

ARCH REINSURANCE LTD. AND SUBSIDIARIES

(a wholly-owned subsidiary of Arch Capital Group Ltd.)

Consolidated Financial Statements

December 31, 2009 and 2008

INDEX TO FINANCIAL STATEMENTS

Arch Reinsurance Ltd. and Subsidiaries	<u>Pages</u>
Report of Independent Auditors.....	2
Consolidated Balance Sheets at December 31, 2009 and 2008	3
Consolidated Statements of Income for the years ended December 31, 2009 and 2008	4
Consolidated Statements of Changes in Shareholder's Equity for the years ended December 31, 2009 and 2008	5
Consolidated Statements of Comprehensive Income for the years ended December 31, 2009 and 2008	6
Consolidated Statements of Cash Flows for the years ended December 31, 2009 and 2008	7
Notes to Consolidated Financial Statements.....	8

Report of Independent Auditors

To the Board of Directors and Shareholder of
Arch Reinsurance Ltd.:

In our opinion, the accompanying consolidated balance sheets and the related consolidated statements of income, changes in shareholder's equity, comprehensive income, and cash flows present fairly, in all material respects, the financial position of Arch Reinsurance Ltd. and its subsidiaries (collectively the "Company"), a wholly-owned subsidiary of Arch Capital Group Ltd., at December 31, 2009 and December 31, 2008, and the results of their operations and their cash flows for the years then ended in conformity with accounting principles generally accepted in the United States of America. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits. We conducted our audits of these statements in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, and evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

As discussed in Note 2 to the consolidated financial statements, the Company changed the manner in which it accounts for other-than-temporary impairment losses in 2009.

PricewaterhouseCoopers LLP

April 23, 2010

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

	December 31,	
	2009	2008
Assets		
Investments:		
Fixed maturities available for sale, at market value (amortized cost: 2009, \$9,220,349; 2008, \$8,308,558).....	\$9,384,743	\$8,115,767
Short-term investments available for sale, at market value (amortized cost: 2009, \$548,847; 2008, \$468,875)	549,867	470,373
Investment of funds received under securities lending agreements, at market value (amortized cost: 2009, \$96,590; 2008, \$493,902).....	91,160	473,766
TALF investments, at market value.....	250,265	—
Other investments (cost: 2009, \$162,505; 2008, \$125,858)	172,172	109,601
Investment funds accounted for using the equity method.....	391,869	301,027
Total investments	10,840,076	9,470,534
Cash.....	316,421	230,856
Accrued investment income	70,605	77,988
Investment in joint venture (cost: 2009 and 2008, \$100,000).....	102,855	98,341
Fixed maturities and short-term investments pledged under securities lending agreements, at market value.....	212,820	728,065
Securities purchased under agreements to resell using funds received under securities lending agreements.....	115,839	256,428
Premiums receivable	618,257	660,575
Unpaid losses and loss adjustment expenses recoverable.....	1,783,260	1,860,674
Paid losses and loss adjustment expenses recoverable	61,355	63,883
Prepaid reinsurance premiums.....	287,135	320,501
Deferred acquisition costs, net.....	280,372	295,192
Receivable for securities sold.....	187,171	105,072
Other assets	432,268	398,444
Total Assets	\$15,308,434	\$14,566,553
Liabilities		
Reserve for losses and loss adjustment expenses.....	\$7,997,172	\$7,798,496
Unearned premiums	1,442,481	1,543,476
Reinsurance balances payable	164,922	153,082
TALF borrowings, at market value	217,565	—
Securities lending payable.....	219,116	753,528
Payable for securities purchased.....	136,381	123,309
Other liabilities.....	459,093	399,233
Total Liabilities	10,636,730	10,771,124
Commitments and Contingencies		
Shareholder's Equity		
Common shares (\$1.00 par value, 2,625,000 shares authorized, issued: 2009 and 2008, 2,560,423	2,560	2,560
Additional paid-in capital.....	2,225,752	2,203,440
Retained earnings	2,304,966	1,845,420
Accumulated other comprehensive income (loss), net of deferred income tax.....	138,426	(255,991)
Total Shareholder's Equity	4,671,704	3,795,429
Total Liabilities and Shareholder's Equity	\$15,308,434	\$14,566,553

See Notes to Consolidated Financial Statements

ARCH REINSURANCE LTD. AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF INCOME
(U.S. dollars in thousands)

	Years Ended December 31,	
	2009	2008
Revenues		
Net premiums written.....	\$2,763,112	\$2,805,726
Decrease in unearned premiums	79,633	39,728
Net premiums earned	2,842,745	2,845,454
Net investment income.....	389,958	467,231
Net realized gains (losses).....	143,529	(5,282)
Other-than-temporary impairment losses.....	(147,509)	(181,071)
Less investment impairments recognized in other comprehensive income, before taxes	81,376	—
Net impairment losses recognized in earnings	(66,133)	(181,071)
Equity in net income (loss) of investment funds accounted for using the equity method.....	167,819	(178,608)
Other income.....	20,116	13,543
Total Revenues	3,498,034	2,961,267
Expenses		
Losses and loss adjustment expenses	1,654,674	1,848,744
Acquisition expenses.....	493,560	490,509
Other operating expenses	360,413	366,670
Interest expense.....	1,625	—
Net foreign exchange (gains) losses.....	39,157	(96,585)
Total Expenses	2,549,429	2,609,338
Income Before Income Taxes	948,605	351,929
Income taxes:		
Current tax expense.....	22,638	22,051
Deferred tax benefit.....	(2,518)	(9,169)
Income tax expense	20,120	12,882
Net Income	\$928,485	\$339,047

See Notes to Consolidated Financial Statements

ARCH REINSURANCE LTD. AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF CHANGES IN SHAREHOLDER'S EQUITY
(U.S. dollars in thousands)

	Years Ended December 31,	
	2009	2008
Common Shares		
Balance at beginning of year.....	\$2,560	\$1,250
Common shares issued to parent.....	—	1,310
Balance at end of year.....	2,560	2,560
Additional Paid-in Capital		
Balance at beginning of year.....	2,203,440	2,085,153
Common shares issued to parent.....	—	99,940
Amortization of share-based compensation	18,959	20,570
Other	3,353	(2,223)
Balance at end of year.....	2,225,752	2,203,440
Retained Earnings		
Balance at beginning of year.....	1,845,420	2,033,423
Cumulative effect of change in accounting principle (1)	61,469	—
Balance at beginning of year, as adjusted	1,906,889	2,033,423
Dividends paid to parent	(530,408)	(527,050)
Net income	928,485	339,047
Balance at end of year.....	2,304,966	1,845,420
Accumulated Other Comprehensive Income (Loss)		
Balance at beginning of year.....	(255,991)	155,083
Cumulative effect of change in accounting principle (1)	(61,469)	—
Balance at beginning of year, as adjusted	(317,460)	155,083
Change in unrealized appreciation (decline) in value of investments, net of deferred income tax.....	525,903	(375,534)
Portion of other-than-temporary impairment losses recognized in other comprehensive income, net of deferred income tax.....	(81,376)	—
Foreign currency translation adjustments, net of deferred income tax.....	11,359	(35,540)
Balance at end of year.....	138,426	(255,991)
Total Shareholder's Equity	\$4,671,704	\$3,795,429

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

See Notes to Consolidated Financial Statements

ARCH REINSURANCE LTD. AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME
(U.S. dollars in thousands)

	Years Ended December 31,	
	2009	2008
Comprehensive Income		
Net income.....	\$928,485	\$339,047
Other comprehensive income (loss), net of deferred income tax		
Unrealized appreciation (decline) in value of investments:		
Unrealized holding gains (losses) arising during year	574,428	(583,751)
Portion of other-than-temporary impairment losses recognized in other comprehensive income, net of deferred income tax	(81,376)	—
Reclassification of net realized (gains) losses, net of income taxes, included in net income	(48,525)	208,217
Foreign currency translation adjustments.....	11,359	(35,540)
Other comprehensive income (loss)	455,886	(411,074)
Comprehensive Income (Loss)	\$1,384,371	(\$72,027)

See Notes to Consolidated Financial Statements

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

	Years Ended December 31,	
	2009	2008
Operating Activities		
Net income	\$928,485	\$339,047
Adjustments to reconcile net income to net cash provided by operating activities:		
Net realized (gains) losses	(123,788)	10,095
Net impairment losses recognized in earnings.....	66,133	181,071
Equity in net (income) loss of investment funds accounted for using the equity method and other income	(183,038)	166,610
Share-based compensation.....	18,959	16,517
Changes in:		
Reserve for losses and loss adjustment expenses, net of unpaid losses and loss adjustment expenses recoverable	219,607	658,501
Unearned premiums, net of prepaid reinsurance premiums	(79,843)	(42,029)
Premiums receivable	52,835	8,031
Deferred acquisition costs, net	17,572	(9,626)
Reinsurance balances payable	9,762	(153,882)
Other liabilities.....	(4,383)	(88,932)
Other items, net	116,712	90,973
Net Cash Provided By Operating Activities	1,039,013	1,176,376
Investing Activities		
Purchases of:		
Fixed maturity investments	(21,266,285)	(17,378,709)
Other investments.....	(260,947)	(480,417)
Proceeds from the sales of:		
Fixed maturity investments	19,774,950	16,139,432
Other investments.....	303,888	460,178
Proceeds from redemptions and maturities of fixed maturity investments	785,118	582,342
Net sales of short-term investments	31,979	67,807
Change in investment of securities lending collateral	534,412	750,195
Investment in joint venture.....	—	(100,000)
Purchases of furniture, equipment and other assets	(19,194)	(9,669)
Net Cash Provided By (Used For) Investing Activities	(116,079)	31,159
Financing Activities		
Proceeds from TALF borrowings.....	219,843	—
Repayments of TALF borrowings.....	(1,103)	—
Change in securities lending collateral	(534,412)	(750,195)
Other	3,169	2,161
Advance from parent (see Note 5).....	—	100,000
Dividends paid to parent	(530,408)	(527,050)
Net Cash Used For Financing Activities	(842,911)	(1,175,084)
Effects of exchange rate changes on foreign currency cash	5,542	(20,849)
Increase in cash	85,565	11,602
Cash beginning of year.....	230,856	219,254
Cash end of year	\$316,421	\$230,856
Interest paid.....	\$1,625	—

See Notes to Consolidated Financial Statements

ARCH REINSURANCE LTD. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

1. Organization

Arch Reinsurance Ltd. (“Arch Re Ltd.”) is a Bermuda limited liability company, incorporated in May 2001 in Bermuda, and is a wholly owned subsidiary of Arch Capital Group Ltd. (“ACGL”), a Bermuda exempted public limited liability company. Arch Re Ltd. is licensed as a Class 4 insurer under the Insurance Act 1978 of Bermuda and is licensed to underwrite both general and long-term business on an insurance and reinsurance basis. Arch Re Ltd. and its subsidiaries (collectively, the “Company”) provide insurance and reinsurance on a worldwide basis.

