\$ 339,104	39.3
Property excluding property catastrophe	164,297	21.9	195,567	22.7
Property catastrophe	158,173	21.1	104,122	12.1
Other specialty	101,967	13.6	157,757	18.3
Marine and aviation	63,527	8.5	61,978	7.2
Other	6,922	0.9	3,193	0.4
Total	\$ 749,468	100.0	\$ 861,721	100.0
<b>Net premiums earned (1)</b>				
Casualty (2)	\$ 271,556	41.7	\$ 354,671	44.7
Property excluding property catastrophe	137,776	21.2	161,288	20.3
Property catastrophe	72,842	11.2	98,587	12.4
Other specialty	104,624	16.1	128,889	16.3
Marine and aviation	56,643	8.7	47,351	6.0
Other	7,057	1.1	2,134	0.3
Total	\$ 650,498	100.0	\$ 792,920	100.0
<b>Net premiums written (1)</b>				
Pro rata	\$ 448,787	59.9	\$ 560,973	65.1
Excess of loss	300,681	40.1	300,748	34.9
Total	\$ 749,468	100.0	\$ 861,721	100.0
<b>Net premiums earned (1)</b>				
Pro rata	\$ 471,254	72.4	\$ 616,726	77.8
Excess of loss	179,244	27.6	176,194	22.2
Total	\$ 650,498	100.0	\$ 792,920	100.0
<b>Net premiums written by client location (1)</b>				
United States	\$ 460,447	61.4	\$ 505,992	58.7
Europe	162,048	21.6	238,926	27.7
Bermuda	98,692	13.2	67,682	7.9
Other	28,281	3.8	49,121	5.7
Total	\$ 749,468	100.0	\$ 861,721	100.0

(1) Reinsurance segment results include premiums written and earned assumed through intersegment transactions of \$18.3 million and \$21.4 million, respectively, for the six months ended June 30, 2007 and \$22.4 million and \$25.1 million, respectively, for the six months ended June 30, 2006. Reinsurance segment results exclude premiums written and earned ceded through intersegment transactions of \$0.8 million for the six months ended June 30, 2007 and \$0.8 million and \$1.4 million, respectively, for the six months ended June 30, 2006.

(2) Includes professional liability and executive assurance business.

## 5. Reinsurance

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

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

	(Unaudited) Three Months Ended June 30,		(Unaudited) Six Months Ended June 30,	
(U.S. dollars in thousands)	2007	2006	2007	2006
Premiums Written				
Direct	\$ 673,960	\$ 635,250	\$ 1,323,840	\$ 1,236,949
Assumed	428,250	501,024	988,984	1,067,139
Ceded	(344,315 )	(341,716 )	(683,184 )	(635,811 )
Net	\$ 757,895	\$ 794,558	\$ 1,629,640	\$ 1,668,277
Premiums Earned				
Direct	\$ 655,173	\$ 609,486	\$ 1,292,181	\$ 1,184,904
Assumed	407,543	477,244	823,675	896,521
Ceded	(311,304 )	(289,280 )	(618,951 )	(522,374 )
Net	\$ 751,412	\$ 797,450	\$ 1,496,905	\$ 1,559,051
Losses and Loss Adjustment Expenses				
Direct	\$ 378,249	\$ 485,740	\$ 737,725	\$ 867,845
Assumed	183,150	249,357	378,421	495,966
Ceded	(135,736 )	(272,842 )	(270,422 )	(433,378 )
Net	\$ 425,663	\$ 462,255	\$ 845,724	\$ 930,433

The Company monitors the financial condition of its reinsurers and attempts to place coverages only with substantial, financially sound carriers. At June 30, 2007 and December 31, 2006, approximately 90.3% and 92.3%, respectively, of the Company's reinsurance recoverables on paid and unpaid losses (not including prepaid reinsurance premiums) of \$1.68 billion and \$1.67 billion, respectively, were due from carriers which had an A.M. Best rating of A- or better. At June 30, 2007 and December 31, 2006, the largest reinsurance recoverables from any one carrier were less than 5.4% and 5.1%, respectively, of the Company's total shareholders' equity.