In October 2001, ACGL launched an underwriting initiative to meet current and future demand in the global insurance and reinsurance markets that included the recruitment of new management teams and an equity capital infusion of \$763 million, of which \$508 million was contributed to Arch Re Ltd. During 2002 to 2009, additional capital contributions were made to Arch Re Ltd. by ACGL following capital raising activities. On December 31, 2002, ACGL contributed 86.6% of its investment in Arch Capital Group (U.S.) Inc. (“Arch-U.S.”) and its subsidiaries to Arch Re Ltd., with the remaining 13.4% of Arch-U.S. and its subsidiaries contributed to Arch Re Ltd. on December 30, 2005. During 2008, Arch Re Ltd. formed Arch Underwriting at Lloyd’s Ltd, a United Kingdom company, and Arch Syndicate Investments Ltd, a United Kingdom company. In addition, during 2008, Arch Re Ltd. formed Arch Financial Holdings Europe I Limited, an Ireland company, and its subsidiaries, including Arch Reinsurance Europe Underwriting Limited (“Arch Re Europe”). On December 31, 2008, ACGL contributed 100% of its investment in Arch Insurance Company (Europe) Limited (“Arch Insurance Company Europe”), a United Kingdom company, and its subsidiary, Arch Europe Insurance Services Limited, a United Kingdom company, to Arch Re Europe. The transaction was accounted for using the pooling method and is reflected in the consolidated financial statements for all periods presented (see Note 17). In 2009, the Company received approval from the Lloyd’s Franchise Board and the Financial Services Authority in the United Kingdom to establish a managing agent and syndicate at Lloyd’s of London (“Lloyd’s”). The new Lloyd’s syndicate 2012 (“Arch Syndicate 2012”) commenced underwriting in the second quarter of 2009. Arch Underwriting at Lloyd’s (Australia) Pty Ltd (“AUAL Australia”), based in Sydney, Australia, and Arch Underwriting at Lloyd’s (South Africa) (Pty) Limited (“AUAL South Africa”), based in Johannesburg, South Africa, were each formed in 2009 as services companies to underwrite on behalf of Arch Syndicate 2012. AUAL Australia commenced operations in the 2009 fourth quarter, and AUAL South Africa is expected to commence operations in 2010. In addition, during 2009, Arch Re Ltd. formed Arch Investments I LLC, a Delaware limited liability company, owned 100% by its subsidiary, Arch Capital Holdings Ltd. (“ACHL”), and also formed Arch Underwriting Agency LLC, a Delaware limited liability company, owned 100% by a subsidiary of Arch-U.S.

During 2009 and 2008, Arch Re Ltd. paid \$530.4 and \$527.1 million, respectively, of dividends to ACGL.

2. Significant Accounting Policies

(a) Basis of Presentation

The consolidated financial statements have been prepared in conformity with accounting principles generally accepted in the United States of America (“GAAP”). Results of operations include the accounts of Arch Re Ltd., its Lloyd’s subsidiaries, ACHL and its subsidiary, Arch Re Accident & Health ApS, Arch Syndicate Investments Ltd., Arch Underwriting Services Ltd., and Arch Financial Holdings Europe I Limited and its subsidiaries, which include Arch Re Europe and Arch Insurance Company Europe, and Arch-U.S. and its subsidiaries, which include Arch Reinsurance Company (“Arch Re U.S.”), Arch Insurance Company, Arch Specialty Insurance Company, Arch Excess & Surplus Insurance Company and Arch Indemnity Insurance Company (formerly known as Western Diversified Casualty Insurance Company). All significant intercompany transactions and balances have been eliminated in consolidation. The preparation of financial statements in

ARCH REINSURANCE LTD. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

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.

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, shareholder's equity or cash flows. Tabular amounts are in U.S. Dollars in thousands, except share amounts, unless otherwise noted.

(b) Premium Revenues and Related Expenses

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

Reinsurance premiums written include amounts reported by brokers and ceding companies, supplemented by the Company's own estimates of premiums where reports have not been received. The determination of premium estimates requires a review of the Company's experience with the ceding companies, familiarity with each market, the timing of the reported information, an analysis and understanding of the characteristics of each line of business, and management's judgment of the impact of various factors, including premium or loss trends, on the volume of business written and ceded to the Company. On an ongoing basis, the Company's underwriters review the amounts reported by these third parties for reasonableness based on their experience and knowledge of the subject class of business, taking into account the Company's historical experience with the brokers or ceding companies. In addition, reinsurance contracts under which the Company assumes business generally contain specific provisions which allow the Company to perform audits of the ceding company to ensure compliance with the terms and conditions of the contract, including accurate and timely reporting of information. Based on a review of all available information, management establishes premium estimates where reports have not been received. Premium estimates are updated when new information is received and differences between such estimates and actual amounts are recorded in the period in which estimates are changed or the actual amounts are determined.

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

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

ARCH REINSURANCE LTD. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

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

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

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

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

Acquisition expenses and other expenses that vary with, and are directly related to, the acquisition of business related to the Company's underwriting operations are deferred and amortized over the period in which the related premiums are earned. Acquisition expenses, net of ceding commissions received from unaffiliated reinsurers, consist principally of commissions, brokerage and taxes paid to obtain the Company's business. Other operating expenses also include expenses that vary with, and are directly related to, the acquisition of business. Deferred acquisition costs, which are based on the related unearned premiums, are carried at their estimated realizable value and take into account anticipated losses and loss adjustment expenses, based on historical and current experience, and anticipated investment income. A premium deficiency occurs if the sum of anticipated losses and loss adjustment expenses, unamortized acquisition costs and maintenance costs and anticipated investment income exceed unearned premiums. A premium deficiency is recorded by charging any unamortized acquisition costs to expense to the extent required in order to eliminate the deficiency. If the premium deficiency exceeds unamortized acquisition costs then a liability is accrued for the excess deficiency. No significant premium deficiency charges were recorded by the Company during 2009 or 2008.

(c) Deposit Accounting

Certain assumed reinsurance contracts, which pursuant to Financial Accounting Standards Board ("FASB") guidance regarding the accounting and reporting for reinsurance and short-duration and long-duration contracts, are deemed not to transfer insurance risk, are accounted for using the deposit method of accounting as prescribed in the FASB guidance regarding the accounting for insurance and reinsurance contracts that do not

ARCH REINSURANCE LTD. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

transfer insurance risk. However, it is possible that the Company could incur financial losses on such contracts. Management exercises significant judgment in the assumptions used in determining whether assumed contracts should be accounted for as reinsurance contracts or deposit insurance contracts. Under the FASB guidance, for those contracts that contain an element of underwriting risk, the estimated profit margin is deferred and amortized over the contract period and such amount is included in the Company's underwriting results. When the estimated profit margin is explicit, the margin is reflected as fee income and any adverse financial results on such contracts are reflected as incurred losses. When the estimated profit margin is implicit, the margin is reflected as an offset to paid losses and any adverse financial results on such contracts are reflected as incurred losses. For those contracts that do not transfer an element of underwriting risk, the projected profit is reflected in earnings over the estimated settlement period using the interest method and such profit is included in investment income. Additional judgments are required when applying the accounting guidance with respect to the revenue recognition criteria for contracts deemed not to transfer insurance risk. Deposit accounting liabilities, which totaled \$38.2 million and \$39.8 million, respectively, at December 31, 2009 and 2008, are included in "Other liabilities" on the Company's balance sheet.

(d) Retroactive Accounting

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

(e) Reinsurance Ceded

In the normal course of business, the Company purchases reinsurance to increase capacity and to limit the impact of individual losses and events on its underwriting results by reinsuring certain levels of risk with other insurance enterprises or reinsurers. The Company uses pro rata, excess of loss and facultative reinsurance contracts. Reinsurance ceding commissions are recognized as income on a pro rata basis over the period of risk. The portion of such commissions that will be earned in the future is deferred and reported as a reduction to acquisition costs. The accompanying consolidated statement of income reflects premiums and losses and loss adjustment expenses and acquisition costs, net of reinsurance ceded (see Note 3). Ceded unearned premiums are reported as prepaid reinsurance premiums and estimated amounts of reinsurance recoverable on unpaid losses are reported as unpaid losses and loss adjustment expenses recoverable. Reinsurance premiums ceded and unpaid losses and loss adjustment expenses recoverable are estimated in a manner consistent with that of the original policies issued and the terms of the reinsurance contracts. To the extent that any reinsurer does not meet its obligations under reinsurance agreements, the Company must discharge the liability.

(f) Cash

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

(g) Investments

The Company currently classifies all of its fixed maturity investments and short-term investments as "available for sale" and, accordingly, they are carried at estimated market value. The market value of fixed maturity securities is generally determined from quotations received from nationally recognized pricing services, or when such prices are not available, by reference to broker or underwriter bid indications. Short-term

ARCH REINSURANCE LTD. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

investments comprise securities due to mature within one year of the date of issue. Short-term investments include certain cash equivalents which are part of investment portfolios under the management of external and internal investment managers.

The Company participates in a securities lending program as a mechanism for generating additional interest income on its fixed income portfolio. Under the security lending agreements, certain of its fixed income portfolio securities are loaned to third parties, primarily major brokerage firms, for short periods of time through a lending agent. Such securities have been reclassified as “Fixed maturities and short-term investments pledged under securities lending agreements, at market value.” 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. 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 “Investment of funds received under securities lending agreements, at market value” and “Securities purchased under agreements to resell using funds received under securities lending agreements.”

During 2009, the Company purchased asset-backed and commercial mortgage-backed securities under the Federal Reserve Bank of New York’s (“FRBNY”) Term Asset-Backed Securities Loan Facility (“TALF”) program. TALF provides secured financing for asset-backed securities backed by certain types of consumer and small business loans and for legacy commercial mortgage-backed securities. TALF financing is non-recourse to the Company, except in certain limited instances, and is collateralized by the purchased securities and provides financing for the purchase price of the securities, less a ‘haircut’ that varies based on the type of collateral. The Company can deliver the collateralized securities to a special purpose vehicle created by FRBNY in full defeasance of the borrowing. The Company elected to carry the securities and related borrowings at fair value under the fair value option afforded by accounting guidance regarding the fair value option for financial assets and financial liabilities. The securities purchased under TALF are reflected as “TALF investments, at market value” and the secured financing from the FRBNY is reflected as “TALF borrowings, at market value.” Changes in market value for both the securities and borrowings are included in “Net realized gains (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 Company’s investment portfolio includes certain funds that invest in fixed maturity securities which, due to their ownership structure, are accounted for by the Company using the equity method. In applying the equity method, these investments are initially recorded at cost and are subsequently adjusted based on the Company’s 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). Such investments are generally recorded on a one month lag with some investments reported for on a three month lag based on the availability of reports from the investment funds. Changes in the carrying value of such investments are recorded in net income as “Equity in net income (loss) of investment funds accounted for using the equity method” while changes in the carrying value of the Company’s other fixed income investments are recorded as an unrealized gain or loss component of accumulated other comprehensive income in shareholders’ equity. As such, fluctuations in the carrying value of the investment funds accounted for using the equity method may increase the volatility of the Company’s reported results of operations.

Other investments include: (i) mutual funds which invest in fixed maturity securities and (ii) privately held securities and other which include the Company’s investment in Aeolus LP (see Note 11) and an equity portfolio which was added in 2009. Investments in equity securities are carried at estimated market value in accordance with FASB guidance regarding the accounting for certain investments in debt and equity securities. The estimated market value of investments in privately held securities, other than those carried under the equity method, are initially valued based upon transaction price and then adjusted upwards or downwards from the

ARCH REINSURANCE LTD. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

transaction price to reflect expected exit values. The Company elected to carry the equity portfolio at fair value under the fair value option afforded by accounting guidance regarding the fair value option for financial assets and liabilities.

In April 2009, the FASB issued guidance regarding the recognition and presentation of other-than-temporary impairments, which requires entities to separate an other-than-temporary impairment (“OTTI”) of a debt security into two components when there are credit related losses associated with the impaired debt security for which the Company asserts that it does not have the intent to sell the security, and it is more likely than not that it will not be required to sell the security before recovery of its cost basis. Prior to January 1, 2009, the Company had to determine whether it had the intent and ability to hold the investment for a sufficient period of time for the value to recover. The Company’s process for identifying declines in the market value of investments that were considered other-than-temporary involved consideration of several factors. These factors included (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, and (iii) the significance of the decline. When the analysis of such factors resulted in the Company’s conclusion that declines in market values were other-than-temporary, the cost of the securities was written down to market value and the reduction in value was reflected as a realized loss. Effective under this guidance, the amount of the OTTI related to a credit loss is recognized in earnings, and the amount of the OTTI related to other factors (*e.g.*, interest rates, market conditions, etc.) is recorded as a component of other comprehensive income (loss). In instances where no credit loss exists but it is more likely than not that the Company will have to sell the debt security prior to the anticipated recovery, the decline in market value below amortized cost is recognized as an OTTI in earnings. In periods after the recognition of an OTTI on debt securities, the Company accounts for such securities as if they had been purchased on the measurement date of the OTTI at an amortized cost basis equal to the previous amortized cost basis less the OTTI recognized in earnings. For debt securities for which OTTI were recognized in earnings, the difference between the new amortized cost basis and the cash flows expected to be collected will be accreted or amortized into net investment income. This guidance was effective for periods ending after June 15, 2009, and, accordingly, the Company adopted this guidance in 2009.

Under FASB guidance regarding the accounting for derivative instruments and hedging activities, all derivative financial instruments, including embedded derivative instruments, are required to be recognized as either assets or liabilities in the consolidated balance sheets and measured at market value. The accounting for gains and losses associated with changes in the market value of a derivative and the effect on the consolidated financial statements depends on whether it has been designated and qualifies as part of a hedging relationship and whether the hedge is highly effective in achieving offsetting changes in the market value of the asset or liability hedged. The Company’s investment strategy allows for the use of derivative instruments. Derivative instruments may be used to enhance investment performance, replicate investment positions or manage market exposures and duration risk that would be allowed under the Company’s investment guidelines if implemented in other ways. Pursuant to FASB guidance, these instruments, which have no hedging designation, are recognized as assets and liabilities in the Company’s balance sheet at market value, based on quoted market prices, and all realized and unrealized contract gains and losses are included in net realized gains and losses in its results of operations.

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

ARCH REINSURANCE LTD. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

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

(h) Reserves for Losses and Loss Adjustment Expenses

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

(i) Foreign Exchange

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

ARCH REINSURANCE LTD. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(j) Income Taxes

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

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

(k) Share-Based Payment Arrangements

Certain of the Company's employees participate in ACGL's long-term incentive and share award plans. The expenses incurred under such plans are included in the Company's results of operations.

The Company applies a fair value based measurement method in accounting for its share-based payment arrangements with eligible employees and directors. Compensation expense is estimated based on the fair value of the award at the grant date and is recognized in net income over the requisite service period with a corresponding increase in shareholder's equity. No value is attributed to awards that employees forfeit because they fail to satisfy vesting conditions. As such, the number of shares granted is reduced by assumed forfeitures and adjusted based on actual forfeitures until vesting. The Company's share-based payment arrangements generally vest over a three year period with one-third vesting on the first, second and third anniversaries of the grant date. The share-based compensation expense associated with such awards that have graded vesting features and vest based on service conditions only is calculated on a straight-line basis over the requisite service period for the entire award. 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. These charges had no impact on the Company's cash flows or total shareholder's equity. See Note 13 for information relating to the Company's share-based payment awards.

(l) Guaranty Fund and Other Related Assessments

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

(o) Recent Accounting Pronouncements

In January 2010, the FASB issued an Accounting Standards Update ("ASU") to improve disclosure requirements related to fair value measurements. The ASU requires more robust disclosures about (i) different classes of assets and liabilities measured at fair value, (ii) the valuation techniques and inputs to fair value measurements for both Levels 2 and 3, (iii) the activity within Level 3 fair value measurements (*i.e.*, in the reconciliation for fair value measurements using significant unobservable inputs activity should be presented on

ARCH REINSURANCE LTD. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

a gross basis), and (iv) the transfers between Levels 1, 2 and 3, (*i.e.*, include the reasons for significant transfers in and out of Levels 1 and 2).The ASU is effective for interim and annual reporting periods beginning after December 15, 2009, except for the disclosures about purchases, sales, issuances, and settlements in the roll forward activity in Level 3 fair value measurements, which will become effective for fiscal years beginning after December 15, 2010. Accordingly, the Company will adopt the appropriate disclosure provisions of the ASU on January 1, 2010.

In September 2009, the FASB issued an ASU regarding the estimation of the fair value of investments in certain entities that calculate net asset value per share (or its equivalent). This ASU provides additional guidance on estimating the fair value of certain alternative investments and its provisions create a practical expedient to measure the fair value of an alternative investment on the basis of the net asset value per share of the investment. The ASU also requires additional disclosures about the attributes of certain alternative investments. The ASU is effective for interim and annual reporting periods ending after December 15, 2009 and, accordingly, the Company adopted this ASU in 2009. The adoption did not have a material impact on the Company's consolidated financial position or results of operations.

In August 2009, the FASB issued an ASU to amend the guidance regarding the fair value measurement of liabilities. This ASU provides clarification that in circumstances in which a quoted price in an active market for an identical liability is not available, a reporting entity is required to measure fair value using other valuation techniques, including a technique that uses: (a) the quoted price of the identical liability when traded as an asset; and (b) quoted prices for similar liabilities or similar liabilities when traded as assets. The amendments in this ASU also clarify that when estimating the fair value of a liability, a reporting entity is not required to include a separate input or adjustment to other inputs relating to the existence of a restriction that prevents the transfer of the liability. Lastly, this ASU clarifies that both a quoted price in an active market for the identical liability at the measurement date and the quoted price for the identical liability when traded as an asset in an active market when no adjustments to the quoted price of the asset are required are Level 1 fair value measurements. This ASU was effective for the Company in the interim period ending September 30, 2009, and the adoption did not have a material impact on the Company's consolidated financial position or results of operations.

In June 2009, the FASB approved the "FASB Accounting Standards Codification" (the "Codification") as the single source of authoritative nongovernmental GAAP effective July 1, 2009. The Codification does not change current GAAP, but is intended to simplify user access to all authoritative GAAP by providing all the authoritative literature related to a particular topic in one place. All existing accounting standard documents will be superseded and all other accounting literature not included in the Codification will be considered non-authoritative. The Codification was effective for the Company in the interim period ending September 30, 2009, and the adoption did not impact its consolidated financial position or results of operations.

In June 2009, the FASB issued amendments to the guidance regarding the consolidation of variable interest entities ("VIEs"), which affect all entities currently within the scope of the December 2003 revised version of the guidance, as well as qualifying special-purpose entities that are currently excluded from the scope of the guidance. The amendments require an analysis to determine whether a variable interest gives a company a controlling financial interest in a VIE. In addition, they require an ongoing reassessment of all VIEs and eliminate the quantitative approach previously required for determining whether a company is the primary beneficiary. The amendments are effective for fiscal years beginning after November 15, 2009. Accordingly, the Company will adopt the amended guidance on January 1, 2010. The Company does not anticipate that adopting the provisions under the amended guidance will significantly impact its consolidated financial position and results of operations. See Note 12, "Commitments and Contingencies—Variable Interest Entities" for additional information.

In June 2009, the FASB issued an amendment to the guidance regarding accounting for transfers of financial assets. This amendment removes the concept of a qualifying special-purpose entity from the guidance

ARCH REINSURANCE LTD. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

regarding the accounting for transfers and servicing of financial assets and extinguishment of liabilities, and removes the exception from applying to the consolidation of VIEs. This amendment also clarifies the requirements for isolation and limitations on portions of financial assets that are eligible for sale accounting and enhances disclosures about transfers of financial assets and a transferor's continuing involvement with transferred financial assets. This amendment is effective prospectively to transfers of financial assets occurring in fiscal years beginning after November 15, 2009. Accordingly, the Company will adopt this amendment on January 1, 2010. The Company does not anticipate that adopting the provisions under the amended guidance will significantly effect its consolidated financial position and results of operations.

In May 2009, the FASB issued guidance regarding subsequent events, which establishes general standards for accounting for and disclosure of events that occur after the balance sheet date but before the financial statements are issued or are available to be issued. The guidance requires the disclosure of the date through which an entity has evaluated subsequent events, which is the date that the financials statements are available to be issued. This guidance was effective with interim and annual financial periods ending after June 15, 2009, and the adoption did not impact the Company's consolidated financial position or results of operations. See Note 18, "Subsequent Events."

In April 2009, the FASB issued guidance regarding the recognition and presentation of other-than-temporary impairments, which requires entities to separate an other-than-temporary impairment of a debt security into two components when there are credit related losses associated with the impaired debt security for which the Company asserts that it does not have the intent to sell the security, and it is more likely than not that it will not be required to sell the security before recovery of its cost basis. The amount of the other-than-temporary impairment related to a credit loss is recognized in earnings, and the amount of the other-than-temporary impairment related to other factors (e.g., interest rates, market conditions, etc.) is recorded as a component of other comprehensive income (loss). This guidance was effective for periods ending after June 15, 2009 and, accordingly, the Company adopted this guidance in 2009. See Note 6, "Investment Information—Other-Than-Temporary Impairments."

In April 2009, the FASB issued guidance regarding the determination of fair value when the volume and level of activity for the asset or liability have significantly decreased and the identification of transactions that are not orderly. This guidance also amended guidance regarding fair value measurements to expand certain disclosure requirements. This guidance was effective for periods ending after June 15, 2009, and its adoption did not have a material impact on the Company's consolidated financial position or results of operations. See Note 7, "Fair Value."

In April 2009, the FASB issued guidance regarding the interim disclosures about fair value of financial instruments, which requires disclosures about fair value of financial instruments in interim and annual financial statements. This guidance was effective for periods ending after June 15, 2009, and the Company has included the required disclosures in its notes to consolidated financial statements where applicable.

ARCH REINSURANCE LTD. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

3. Reinsurance

In the normal course of business, Arch Re Ltd. and its insurance subsidiaries cede a portion of their premium through pro rata and excess of loss reinsurance agreements on a treaty or facultative basis. Arch Re Ltd. and its 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 Arch Re Ltd. and its reinsurance subsidiaries, and the ceding company. In addition, Arch Re Ltd. and its reinsurance subsidiaries may purchase retrocessional coverage as part of their risk management program. Reinsurance recoverables are recorded as assets, predicated on the reinsurers’ ability to meet their obligations under the reinsurance agreements. If the reinsurers are unable to satisfy their obligations under the agreements, Arch Re Ltd. and its insurance or reinsurance subsidiaries would be liable for such defaulted amounts (see Note 12).