On December 29, 2005, Arch Reinsurance Ltd. ( Arch Re Bermuda ) entered into a quota share reinsurance treaty with Flatiron Re Ltd., a newly-formed Bermuda reinsurance company, pursuant to which Flatiron Re Ltd. is assuming a 45% quota share (the Treaty ) of certain lines of property and marine business underwritten by Arch Re Bermuda for unaffiliated third parties for the 2006 and 2007 underwriting years (January 1, 2006 to December 31, 2007). The quota share is subject to decrease by Arch Re Bermuda under certain circumstances. In addition, in certain circumstances, Flatiron Re Ltd. may extend at its option the coverage provided by the Treaty to Arch Re Bermuda's 2008 underwriting year. Effective June 28, 2006, the parties amended the Treaty to increase the percentage ceded to Flatiron Re Ltd. from 45% to 70% of all covered business bound by Arch Re Bermuda from (and including) June 28, 2006 until (and including) August 15, 2006 provided such business did not incept beyond September 30, 2006. The ceding percentage for all business bound outside of this period will continue to be 45%, subject to adjustment as provided under the Treaty.

Flatiron Re Ltd. is required to contribute funds into a trust for the benefit of Arch Re Bermuda (the Trust ). Effective June 28, 2006, the parties amended the Treaty to provide that, for the period ending on December 31 of the final underwriting year covered by the Treaty, the amount required to be on deposit in the Trust, together with certain other amounts, will be an amount equal to the greater of (1) \$800 million and (2) a calculated amount estimated to cover ceded losses arising from in excess of two 1-in-250 year events for the applicable forward twelve-month period (the Requisite Funded Amount ). For the period after the end of the final underwriting year covered by the Treaty through the earning of all written premium, the Requisite Funded Amount will be the calculated amount described in clause (2) above. If the actual amounts on deposit in the Trust, together with certain other amounts (the Funded Amount ), do not at least equal the Requisite Funded Amount, Arch Re Bermuda will, among other things, reduce the percentage of business ceded on a prospective basis and, at Arch Re Bermuda's option under certain circumstances, recapture unearned premium reserves and reassume losses that would have been ceded in respect of such unearned premiums. No assurances can be given that actual losses will not exceed the Requisite Funded Amount or that Flatiron Re Ltd. will make, or will have the ability to make, the required contributions into the Trust. Arch Re Bermuda will have the right to terminate its obligations to cede business to Flatiron Re Ltd. if, among other things, the assets held in the Trust do not meet certain conditions, if ceded unpaid loss reserves equal or exceed the Funded Amount or if the direct or indirect ownership of Flatiron Re Ltd. changes in certain respects.

Arch Re Bermuda pays to Flatiron Re Ltd. a reinsurance premium in the amount of the ceded percentage of the original gross written premium on the business reinsured with Flatiron Re Ltd. less a ceding commission, which includes a reimbursement of direct acquisition expenses as well as a commission to Arch Re Bermuda for generating the business. The Treaty also provides for a profit commission to Arch Re Bermuda based on the underwriting results for the 2006 and 2007 underwriting years on a cumulative basis. For the 2007 second quarter, \$115.9 million of premiums written, \$72.5 million of premiums earned and \$28.0 million of losses and loss adjustment expenses were ceded to Flatiron Re Ltd. by Arch Re Bermuda, compared to \$77.7 million of premiums written, \$25.3 million of premiums earned and \$7.0 million of losses and loss adjustment expenses for the 2006 second quarter. For the six months ended June 30, 2007, \$224.8 million of premiums written, \$138.5 million of premiums earned and \$53.4 million of losses and loss adjustment expenses were ceded to Flatiron Re Ltd. by Arch Re Bermuda, compared to \$160.1 million of premiums written, \$43.6 million of premiums earned and \$13.7 million of losses and loss adjustment expenses for the six months ended June 30, 2006.