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

	Years Ended December 31,	
	2009	2008
Premiums Written		
Direct.....	\$2,427,044	\$2,385,807
Assumed.....	1,165,887	1,283,269
Ceded	(829,819)	(863,350)
Net.....	<u>\$2,763,112</u>	<u>\$2,805,726</u>
Premiums Earned		
Direct.....	2,439,173	2,479,271
Assumed.....	1,269,454	1,402,478
Ceded	(865,882)	(1,036,295)
Net.....	<u>\$2,842,745</u>	<u>\$2,845,454</u>
Losses and Loss Adjustment Expenses		
Direct.....	\$1,486,349	\$1,717,158
Assumed.....	559,776	836,000
Ceded	(391,451)	(704,414)
Net.....	<u>\$1,654,674</u>	<u>\$1,848,744</u>

The Company monitors the financial condition of its reinsurers and attempts to place coverages only with substantial, financially sound carriers. At December 31, 2009, approximately 83.9% of the Company’s 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 less than 5.4% of the Company’s total shareholder’s equity. At December 31, 2008, approximately 82.3% of the Company’s reinsurance recoverables on paid and unpaid losses (not including prepaid reinsurance premiums) of \$1.92 billion were due from carriers which had an A.M. Best rating of “A-” or better, and the largest reinsurance recoverable from any one carrier was less than 6.6%, of the Company’s total shareholder’s equity.

On December 29, 2005, Arch Re Ltd. entered into a quota share reinsurance treaty with Flatiron Re Ltd. (“Flatiron”), a Bermuda reinsurance company, pursuant to which Flatiron assumed a 45% quota share (the “Treaty”) of certain lines of property and marine business underwritten by Arch Re Ltd. for unaffiliated third parties for the 2006 and 2007 underwriting years (January 1, 2006 to December 31, 2007). Effective June 28, 2006, the parties amended the Treaty to increase the percentage ceded to Flatiron from 45% to 70% of all

ARCH REINSURANCE LTD. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

covered business bound by Arch Re Ltd. from (and including) June 28, 2006 until (and including) August 15, 2006 provided such business did not incept beyond September 30, 2006. The ceding percentage for all business bound outside of this period continued to be 45%. On December 31, 2007, the Treaty expired by its terms.

Flatiron is required to contribute funds into a trust for the benefit of Arch Re Ltd. (the "Trust"). Effective June 28, 2006, the parties amended the Treaty to provide that, through the earning of all written premium, the amount required to be on deposit in the Trust, together with certain other amounts, will be an amount equal to 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"). 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 Ltd. will, among other things, recapture unearned premium reserves and reassume losses that would have been ceded in respect of such unearned premiums. No assurances can be given that actual losses will not exceed the Requisite Funded Amount or that Flatiron will make, or will have the ability to make, the required contributions into the Trust.

Arch Re Ltd. pays to Flatiron a reinsurance premium in the amount of the ceded percentage of the original gross written premium on the business reinsured less a ceding commission, which includes a reimbursement of direct acquisition expenses as well as a commission to Arch Re Ltd. for generating the business. The Treaty also provides for a profit commission to the Arch Re Ltd. based on the underwriting results for the 2006 and 2007 underwriting years on a cumulative basis. For 2009, \$3.8 million of premiums written, \$22.0 million of premiums earned and a reduction of \$11.6 million of losses and loss adjustment expenses were ceded to Flatiron by Arch Re Ltd., compared to \$24.7 million of premiums written, \$151.4 million of premiums earned and \$48.6 million of losses and loss adjustment expenses for 2008. Reinsurance recoverables from Flatiron, which is not rated by A.M. Best, were \$97.6 million at December 31, 2009, compared to \$148.7 million at December 31, 2008. As noted above, Flatiron is required to contribute funds into a trust for the benefit of Arch Re Ltd. The recoverable from Flatiron was fully collateralized through such trust at December 31, 2009 and 2008.

ARCH REINSURANCE LTD. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

4. Reserve for Losses and Loss Adjustment Expenses

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

	<u>December 31,</u>	
	<u>2009</u>	<u>2008</u>
Reserve for losses and loss adjustment expenses at beginning of year	\$7,798,496	\$7,214,324
Unpaid losses and loss adjustment expenses recoverable	<u>1,860,674</u>	<u>1,731,491</u>
Net reserve for losses and loss adjustment expenses at beginning of year.....	5,937,822	5,482,833
Net incurred losses and loss adjustment expenses incurred relating to losses occurring in:		
Current year	1,843,875	2,158,914
Prior years.....	<u>(189,201)</u>	<u>(310,170)</u>
Total net incurred losses and loss adjustment expenses.....	1,654,674	1,848,744
Foreign exchange (gains) losses.....	60,506	(133,881)
Net paid losses and loss adjustment expenses relating to losses occurring in:		
Current year	(272,295)	(305,513)
Prior years.....	<u>(1,166,795)</u>	<u>(954,361)</u>
Total net paid losses and loss adjustment expenses	(1,439,090)	(1,259,874)
Net reserve for losses and loss adjustment expenses at end of year	6,213,912	5,937,822
Unpaid losses and loss adjustment expenses recoverable	<u>1,783,260</u>	<u>1,860,674</u>
Reserve for losses and loss adjustment expenses at end of year	<u>\$7,997,172</u>	<u>\$7,798,496</u>

2009 Prior Year Reserve Development

During 2009, the Company recorded estimated net favorable development on prior year loss reserves of \$189.2 million, which consisted of \$142.1 million from its reinsurance operations and \$47.1 million from its insurance operations.

The reinsurance operations' net favorable development of \$142.1 million consisted of \$81.7 million from short-tailed lines and \$80.4 million from long-tailed lines, partially offset by \$20.0 million of adverse development on medium-tailed lines. Favorable development in short-tailed lines included \$57.6 million of favorable development from property catastrophe and other property lines. Such amount included reductions in 2005 to 2008 underwriting years of \$9.9 million, \$2.2 million, \$17.8 million and \$25.7 million, respectively. In addition, favorable development in short-tailed lines included \$21.8 million from other specialty business, including \$6.2 million and \$7.5 million from the 2004 and 2005 underwriting years. The reduction of loss estimates for the reinsurance operations' short-tailed lines primarily resulted from a lower level of reported and paid claims activity than previously anticipated which led to decreases in certain loss ratio selections during 2009. Net favorable development of \$80.4 million in long-tailed lines included reductions in casualty reserves of \$27.0 million, \$34.6 million and \$17.6 million from the 2004 to 2006 underwriting years which primarily resulted from a lower level of reported and paid claims activity than previously anticipated on U.S. and international excess liability, professional liability and D&O lines. Over time, historical loss information for older underwriting years has been given more weight in the reinsurance operations' reserving process based on the continued maturation of its reserves. Adverse development on medium-tailed lines resulted from increases on marine exposures in the 2008 underwriting year of

ARCH REINSURANCE LTD. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

\$31.8 million, due in part to increases in Hurricane Ike estimates, partially offset by reductions in the 2004 to 2006 underwriting years.

The insurance operations' net favorable development of \$47.1 million was primarily due to reductions in reserves in medium-tailed and short-tailed lines of business. Such amount included favorable development in professional liability reserves from the 2005 to 2007 accident years (*i.e.*, the year in which a loss occurred) of \$6.3 million, \$16.1 million and \$8.6 million, respectively, and adverse development on the 2008 accident year of \$9.4 million. In addition, favorable development on construction reserves from the 2005 and 2006 accident years contributed \$10.6 million and \$5.4 million, respectively, which resulted from lower than expected large loss activity. Favorable development in short-tailed lines primarily consisted of reductions in property reserves from the 2007 and 2008 accident years of \$9.4 million and \$11.1 million, respectively. Offsetting favorable development on medium-tailed and short-tailed lines of business were increases in executive assurance reserves for the 2007 and 2008 accident years of \$14.8 million and \$28.3 million, respectively, due to large specific risk loss activity relating to the credit crisis, partially offset by favorable development in the 2004 to 2006 accident years of \$4.1 million, \$17.5 million and \$3.6 million, respectively. Reductions in the 2004 to 2006 accident years relate to less large loss activity than expected in commercial D&O, a distinctive downward trend in security class action cases filed from 2004 through 2006, and to the claims-made nature of the coverage. The claims-made aspect eliminates the potential of new claims being reported for these years, and narrows the remaining liability to changes in reserve estimation for claims which have already been reported.

2008 Prior Year Reserve Development

During 2008, the Company recorded estimated net favorable development on prior year loss reserves of \$310.2 million, which consisted of \$231.2 million from its reinsurance operations and \$79.0 million from its insurance operations.

The reinsurance operations' net favorable development of \$231.2 million consisted of \$126.1 million from short-tailed lines and \$105.1 million from medium-tailed and long-tailed business. The reinsurance operations' favorable development in short-tailed lines of \$126.1 million included \$73.5 million of favorable development from property catastrophe and other property lines. Of such amount, \$42.0 million of favorable development came from the reinsurance operations' property catastrophe business, including \$10.8 million, \$11.4 million and \$15.7 million from the 2005 to 2007 underwriting years, respectively. The remainder was attributable to favorable development on other property business, primarily from the 2005 underwriting year. In addition, favorable development in short-tailed lines reflected \$46.5 million of favorable development in other specialty business, including \$16.7 million, \$5.1 million and \$9.5 million from the 2005 to 2007 underwriting years, respectively, with the remainder attributable to earlier underwriting years. The reduction of loss estimates for the reinsurance operations' short-tailed lines primarily resulted from a lower level of reported and paid claims activity than previously anticipated which led to decreases in certain loss ratio selections during 2008. The net favorable development of \$105.1 million in medium-tailed and long-tailed lines was primarily in casualty reserves from the 2003 to 2005 underwriting years, which contributed \$31.0 million, \$38.7 million and \$14.2 million, respectively. The reductions in casualty reserves primarily resulted from a lower level of reported and paid claims activity than previously anticipated on U.S. and international excess liability, professional liability and D&O lines.

ARCH REINSURANCE LTD. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

The insurance operations' net favorable development of \$79.0 million was primarily due to reductions in reserves in medium-tailed and long-tailed lines of business. Over 80 percent of this development is related to the executive assurance and professional liability lines of business. Executive assurance reserves developed favorably for accident years 2004 through 2006 by \$15.8 million, \$17.3 million, and \$17.6 million, respectively. These reductions relate to less large loss activity than expected in commercial D&O, a distinctive downward trend in security class action cases filed from 2004 through 2006, and to the claims-made nature of the coverage. Accident year 2007 experienced unfavorable development of \$19.7 million relating to the re-evaluation of claims given additional information available during 2008 regarding the impact of the credit crisis. Reserves for professional liability developed favorably as well, with the majority of the favorable development relating to accident years 2003 through 2005 with \$5.2 million, \$8.1 million, and \$19.1 million, respectively.

5. Investment in Joint Venture

During 2008, Arch Re Ltd. received an advance of \$100 million from ACGL, which it subsequently repaid by the issuance of 60,423 shares of common stock to ACGL at \$1 par value per share. Arch Re Ltd. used the funds obtained from ACGL to provide \$100.0 million of funding to Gulf Reinsurance Limited ("Gulf Re"), a newly formed reinsurer based in the Dubai International Financial Centre, pursuant to the joint venture agreement with Gulf Investment Corporation GSC ("GIC"). Under the agreement, Arch Re Ltd. and GIC each own 50% of Gulf Re, which commenced underwriting activities in June 2008. Gulf Re provides property and casualty reinsurance primarily in the member states of the Gulf Cooperation Council, which include Bahrain, Kuwait, Oman, Qatar, Saudi Arabia and the United Arab Emirates. The initial capital of the joint venture consisted of \$200.0 million with an additional \$200.0 million commitment to be funded equally by Arch Re Ltd. and GIC depending on the joint venture's business needs. Arch Re Ltd. accounts for its investment in Gulf Re, shown as "Investment in joint venture," using the equity method and records its equity in the operating results of Gulf Re in "Other income" on a quarter lag basis.

6. Investment Information

The following table summarizes the Company's invested assets:

	December 31,	
	2009	2008
Fixed maturities available for sale, at market value	\$9,384,743	\$8,115,767
Fixed maturities pledged under securities lending agreements, at market value (1)	208,826	626,501
Total fixed maturities	9,593,569	8,742,268
Short-term investments available for sale, at market value	549,867	470,373
Short-term investments pledged under securities lending agreements, at market value (1)	3,994	101,564
TALF investments, at market value	250,265	—
Other investments.....	172,172	109,601
Investment funds accounted for using the equity method	391,869	301,027
Total investments (1)	10,961,736	9,724,833
Securities transactions entered into but not settled at the balance sheet date	50,790	(18,237)
Total investments, net of securities transactions	<u>\$11,012,526</u>	<u>\$9,706,596</u>

- (1) In securities lending transactions, the Company receives collateral in excess of the market value of the fixed maturities and short-term investments pledged under securities lending agreements. For purposes of this table, the Company has excluded the collateral received and reinvested at December 31, 2009 and December 31, 2008 of \$207.0 million and \$730.2 million, respectively, and included the \$212.8 million and \$728.1 million, respectively, of "fixed maturities and short-term investments pledged under securities lending agreements, at market value."

ARCH REINSURANCE LTD. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

Fixed Maturities and Fixed Maturities Pledged Under Securities Lending Agreements

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

	Estimated Market Value	Gross Unrealized Gains	Gross Unrealized Losses	Amortized Cost	OTTI Unrealized Losses (1)
December 31, 2009:					
Corporate bonds.....	\$3,130,901	\$99,355	(\$12,922)	\$3,044,468	(\$19,667)
U.S. government and government agencies...	1,549,676	8,628	(12,981)	1,554,029	(499)
Mortgage backed securities	1,449,382	13,158	(45,536)	1,481,760	(43,930)
Commercial mortgage backed securities	1,185,799	35,161	(11,724)	1,162,362	(3,750)
Municipal bonds	957,752	44,043	(2,284)	915,993	(145)
Non-U.S. government securities.....	752,215	41,858	(7,712)	718,069	(351)
Asset backed securities	567,844	21,713	(8,220)	554,351	(6,111)
Total	<u>\$9,593,569</u>	<u>\$263,916</u>	<u>(\$101,379)</u>	<u>\$9,431,032</u>	<u>(\$74,453)</u>
December 31, 2008:					
Corporate bonds.....	\$2,018,471	\$51,108	(\$98,963)	\$2,066,326	—
U.S. government and government agencies...	1,458,345	77,372	(14,159)	1,395,132	—
Mortgage backed securities	1,581,736	23,306	(125,759)	1,684,189	—
Commercial mortgage backed securities	1,219,737	16,128	(68,212)	1,271,821	—
Municipal bonds	965,966	26,815	(1,730)	940,881	—
Non-U.S. government securities.....	527,972	33,690	(31,884)	526,166	—
Asset backed securities	970,041	1,121	(70,762)	1,039,682	—
Total	<u>\$8,742,268</u>	<u>\$229,540</u>	<u>(\$411,469)</u>	<u>\$8,924,197</u>	<u>—</u>

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

The contractual maturities of the Company's fixed maturities and fixed maturities pledged under securities lending agreements are shown below. Expected maturities, which are management's best 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	December 31, 2009		December 31, 2008	
	Estimated Market Value	Amortized Cost	Estimated Market Value	Amortized Cost
Due in one year or less	\$227,668	\$220,095	\$172,850	\$168,877
Due after one year through five years	3,983,984	3,880,956	2,447,101	2,448,589
Due after five years through 10 years	1,842,705	1,798,650	1,725,299	1,685,239
Due after 10 years	336,187	332,858	625,504	625,800
	<u>6,390,544</u>	<u>6,232,559</u>	<u>4,970,754</u>	<u>4,928,505</u>
Mortgage backed securities	1,449,382	1,481,760	1,581,736	1,684,189
Commercial mortgage backed securities.....	1,185,799	1,162,362	1,219,737	1,271,821
Asset backed securities	567,844	554,351	970,041	1,039,682
Total.....	<u>\$9,593,569</u>	<u>\$9,431,032</u>	<u>\$8,742,268</u>	<u>\$8,924,197</u>

The Company had gross unrealized losses on its fixed maturities and fixed maturities pledged under securities lending agreements of \$101.4 million at December 31, 2009. At December 31, 2009, on a lot level

ARCH REINSURANCE LTD. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

basis, approximately 1,420 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 \$2.2 million. The Company had gross unrealized losses on its fixed maturities and fixed maturities pledged under securities lending agreements of \$411.5 million at December 31, 2008. At December 31, 2008, on a lot level basis, approximately 2,360 security lots out of a total of approximately 3,900 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 \$6.1 million.

ARCH REINSURANCE LTD. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

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

	Less than 12 Months		12 Months or More		Total	
	Estimated Market Value	Gross Unrealized Losses	Estimated Market Value	Gross Unrealized Losses	Estimated Market Value	Gross Unrealized Losses
December 31, 2009:						
Corporate bonds.....	\$546,087	(\$7,681)	\$45,399	(\$5,241)	\$591,486	(\$12,922)
U.S. government and government agencies	1,111,711	(12,492)	5,309	(489)	1,117,020	(12,981)
Mortgage backed securities	636,817	(33,388)	62,382	(12,148)	699,199	(45,536)
Commercial mortgage backed securities	154,087	(4,808)	67,744	(6,916)	221,831	(11,724)
Municipal bonds	151,412	(2,284)	—	—	151,412	(2,284)
Non-U.S. government securities.....	218,394	(7,712)	—	—	218,394	(7,712)
Asset backed securities	101,679	(5,838)	22,915	(2,382)	124,594	(8,220)
Total.....	<u>2,920,187</u>	<u>(74,203)</u>	<u>203,749</u>	<u>(27,176)</u>	<u>3,123,936</u>	<u>(101,379)</u>
Other investments	9,071	(304)	29,439	(5,195)	38,510	(5,499)
Short-term investments	64,616	(1,858)	—	—	64,616	(1,858)
Total.....	<u>\$2,993,874</u>	<u>(\$76,365)</u>	<u>\$233,188</u>	<u>(\$32,371)</u>	<u>\$3,227,062</u>	<u>(\$108,736)</u>
December 31, 2008:						
Corporate bonds.....	\$869,868	(\$89,430)	\$30,608	(\$9,533)	\$900,476	(\$98,963)
U.S. government and government agencies.....	356,719	(14,159)	—	—	356,719	(14,159)
Mortgage backed securities	417,373	(105,154)	23,295	(20,605)	440,668	(125,759)
Commercial mortgage backed securities	714,497	(68,210)	52	(2)	714,549	(68,212)
Municipal bonds	93,072	(1,730)	—	—	93,072	(1,730)
Non-U.S. government securities...	223,314	(31,882)	142	(2)	223,456	(31,884)
Asset backed securities	888,908	(63,845)	26,185	(6,917)	915,093	(70,762)
Total.....	<u>3,563,751</u>	<u>(374,410)</u>	<u>80,282</u>	<u>(37,059)</u>	<u>3,644,033</u>	<u>(411,469)</u>
Other investments.....	20,510	(3,649)	13,715	(20,919)	34,225	(24,568)
Short-term investments.....	33,080	(2,535)	—	—	33,080	(2,535)
Total.....	<u>\$3,617,341</u>	<u>(\$380,594)</u>	<u>\$93,997</u>	<u>(\$57,978)</u>	<u>\$3,711,338</u>	<u>(\$438,572)</u>

Other-Than-Temporary Impairments

Adoption of Accounting Guidance

This guidance requires that the Company record, as of the beginning of the interim period of adoption, a cumulative effect adjustment to reclassify the noncredit component of a previously recognized OTTI from retained earnings to other comprehensive income (loss). For purposes of calculating the cumulative effect adjustment, the Company reviewed OTTI it had recorded through realized losses on securities held at December 31, 2008, which were \$171.1 million, and estimated the portion related to credit losses (*i.e.*, where the present value of cash flows expected to be collected are lower than the amortized cost basis of the security) and the portion related to all other factors. The Company determined that \$109.1 million of the OTTI previously

ARCH REINSURANCE LTD. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

recorded related to specific credit losses and \$62.0 million related to all other factors. The Company increased the amortized cost basis of these debt securities by \$62.0 million and recorded a cumulative effect adjustment, net of tax, in its shareholder's equity section. The cumulative effect adjustment had no effect on total shareholder's equity as it increased retained earnings and reduced accumulated other comprehensive income.

2009 and 2008 Periods

The Company performed quarterly reviews of its investments in the 2009 and 2008 periods in order to determine whether declines in market value below the amortized cost basis were considered other-than-temporary in accordance with applicable guidance. For the year ended December 31, 2009, the Company recorded \$66.1 million of net impairment losses recognized in earnings.

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 for the year ended December 31, 2009:

Year Ended December 31, 2009:

Beginning balance at January 1, 2009	\$35,474
Credit loss impairments recognized on securities not previously impaired	16,221
Credit loss impairments recognized on securities previously impaired	35,530
Reductions for increases in cash flows expected to be collected that are recognized over the remaining life of the security	—
Credit loss impairments previously recognized in AOCI on securities sold during the period.....	(3,078)
Ending balance at December 31, 2009	<u>\$84,147</u>

A description of the methodology and significant inputs used to measure the amount of OTTI related to credit losses of \$66.1 million for the year ended December 31, 2009 follows. At December 31, 2009, the Company did not have the intent to sell such securities, and determined that it is more likely than not that the Company will not be required to sell the securities before recovery of their cost basis.