## 6. Deposit Accounting

Certain assumed reinsurance contracts are deemed, under current financial accounting standards, not to transfer insurance risk, and are accounted for using the deposit method of accounting. To meet risk transfer requirements, a reinsurance contract must include both insurance risk, consisting of underwriting and timing risk, and it must be reasonably possible that the reinsurer may realize a significant loss under the contract. For those contracts that do not transfer timing risk or sufficient underwriting risk, the estimated profit margin is deferred and amortized over the contract period and such amount is included in the Company's underwriting results. When the estimated profit margin is explicit, the margin is reflected as fee income and any adverse financial results on such contracts are reflected as incurred losses. Although such deposit liabilities arise from contracts that the Company sold for which there is not a significant transfer of risk, it is possible that the Company could incur financial losses on such contracts. The Company recorded fee income on such contracts of \$0.8 million and \$2.3 million, respectively, for the 2007 and 2006 second quarters, and \$1.4 million and \$2.6 million, respectively, for the six months ended June 30, 2007 and 2006. When the estimated profit margin is implicit, the margin is reflected as an offset to paid losses and any adverse financial results on such contracts are reflected as incurred losses. The Company recorded a de minimis amount as an offset to paid losses on such contracts in the 2007 periods, compared to \$0.7 million for the 2006 second quarter and \$1.3 million for the six months ended June 30, 2006. On a notional basis, the amount of premiums from such contracts were nil and \$5.3 million, respectively, for the 2007 and 2006 second quarters, and \$0.3 million and \$11.3 million, respectively, for the six months ended June 30, 2007 and 2006.

In making any determination to account for a contract using the deposit method of accounting, the Company is required to make many estimates and judgments under the current financial accounting standards.

## 7. Investment Information

The following table summarizes the Company's invested assets:

(U.S. dollars in thousands)	(Unaudited) June 30, 2007	December 31, 2006
Fixed maturities available for sale, at fair value	\$ 6,923,478	\$ 6,876,548
Fixed maturities pledged under securities lending agreements, at fair value (1)	1,085,757	860,803
Total fixed maturities	8,009,235	7,737,351
Short-term investments available for sale, at fair value	1,114,485	957,698
Other investments	461,835	307,082
Total investments (1)	9,585,555	9,002,131
Securities transactions entered into but not settled at the balance sheet date	(379,670)	(227,941)
Total investments, net of securities transactions	\$ 9,205,885	\$ 8,774,190

(1) In securities lending transactions, the Company receives collateral in excess of the fair value of the fixed maturities and short-term investments pledged under securities lending agreements. For purposes of this table, the Company has excluded the collateral received at June 30, 2007 and December 31, 2006 of \$1.11 billion and \$891.4 million, respectively, which is reflected as short-term investment of funds received under securities lending agreements, at fair value and included the \$1.09 billion and \$860.8 million, respectively, of fixed maturities and short-term investments pledged under securities lending agreements, at fair value.

### Fixed Maturities and Fixed Maturities Pledged Under Securities Lending Agreements

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

(U.S. dollars in thousands)	Estimated Fair Value	Gross Unrealized Gains	Gross Unrealized Losses	Amortized Cost
<b>June 30, 2007 (Unaudited):</b>				
U.S. government and government agencies	\$ 2,106,798	\$ 1,794	\$ (26,077)	\$ 2,131,081
Corporate bonds	1,561,710	3,731	(15,361)	1,573,340
Mortgage backed securities	1,205,525	1,377	(12,889)	1,217,037
Commercial mortgage backed securities	1,039,341	756	(5,934)	1,044,519
Municipal bonds	853,218	158	(12,867)	865,927
Asset backed securities	791,876	358	(2,461)	793,979
Non-U.S. government securities	450,767	15,417	(10,078)	445,428
Total	\$ 8,009,235	\$ 23,591	\$ (85,667)	\$ 8,071,311
<b>December 31, 2006:</b>				
U.S. government and government agencies	\$ 1,922,511	\$ 12,835	\$ (10,806)	\$ 1,920,482
Corporate bonds	1,504,989	9,196	(5,634)	1,501,427
Mortgage backed securities	1,183,805	7,866	(1,678)	1,177,617
Commercial mortgage backed securities	868,586	4,953	(1,098)	864,731
Municipal bonds	815,204	1,323	(3,885)	817,766
Asset backed securities	907,829	923	(1,457)	908,363
Non-U.S. government securities	534,427	15,776	(4,718)	523,369
Total	\$ 7,737,351	\$ 52,872	\$ (29,276)	\$ 7,713,755

In February 2006, the FASB issued SFAS No. 155, "Accounting for Certain Hybrid Financial Instruments" an amendment of FASB Statements No. 133 and 140 (SFAS No. 155). Upon adopting SFAS No. 155 on January 1, 2007, the Company applied the "fair value option" to certain hybrid securities which are included in the Company's fixed maturities. The fair market values of such securities at June 30, 2007 were approximately \$66.3 million. The change in market value of such securities is reflected as realized gains or losses. The adoption of SFAS No. 155 did not have a material impact on the Company's results of operations.

The Company's investment portfolio, which includes fixed maturity securities, short-term investments and other investments, had a "AA+" average Standard & Poor's quality rating at June 30, 2007, compared to "AAA" at December 31, 2006. The credit quality distribution of the Company's fixed maturities and fixed maturities pledged under securities lending agreements are shown below:

(U.S. dollars in thousands)	(Unaudited) June 30, 2007 Estimated Fair Value	% of Total	December 31, 2006 Estimated Fair Value	% of Total
<b>Rating (1)</b>				
AAA	\$ 6,761,360	84.4	\$ 6,366,059	82.3
AA	560,466	7.0	605,427	7.8
A	350,195	4.4	430,103	5.6
BBB	207,807	2.6	194,408	2.5
BB	23,399	0.3	32,572	0.4
B	54,222	0.7	64,636	0.8
Lower than B	13,213	0.1	11,149	0.2
Not rated	38,573	0.5	32,997	0.4
Total	\$ 8,009,235	100.0	\$ 7,737,351	100.0

(1) Ratings as assigned by Standard & Poor's.



**Securities Lending Agreements**

The Company participates in a securities lending program under which certain of its fixed income portfolio securities are loaned to third parties, primarily major brokerage firms, for short periods of time through a lending agent. Such securities have been reclassified as Fixed maturities and short-term investments pledged under securities lending agreements, at fair value. The Company maintains control over the securities it lends, retains the earnings and cash flows associated with the loaned securities and receives a fee from the borrower for the temporary use of the securities. Collateral received, primarily in the form of cash, is required at a rate of 102% of the market value of the loaned securities (or 105% of the market value of the loaned securities when the collateral and loaned securities are denominated in non-U.S. currencies) including accrued investment income and is monitored and maintained by the lending agent. Such collateral is reinvested and is reflected as Short-term investment of funds received under securities lending agreements, at fair value. At June 30, 2007, the fair value and amortized cost of fixed maturities and short-term investments pledged under securities lending agreements were \$1.09 billion and \$1.10 billion, respectively, while collateral received totaled \$1.11 billion at fair value and amortized cost. At December 31, 2006, the fair value and amortized cost of fixed maturities and short-term investments pledged under securities lending agreements were \$860.8 million and \$854.8 million, respectively, while collateral received totaled \$891.4 million at fair value and amortized cost.

**Investment-Related Derivatives**

The Company's investment strategy allows for the use of derivative securities. Derivative instruments may be used to enhance investment performance, replicate investment positions or manage market exposures and duration risk that would be allowed under the Company's investment guidelines if implemented in other ways. The fair values of those derivatives are based on quoted market prices. At June 30, 2007 and December 31, 2006, the notional value of the net long position for equity futures was \$94.7 million and \$78.6 million, respectively, and the notional value of the net short position for Treasury note futures was \$48.3 million and \$35.2 million, respectively. For the 2007 second quarter and six months ended June 30, 2007, the Company recorded net realized gains of \$4.8 million and \$3.9 million, respectively, related to changes in the fair value of all futures contracts, compared to net realized losses of \$1.8 million and \$1.2 million, respectively, for the 2006 second quarter and six months ended June 30, 2006. At June 30, 2007, the carrying value and fair value of all futures contracts was \$0.2 million, compared to \$0.3 million at December 31, 2006.

**Other Investments**

The following table details the Company's other investments:

(U.S. dollars in thousands)	(Unaudited) June 30, 2007 Estimated Fair Value	Cost	December 31, 2006 Estimated Fair Value		Cost
Alternative investment funds	\$ 303,837	\$ 304,241	\$ 167,497	\$ 167,703	
Equity securities	94,586	71,063	75,496	60,619	
Privately held securities	63,412	54,182	64,089	54,601	
Total	\$ 461,835	\$ 429,486	\$ 307,082	\$ 282,923	

Alternative investment funds primarily include funds that invest in investment grade and non-investment grade fixed income securities and funds that invest in senior floating rate loans; equity securities include certain investments in mutual funds and other preferred stocks; and privately held securities include the Company's investment in Aeolus LP (see Note 10). The Company's investment commitments relating to its other investments totaled approximately \$79.5 million at June 30, 2007.