- Corporate bonds – the Company recorded \$3.8 million of OTTI related to credit losses in the year ended December 31, 2009. The Company reviewed the business prospects, credit ratings, estimated loss given default factors and incorporated available information received from asset managers and rating agencies for each security. The amortized cost basis of the corporate bonds were adjusted down, if required, to the expected recovery value calculated in the OTTI review process;
- Asset backed securities – the Company recorded \$26.8 million of OTTI related to credit losses in the year ended December 31, 2009. The Company utilized 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 on home equity asset backed securities 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. The significant inputs in the models include the expected default rates, delinquency rates and foreclosure costs. In the 2009 first and second quarters, the expected recovery values were reduced on a number of asset backed securities backed by sub-prime or Alt-A collateral due to reductions in the expected recovery values on such securities in each period. In the 2009 third and fourth quarters, the declines in expected recovery values were, in general, more moderate than in the earlier periods. These reductions followed the quarterly review of information received which indicated increases in expected default rates, foreclosure costs and other factors. On an ongoing basis, the

ARCH REINSURANCE LTD. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

Company reviews the process used by each asset manager in developing their analysis and, following such reviews, the Company determines what the expected recovery values are for each security, which incorporates both base case and stress case scenarios. For non-home equity asset backed securities, the Company used reports and analysis from asset managers and rating agencies in order to determine an expected recovery value for such securities. The amortized cost basis of the asset backed securities were adjusted down, if required, to the expected recovery value calculated in the OTTI review process;

- Mortgage backed securities – the Company recorded \$17.7 million of OTTI related to credit losses in the year ended December 31, 2009. The Company utilized 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. The significant inputs in the models include the expected default rates, delinquency rates and foreclosure costs. In the 2009 first quarter, the expected recovery values were reduced on a number of mortgage backed securities due to reductions in the expected recovery values on such securities in each period. In the 2009 second through fourth quarters, the declines in expected recovery values were, in general, more moderate than in the 2009 first quarter. These reductions followed the quarterly review of information received which indicated increases in expected default expectations and foreclosure costs. On an ongoing basis, the Company reviews the process used by each asset manager in developing their analysis and, following such reviews, the Company determines what the expected recovery values are for each security, which incorporates both base case and stress case scenarios. 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;
- Investment of funds received under securities lending agreements – the Company recorded \$3.5 million of OTTI related to credit losses in the year ended December 31, 2009. The Company utilized analysis from its securities lending program manager in order to determine an expected recovery value for certain sub-prime securities which are on a watch-list. 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;
- Other investments – the Company recorded \$14.3 million of OTTI related to credit losses in the year ended December 31, 2009. During the 2009 first quarter, the Company's investment in a Euro-denominated bank loan fund was written down to zero as the fund was required to wind down and begin the liquidation process during the period. The fund operated with leverage and was unable to successfully deleverage its balance sheet and restructure.

The Company believes that the \$74.5 million of OTTI included in accumulated other comprehensive income at December 31, 2009 on the securities which were considered by the Company to be impaired was due to market and sector-related factors, including limited liquidity and wide credit spreads (*i.e.*, not credit losses).

For the year ended December 31, 2008, the Company recorded \$181.1 million of OTTI as a charge against earnings. Such amounts were recorded prior to the adoption of the accounting pronouncement discussed above and included a portion related to credit losses and a portion related to all other factors.

Securities Lending Agreements

At December 31, 2009, the market value and amortized cost of fixed maturities and short-term investments pledged under securities lending agreements were \$212.8 million and \$214.7 million, respectively. At December

ARCH REINSURANCE LTD. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

31, 2008, the market value and amortized cost of fixed maturities and short-term investments pledged under securities lending agreements were \$728.1 million and \$717.2 million, respectively.

At December 31, 2009, the market value and amortized cost of the reinvested collateral shown as “Investment of funds received under securities lending agreements” totaled \$91.2 million and \$96.6 million, respectively, while “Securities purchased under agreements to resell using funds received under securities lending agreements” totaled \$115.8 million. At December 31, 2008, the market value and amortized cost of the reinvested collateral shown as “Investment of funds received under securities lending agreements” totaled \$473.8 million and \$493.9 million, respectively, while “Securities purchased under agreements to resell using funds received under securities lending agreements” totaled \$256.4 million. At December 31, 2009, the reinvested collateral included sub-prime securities with a market value of \$18.9 million, compared to \$56.1 million at December 31, 2008.

TALF Program

As of December 31, 2009, the Company had \$250.3 million of securities under TALF which are reflected as “TALF investments, at market value” and \$217.6 million of secured financing from the FRBNY which is reflected as “TALF borrowings, at market value.” Changes in market value for both the securities and borrowings are included in “Net realized gains (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 Company recorded net realized gains for the year ended December 31, 2009 of \$4.2 million on the TALF program, consisting of \$3.0 million and \$1.2 million on changes in market value on the TALF investments and TALF borrowings, respectively.

Other Investments

The following table details the Company’s other investments:

	December 31, 2009		December 31, 2008	
	Estimated Market Value	Cost	Estimated Market Value	Cost
Fixed income mutual funds	\$63,146	\$60,571	\$39,858	\$63,618
Privately held securities and other.....	109,026	101,934	69,743	62,240
Total.....	<u>\$172,172</u>	<u>\$162,505</u>	<u>\$109,601</u>	<u>\$125,858</u>

Other investments include: (i) mutual funds which invest in fixed maturity securities and (ii) privately held securities and other which include the Company’s investment in Aeolus LP (see Note 11) and an equity portfolio which was added in 2009. The Company elected to carry the equity portfolio at fair value under the fair value option afforded by accounting guidance regarding the fair value option for financial assets and liabilities. During 2009, the Company recorded a \$14.3 million OTTI provision in earnings on a Euro-denominated bank loan fund which was written down to zero as the fund was forced to wind down and enter liquidation during the period.

Investment Funds Accounted for Using the Equity Method

For 2009, the Company recorded \$167.8 million of equity in net income related to investment funds accounted for using the equity method, compared to \$178.6 million of equity in net loss for 2008, primarily related to the Company’s investments in U.S. and Euro-denominated bank loan funds, and resulted from the extreme volatility in the capital and credit markets as the market values of the secured loans underlying the holdings in such funds declined significantly in 2008 with a substantial recovery during 2009. Such investments are generally recorded on a one month lag with some investments reported for on a three month lag based on the

ARCH REINSURANCE LTD. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

availability of reports from the investment funds. Investment funds accounted for using the equity method totaled \$391.9 million at December 31, 2009, compared to \$301.0 million at December 31, 2008. The Company's investment commitments relating to investment funds accounted for using the equity method and other investments totaled \$117.2 million at December 31, 2009.

A summary of aggregate financial information for the Company's investment funds accounted for using the equity method as of September 30, 2009 and 2008 and for the nine months ended September 30, 2009 and 2008 is as follows:

	September 30,	
	2009	2008
Invested assets.....	\$4,402,177	\$3,231,308
Total assets.....	4,402,796	3,232,031
Total liabilities.....	607	622
Net assets.....	\$4,402,189	\$3,231,409

	Nine Months Ended September 30,	
	2009	2008
Total revenues.....	\$1,676,117	(\$364,574)
Total expenses.....	41,810	29,459
Net income (loss).....	\$1,634,307	(\$394,033)

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 has investments in segregated portfolios which are primarily used to provide collateral or guarantees for letters of credit to third parties (see Note 12). In addition, the Company maintains assets on deposit which are available to settle insurance and reinsurance liabilities to third parties.

The following table details the value of restricted assets:

	December 31,	
	2009	2008
Assets used for collateral or guarantees.....	\$1,017,482	\$804,934
Deposits with U.S. regulatory authorities.....	279,136	264,988
Trust funds.....	115,585	153,182
Deposits with non-U.S. regulatory authorities.....	76,094	57,336
Total restricted assets.....	\$1,488,297	\$1,280,440

In addition, the Company maintains assets in trust accounts as collateral for insurance and reinsurance transactions with affiliated companies. At December 31, 2009 and 2008, such amounts approximated \$4.28 billion and \$4.02 billion, respectively.

ARCH REINSURANCE LTD. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

Net Investment Income

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

	Years Ended December 31,	
	2009	2008
Fixed maturities	\$404,658	\$437,197
Short-term investments	1,888	20,458
Other (1)	4,413	23,372
Gross investment income	410,959	481,027
Investment expenses	(21,001)	(13,796)
Net investment income	<u>\$389,958</u>	<u>\$467,231</u>

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

Net Realized Gains (Losses)

Net realized gains (losses) were as follows:

	Years Ended December 31,	
	2009	2008
Fixed maturities	\$135,373	(\$18,052)
Other investments	5,166	(10,039)
Other (1)	2,990	22,809
Net realized gains (losses)	<u>\$143,529</u>	<u>(\$5,282)</u>

(1) Primarily consists of net realized gains or losses related to investment-related derivatives, futures contracts, and foreign currency forward contracts as well as \$4.2 million of net realized gains for the TALF program in 2009.

Proceeds from the sales of fixed maturities during 2009 and 2008 were \$19.77 billion and \$16.14 billion, respectively. Gross gains of \$370.5 million and \$249.8 million were realized on those transactions during 2009 and 2008, respectively. Gross losses of \$235.1 million and \$267.9 million were realized during 2009 and 2008, respectively. Realized gains or losses on fixed maturities include changes in the market value of certain hybrid securities pursuant to applicable guidance. The fair market values of such hybrid securities at December 31, 2009 were approximately \$84.8 million, compared to \$43.7 million at December 31, 2008. The Company recorded realized gains of \$14.8 million on such securities in 2009, compared to realized losses of \$5.4 million in 2008.

7. 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).

ARCH REINSURANCE LTD. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

The three levels 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

Fair Value Measurements on a Recurring Basis

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 market 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 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. 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 from 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.

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 market 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 market 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 \$10.71 billion of financial assets and liabilities measured at fair value, approximately \$1.17 billion, or 10.9%, were priced using non-binding broker-dealer quotes.

ARCH REINSURANCE LTD. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

In April 2009, the FASB issued guidance regarding the determination of fair value when the volume and level of activity for the asset or liability have significantly decreased and the identification of transactions that are not orderly. This affirms that the objective of fair value when the market for an asset is not active is the price that would be received to sell the asset in an orderly transaction, and clarifies and includes additional factors for determining whether there has been a significant decrease in market activity for an asset when the market for that asset is not active. Under this guidance, if an entity determines that there has been a significant decrease in the volume and level of activity for the asset or the liability in relation to the normal market activity for the asset or liability (or similar assets or liabilities), then transactions or quoted prices may not accurately reflect fair value. In addition, if there is evidence that the transaction for the asset or liability is not orderly, the entity shall place little, if any weight on that transaction price as an indicator of fair value. This guidance also expanded certain disclosure requirements. This guidance was effective for periods ending after June 15, 2009, and its adoption did not have a material impact on the Company's consolidated financial condition or results of operations.

The Company reviews its securities measured at fair value and discusses the proper classification of such investments with investment advisors and others. Upon adoption of the accounting guidance regarding fair value measurement and at December 31, 2009, the Company determined that Level 1 securities included 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. The Company also determined that Level 1 securities at December 31, 2009 included publicly traded equity securities acquired in the 2009 fourth quarter as part of a global natural resources investment strategy.

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 included corporate bonds, mortgage backed securities, municipal bonds, asset backed securities, certain U.S. government and government agencies, non-U.S. government securities, TALF investments and TALF borrowings, certain short-term securities and certain other investments.

The Company determined that three Euro-denominated corporate bonds which invest in underlying portfolios 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. In addition, the Company determined that two mutual funds, included in other investments, which invest in underlying portfolios 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. These items were reclassified as Level 3 during the 2008 fourth quarter due to the significant dislocation in the credit markets during October and November 2008. The Company believes that the market for such investments, which are primarily investments in an underlying portfolio of structured bank loans, deteriorated in response to market conditions. As such, the inputs to the valuation process for these investments were determined to be less observable than in prior periods. The Company reviews the classification of its investments each quarter. In addition, Level 3 securities include a small number of premium-tax bonds.