**Restricted Assets**

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

(U.S. dollars in thousands)	(Unaudited) June 30, 2007	December 31, 2006
Assets used for collateral or guarantees	\$ 726,653	\$ 798,437
Deposits with U.S. regulatory authorities	244,848	221,864
Trust funds	116,427	104,408
Deposits with non-U.S. regulatory authorities	39,004	34,112
Total restricted assets	\$ 1,126,932	\$ 1,158,821

In addition, certain of the Company's operating subsidiaries maintain assets in trust accounts as collateral for insurance and reinsurance transactions with affiliated companies. At June 30, 2007 and December 31, 2006, such amounts approximated \$3.65 billion and \$3.61 billion, respectively.

**Net Investment Income**

The components of net investment income were as follows:

(U.S. dollars in thousands)	(Unaudited) Three Months Ended June 30, 2007		(Unaudited) Six Months Ended June 30, 2007	
	2007	2006	2007	2006
Fixed maturities	\$ 102,472	\$ 77,163	\$ 200,571	\$ 146,587
Short-term investments	8,829	12,160	18,563	21,947
Other (1)	9,479	3,967	18,140	7,851
Gross investment income	120,780	93,290	237,274	176,385
Investment expenses	(3,481)	(2,787)	(7,286)	(5,556)
Net investment income	\$ 117,299	\$ 90,503	\$ 229,988	\$ 170,829

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



# **Net Realized Gains (Losses)**

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

(U.S. dollars in thousands)	(Unaudited) Three Months Ended June 30,		(Unaudited) Six Months Ended June 30,	
	2007	2006	2007	2006
Fixed maturities	\$ (8,983 )	\$ (33,492 )	\$ (10,127 )	\$ (37,645 )
Other investments	1,000	414	2,139	3,142
Other	4,226	876	3,250	(1,082 )
Net realized losses	\$ (3,757 )	\$ (32,202 )	\$ (4,738 )	\$ (35,585 )

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

For the 2007 second quarter and six months ended June 30, 2007, net realized losses on the Company's fixed maturities of \$9.0 million and \$10.1 million, respectively, included provisions for declines in the market value of investments held in the Company's available for sale portfolio which were considered to be other-than-temporary of \$0.5 million and \$7.7 million, respectively, based on reviews performed in each period. For the 2006 second quarter and six months ended June 30, 2006, net realized losses on the Company's fixed maturities of \$33.5 million and \$37.6 million, respectively, included provisions for declines in the market value of investments held in the Company's available for sale portfolio which were considered to be other-than-temporary of \$11.1 million and \$16.5 million, respectively, based on reviews performed in each period. The declines in market value on such securities were primarily due to the current interest rate environment. The balance of net realized gains or losses in each period primarily resulted from the sale of fixed maturities following the Company's decisions to reduce credit exposure, to change duration targets or to rebalance the investment portfolio.

## 8. Earnings Per Common Share

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

(U.S. dollars in thousands, except share data)	(Unaudited) Three Months Ended June 30,		(Unaudited) Six Months Ended June 30,	
	2007	2006	2007	2006
<b>Basic earnings per common share:</b>				
Net income	\$ 205,855	\$ 142,887	\$ 410,867	\$ 275,177
Preferred dividends	(6,461 )	(5,039 )	(12,922 )	(7,706 )
Net income available to common shareholders	199,394	137,848	397,945	267,471
Divided by:				
Weighted average common shares outstanding	72,494,823	73,188,101	73,209,439	73,044,473
Basic earnings per common share	\$ 2.75	\$ 1.88	\$ 5.44	\$ 3.66
<b>Diluted earnings per common share:</b>				
Net income	\$ 205,855	\$ 142,887	\$ 410,867	\$ 275,177
Preferred dividends	(6,461 )	(5,039 )	(12,922 )	(7,706 )
Net income available to common shareholders	199,394	137,848	397,945	267,471
Divided by:				
Weighted average common shares outstanding	72,494,823	73,188,101	73,209,439	73,044,473
Effect of dilutive securities:				
Nonvested restricted shares	142,705	457,097	157,606	453,448