ARCH REINSURANCE LTD. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

The following table presents the Company's financial assets and liabilities measured at fair value on a recurring basis by level:

	<u>Fair Value Measurement Using:</u>			
	<u>Estimated Market Value</u>	<u>Quoted Prices in Active Markets for Identical Assets (Level 1)</u>	<u>Significant Other Observable Inputs (Level 2)</u>	<u>Significant Unobservable Inputs (Level 3)</u>
December 31, 2009:				
Assets measured at fair value:				
Fixed maturities: (1)				
Corporate bonds	\$3,130,901	\$—	\$2,952,516	\$178,385
U.S. government and government agencies	1,549,676	466,779	1,082,897	—
Mortgage backed securities	1,449,382	—	1,449,382	—
Commercial mortgage backed securities.....	1,185,799	—	1,185,799	—
Municipal bonds.....	957,752	—	957,752	—
Non-U.S. government securities	752,215	—	752,215	—
Asset backed securities	567,844	—	567,844	—
Total.....	<u>9,593,569</u>	<u>466,779</u>	<u>8,948,405</u>	<u>178,385</u>
Short-term investments (1)	553,861	542,659	11,202	—
TALF investments, at market value.....	250,265	—	250,265	—
Other investments.....	95,374	36,374	9,332	49,668
Total assets measured at fair value.....	<u>\$10,493,069</u>	<u>\$1,045,812</u>	<u>\$9,219,204</u>	<u>\$228,053</u>
Liabilities measured at fair value:				
TALF borrowings, at market value	\$217,565	\$—	\$217,565	\$—
December 31, 2008:				
Assets measured at fair value:				
Fixed maturities: (1)				
Corporate bonds	\$2,018,471	\$—	\$1,875,900	\$142,571
U.S. government and government agencies	1,458,345	241,442	1,216,903	—
Mortgage backed securities	1,581,736	—	1,581,736	—
Commercial mortgage backed securities.....	1,219,737	—	1,219,737	—
Municipal bonds.....	965,966	—	965,966	—
Non-U.S. government securities	527,972	—	527,972	—
Asset backed securities	970,041	—	970,041	—
Total.....	<u>8,742,268</u>	<u>241,442</u>	<u>8,358,255</u>	<u>142,571</u>
Short-term investments (1)	571,937	465,291	106,646	—
Other investments.....	36,913	—	(3,426)	40,339
Total assets measured at fair value.....	<u>\$9,351,118</u>	<u>\$706,733</u>	<u>\$8,461,475</u>	<u>\$182,910</u>

(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 and reinvested at December 31, 2009 and December 31, 2008 of \$207.0 million and \$730.2 million, respectively, and included the \$212.8 million and \$728.1 million, respectively, of "fixed maturities and short-term investments pledged under securities lending agreements, at market value."

ARCH REINSURANCE LTD. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

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:

	Fair Value Measurements Using: Significant Unobservable Inputs (Level 3)		
	Corporate Bonds	Other Investments	Total
Year Ended December 31, 2009:			
Beginning balance at January 1, 2009	\$142,571	\$40,339	\$182,910
Total gains or (losses) (realized/unrealized)			
Included in earnings (1)	2,395	(14,117)	(11,722)
Included in other comprehensive income	52,698	24,075	76,773
Purchases, issuances and settlements	(19,279)	(629)	(19,908)
Transfers in and/or out of Level 3	—	—	—
Ending balance at December 31, 2009	<u>\$178,385</u>	<u>\$49,668</u>	<u>\$228,053</u>
Year Ended December 31, 2008:			
Beginning balance at January 1, 2008	\$3,752	\$11,504	\$15,256
Total gains or (losses) (realized/unrealized)			
Included in earnings (1)	(780)	757	(23)
Included in other comprehensive income	—	(2,660)	(2,660)
Purchases, issuances and settlements	2,803	(829)	1,974
Transfers in and/or out of Level 3	136,796	31,567	168,363
Ending balance at December 31, 2008	<u>\$142,571</u>	<u>\$40,339</u>	<u>\$182,910</u>

- (1) Losses on fixed maturities were recorded as a component of net investment income while losses on other investments were recorded in net realized losses.

The amount of total losses for 2009 included in earnings attributable to the change in unrealized gains or losses relating to assets still held at December 31, 2009 was \$2.6 million. The amount of total losses for 2008 included in earnings attributable to the change in unrealized gains or losses relating to assets still held at December 31, 2008 was de minimis.

Fair Value Measurements on a Non-Recurring Basis

The Company measures the fair value of certain assets on a non-recurring basis, generally quarterly, annually, or when events or changes in circumstances indicate that the carrying amount of the assets may not be recoverable. These assets include investment funds accounted for using the equity method, investment in joint venture, certain other investments, goodwill and intangible assets, and long-lived assets. The Company uses a variety of techniques to measure the fair value of these assets when appropriate, as described below:

Investment funds accounted for using the equity method and Investment in joint venture and certain other investments. When the Company determines that the carrying value of these assets may not be recoverable, the Company records the assets at fair value with the loss recognized in income. In such cases, the Company measures the fair value of these assets using the techniques discussed above in “—Fair Value Measurements on a Recurring Basis.”

Goodwill and intangible assets. The goodwill and intangible assets of acquired businesses, which totaled \$24.2 million and \$27.4 million, respectively, at December 31, 2009 and 2008, is included in “Other assets” in the Company’s balance sheet and represents the difference between the purchase price and the fair value of the net tangible assets of the acquired businesses. The Company tests goodwill and intangible assets for impairment

ARCH REINSURANCE LTD. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

whenever events or changes in circumstances indicate the carrying amount may not be recoverable, but at least annually for goodwill. When the Company determines goodwill and intangible assets may be impaired, the Company uses techniques including discounted expected future cash flows, to measure fair value.

Long-Lived Assets. The Company tests its long-lived assets for impairment whenever events or changes in circumstances indicate the carrying amount of a long-lived asset may not be recoverable.

8. 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 market value. The market 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. In addition, 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.

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 December 31, 2009 or December 31, 2008.

The following table summarizes information on the balance sheet locations, market values and notional values of the Company's derivative instruments at December 31, 2009:

	Balance Sheet Location	Asset Derivatives		Liability Derivatives	
		Estimated Market Value	Notional Value	Estimated Market Value	Notional Value
Derivatives not designated as hedging instruments					
Futures contracts	Other investments	\$577	\$472,904	(\$208)	\$513,034
Foreign currency forward contracts ...	Other investments	757	73,340	(12,408)	310,030
TBAs	Fixed maturities	11,070	11,000	(616)	600
Other	Other investments	26	1,975	(1,010)	143,870
Total		<u>\$12,430</u>		<u>(\$14,242)</u>	

ARCH REINSURANCE LTD. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

The following table summarizes information on the balance sheet locations, market values and notional values of the Company's derivative instruments at December 31, 2008:

	<u>Balance Sheet Location</u>	<u>Asset Derivatives</u>		<u>Liability Derivatives</u>	
		<u>Estimated Market Value</u>	<u>Notional Value</u>	<u>Estimated Market Value</u>	<u>Notional Value</u>
Derivatives not designated as hedging instruments					
Futures contracts	Other investments	\$647	\$363,297	(\$1,541)	\$556,268
Foreign currency forward contracts ...	Other investments	3,485	15,294	(14,332)	135,426
Total		<u>\$4,132</u>		<u>(\$15,873)</u>	

The following table summarizes derivative instrument activity in the consolidated statements of operations for the year ended December 31, 2009:

	<u>Location of Gain or (Loss) Recognized in Income on Derivative</u>	<u>Year Ended December 31, 2009</u>
Derivatives not designated as hedging instruments		
Futures contracts	Net realized gains (losses)	\$3,791
Foreign currency forward contracts ...	Net realized gains (losses)	(5,798)
TBAs	Net realized gains (losses)	1,154
Other	Net realized gains (losses)	389
Total		<u>(\$464)</u>

ARCH REINSURANCE LTD. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

9. Other Comprehensive Income (Loss)

Following are the related tax effects allocated to each component of other comprehensive income (loss):

	Before Tax Amount	Tax Expense (Benefit)	Net of Tax Amount
<i>Year Ended December 31, 2009</i>			
Unrealized appreciation in value of investments:			
Unrealized holding gains arising during year	\$585,522	\$11,094	\$574,428
Portion of other-than-temporary impairment losses recognized in other comprehensive income	(81,376)	—	(81,376)
Less reclassification of net realized gains included in net income	54,602	6,077	48,525
Foreign currency translation adjustments	13,555	2,196	11,359
Other comprehensive income	<u>\$463,099</u>	<u>\$7,213</u>	<u>\$455,886</u>
<i>Year Ended December 31, 2008</i>			
Unrealized appreciation (decline) in value of investments:			
Unrealized holding losses arising during year	(\$569,930)	\$13,821	(\$583,751)
Portion of other-than-temporary impairment losses recognized in other comprehensive income	—	—	—
Less reclassification of net realized losses included in net income	(203,163)	5,054	(208,217)
Foreign currency translation adjustments	(38,079)	(2,539)	(35,540)
Other comprehensive income (loss)	<u>(\$404,846)</u>	<u>\$6,228</u>	<u>(\$411,074)</u>

10. Income Taxes

Arch Re Ltd. 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. Arch Re Ltd. has received a written undertaking from the Minister of Finance in Bermuda under the Exempted Undertakings Tax Protection Act 1966 that, in the event that any legislation is enacted in Bermuda imposing any tax computed on profits, income, gain or appreciation on any capital asset, or any tax in the nature of estate duty or inheritance tax, such tax will not be applicable to ACGL or any of its operations until March 28, 2016. This undertaking does not, however, prevent the imposition of taxes on any person ordinarily resident in Bermuda or any company in respect of its ownership of real property or leasehold interests in Bermuda.

Arch Re Ltd. 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.. Arch Re Ltd. 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). Arch Re Ltd. 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 Arch Re Ltd. or its non-U.S. subsidiaries are engaged in a trade or business in the United States. If Arch Re Ltd. or any of its non-U.S. subsidiaries were subject to U.S. income tax, the Company's shareholder's equity and earnings could be materially adversely affected. Arch Re Ltd. has subsidiaries and branches that operate in various

ARCH REINSURANCE LTD. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

jurisdictions around the world that are subject to tax in the jurisdictions in which they operate. The significant jurisdictions in which Arch Re Ltd.'s subsidiaries and branches are subject to tax are the United States, United Kingdom, Ireland, Canada, Switzerland and Denmark.

The components of income taxes attributable to operations were as follows:

	Years Ended December 31,	
	2009	2008
Current expense:		
U.S. Federal	\$19,373	\$15,782
U.S. State	638	638
Non-U.S.	2,627	5,631
	<u>22,638</u>	<u>22,051</u>
Deferred benefit:		
U.S. Federal.....	(1,099)	(7,288)
Non-U.S.	(1,419)	(1,881)
	<u>(2,518)</u>	<u>(9,169)</u>
Income tax expense	<u>\$20,120</u>	<u>\$12,882</u>

The expected tax provision computed on pre-tax income at the weighted average tax rate has been calculated as the sum of the pre-tax income in each jurisdiction multiplied by that jurisdiction's applicable statutory tax rate. A reconciliation of the difference between the provision for income taxes and the expected tax provision at the weighted average tax rate follows:

	Years Ended December 31,	
	2009	2008
Expected income tax expense computed on pre-tax income at weighted average income tax rate	\$30,659	\$19,365
Addition (reduction) in income tax expense resulting from:		
Tax-exempt investment income	(8,911)	(11,403)
Meals and entertainment	453	632
State taxes, net of U.S. federal tax benefit	438	415
U.S. operations' foreign taxes, net of U.S. federal tax benefit	(983)	2,133
Reorganization of foreign branch	—	589
Prior year adjustment	(1,992)	229
Other	456	922
Income tax expense	<u>\$20,120</u>	<u>\$12,882</u>

The Company has net operating loss carryforwards in its U.S. operating subsidiaries totaling \$5.0 million at December 31, 2009. Such net operating losses are currently available to offset future taxable income of the subsidiaries. Under applicable law, the U.S. net operating loss carryforwards expire between 2018 and 2020. The Company also has a foreign tax credit carryforward of \$2.3 million which will expire between 2017 and 2018.

On November 20, 2001, ACGL underwent an ownership change for U.S. federal income tax purposes as a result of the investment led by investment funds associated with Warburg Pincus LLC ("Warburg Pincus") and Hellman and Friedman LLC ("Hellman & Friedman"). As a result of this ownership change, limitations have been imposed upon the utilization by the Company's U.S. operating subsidiaries of existing net operating losses. Utilization by such subsidiaries of the net operating losses and certain of the AMT credit carryforward is limited

ARCH REINSURANCE LTD. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

to approximately \$5.1 million per year in accordance with Section 382 of the Internal Revenue Code of 1986 as amended (the “Code”).

The Company’s Danish subsidiary has a net operating loss carryforward of \$2.3 million which can be carried forward without expiration. The Company’s Irish subsidiary has a net operating loss carryforward of \$2.2 million which can be carried forward without expiration.

Deferred income tax assets and liabilities reflect temporary differences based on enacted tax rates between the carrying amounts of assets and liabilities for financial reporting and income tax purposes. Significant components of the Company’s deferred income tax assets and liabilities were as follows:

	December 31,	
	2009	2008
Deferred income tax assets:		
Net operating loss	\$2,601	\$4,495
Deferred ceding commission	9,548	9,969
AMT credit carryforward	—	1,549
Discounting of net loss reserves	35,657	33,607
Net unearned premium reserve	13,210	13,742
Compensation liabilities	20,564	19,759
Other than temporary impairment on securities	259	899
Foreign tax credit carryforward	2,283	1,494
Net unrealized foreign exchange losses	—	561
Interest expense	3,161	294
Other, net	4,650	3,123
Total deferred tax assets	<u>91,933</u>	<u>89,492</u>
Deferred income tax liabilities:		
Depreciation and amortization	(4,023)	(2,230)
Deferred acquisition costs, net	(2,196)	(3,142)
Deposit accounting liability	(5,090)	(5,315)
Foreign transaction exchange gains	(1,350)	(419)
Net unrealized foreign exchange gains	(1,634)	—
Net unrealized appreciation of investments	(20,876)	(16,662)
Other, net	(1,831)	(2,501)
Total deferred tax liabilities	<u>(37,000)</u>	<u>(30,269)</u>
Net deferred income tax asset	<u>\$54,933</u>	<u>\$59,223</u>

The Company recognizes the tax benefit of tax positions taken or expected to be taken in a tax return that are more likely than not to be realized, assuming the relevant tax authority has full knowledge of all relevant information. The amount recognized represents the largest amount of tax benefit that is greater than 50% likely of being ultimately realized. A liability is recognized for any benefit claimed, or expected to be claimed, in a tax return in excess of the benefit recorded in the financial statements, along with any interest and penalty (if applicable) on the excess. The Company recognizes interest and penalties relating to unrecognized tax benefits in the provision for income taxes. As of December 31, 2009 and 2008, the Company’s total unrecognized tax benefits, including interest and penalties, were nil.

The Company or its subsidiaries or branches files income tax returns in the U.S. federal jurisdiction and various state, local and foreign jurisdictions. With few exceptions, the Company is no longer subject to U.S. federal, state, local, or non-U.S. income tax examination for years before 2006. During 2008, the U.S. Internal

ARCH REINSURANCE LTD. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

Revenue Service closed its examination of the Company's U.S. income tax returns for the 2004 tax year with no change.

In addition to unrecognized tax benefits, the Company provides a valuation allowance to reduce certain deferred tax assets to an amount which management expects to more likely than not be realized. As of December 31, 2009 and 2008, the Company's valuation allowance was nil.

The Company paid \$31.0 million and \$10.9 million for income taxes, net of recoveries, in 2009 and 2008, respectively. As of December 31, 2009, the Company's current income tax recoverable (included in "Other assets") was \$11.6 million.

Federal Excise Taxes

The United States also imposes an excise tax on insurance and reinsurance premiums paid to non-U.S. insurers or reinsurers with respect to risks located in the United States. The rates of tax, unless reduced by an applicable U.S. tax treaty, are four percent for non-life insurance premiums and one percent for life insurance and all reinsurance premiums. The Company incurs federal excise taxes on certain of its reinsurance transactions, including amounts ceded through intercompany transactions. For 2009 and 2008, the Company incurred approximately \$12.8 million of federal excise taxes. Such amounts are reflected as acquisition expenses in the Company's consolidated statements of income.

11. Transactions with Related Parties

During 2006, the Company invested \$50.0 million in Aeolus LP ("Aeolus"), which operates as an unrated reinsurance platform that provides property catastrophe protection to insurers and reinsurers on both an ultimate net loss and industry loss warranty basis. In return for its investment, included in "Other investments" on the Company's balance sheet, the Company received an approximately 4.9% preferred interest in Aeolus and a pro rata share of certain founders' interests. The Company made its investment in Aeolus on the same economic terms as a fund affiliated with Warburg Pincus, which has invested \$350 million in Aeolus. Funds affiliated with Warburg Pincus owned 1.1% of ACGL's outstanding voting shares as of December 31, 2009. In addition, one of the founders of Aeolus is Peter Appel, former President and CEO and a former director of ACGL. During 2009, the Company received a distribution of \$14.0 million from Aeolus as part of a repurchase agreement. Following such receipt, the Company's preferred interest percentage decreased to approximately 4.4%.

During 2009 and 2008 the Company incurred \$10.5 million in administrative and support service fees paid to a wholly owned subsidiary of ACGL, Arch Capital Services Inc., and its subsidiary, Arch International Services Inc. (collectively, "ACSI"). Such fees were incurred pursuant to the terms of specific administrative and support service agreements between Arch Re Ltd. and certain of its subsidiaries and ACSI, and are included in "Other Operating Expenses" in the consolidated statements of income. In addition, during 2009, the Company incurred approximately \$7.3 million in investment service fees paid to Arch Investment Management Ltd. ("AIM"), a wholly-owned subsidiary of ACGL, compared to \$4.0 million incurred during 2008. Such fees are incurred pursuant to the terms of specific investment service agreements between Arch Re Ltd. and certain of its subsidiaries and AIM, and "Net Investment Income" in the consolidated statements of income is net of these fees.

12. Commitments and Contingencies

Concentrations of Credit Risk

The creditworthiness of a counterparty is evaluated by the Company, taking into account credit ratings assigned by independent agencies. The credit approval process involves an assessment of factors, including,

ARCH REINSURANCE LTD. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

among others, the counterparty, country and industry credit exposure limits. Collateral may be required, at the discretion of the Company, on certain transactions based on the creditworthiness of the counterparty.

The areas where significant concentrations of credit risk may exist include unpaid losses and loss adjustment expenses recoverable, prepaid reinsurance premiums and paid losses and loss adjustment expenses recoverable net of reinsurance balances payable (collectively “reinsurance recoverables”), investments and cash and cash equivalent balances. The Company’s reinsurance recoverables at December 31, 2009 and 2008 amounted to \$1.97 billion and \$2.09 billion, respectively, and primarily resulted from reinsurance arrangements entered into in the course of its operations. A credit exposure exists with respect to reinsurance recoverables as they may become uncollectible. The Company manages its credit risk in its reinsurance relationships by transacting with reinsurers that it considers financially sound and, if necessary, the Company may hold collateral in the form of funds, trust accounts and/or irrevocable letters of credit. This collateral can be drawn on for amounts that remain unpaid beyond specified time periods on an individual reinsurer basis.

In addition, the Company underwrites a significant amount of its business through brokers and a credit risk exists should any of these brokers be unable to fulfill their contractual obligations with respect to the payments of insurance and reinsurance balances owed to the Company. During 2009, approximately 15.6% and 21.4% of the Company’s consolidated gross written premiums were generated from or placed by Marsh & McLennan Companies and its subsidiaries and AON Corporation and its subsidiaries, respectively, compared to approximately 17.0% and 15.3% for 2008, respectively. No other broker and no one insured or reinsured accounted for more than 10% of gross premiums written for 2009 and 2008.

The Company’s available for sale investment portfolio is managed in accordance with guidelines that have been tailored to meet specific investment strategies, including standards of diversification, which limit the allowable holdings of any single issue. There were no investments in any entity in excess of 10% of the Company’s shareholder’s equity at December 31, 2009 other than investments issued or guaranteed by the United States government or its agencies. The Company’s unfunded investment commitments relating to investment funds accounted for using the equity method and other investments totaled \$117.2 million at December 31, 2009.

Variable Interest Entities

The Company concluded that, under FASB guidance regarding the consolidation of variable interest entities, it is required to consolidate the assets, liabilities and results of operations (if any) of a managing general agency in which one of its subsidiaries has an investment. Such agency ceased producing business in 1999 and is currently running-off its operations. Based on current information, there are no assets or liabilities of such agency required to be reflected on the face of the Company’s consolidated financial statements that are not, or have not been previously, otherwise reflected therein.

On December 29, 2005, Arch Re Ltd. entered into a quota share reinsurance treaty with Flatiron, a Bermuda reinsurance company, pursuant to which Flatiron is assuming a 45% quota share (the “Treaty”) of certain lines of property and marine business underwritten by Arch Re Ltd. for unaffiliated third parties for the 2006 and 2007 underwriting years (January 1, 2006 to December 31, 2007). On December 31, 2007, the Treaty expired by its terms (see Note 3). Under the guidance governing accounting for VIEs, Arch Re Ltd. has determined that Flatiron is a VIE. Arch Re Ltd. is not the primary beneficiary of Flatiron and, as such, Arch Re Ltd. is not required to consolidate the assets, liabilities and results of operations of Flatiron. Under the amended guidance governing accounting for VIEs, which is effective January 1, 2010, Arch Re Ltd. does not expect that Flatiron will be considered a VIE. See Note 2 (o), “Recent Accounting Pronouncements,” for information on the amended guidance.

ARCH REINSURANCE LTD. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

Letter of Credit and Revolving Credit Facilities

As of December 31, 2009, ACGL had a \$300 million unsecured revolving loan and letter of credit facility and a \$1.0 billion secured letter of credit facility (the "Credit Agreement"). Under the terms of the Credit Agreement, Arch Re U.S. is limited to issuing \$100 million of unsecured letters of credit as part of the \$300 million unsecured revolving loan. Borrowings of revolving loans may be made by ACGL and Arch Re U.S. at a variable rate based on LIBOR or an alternative base rate at their option. Secured letters of credit are available for issuance on behalf of Arch Re Ltd. and its insurance and reinsurance subsidiaries. The Credit Agreement and related documents are structured such that each party that requests a letter of credit or borrowing does so only for itself and for only its own obligations. Issuance of letters of credit and borrowings under the Credit Agreement are subject to compliance with certain covenants and conditions, including absence of a material adverse change. These covenants require, among other things, that ACGL maintain a debt to total capital ratio of not greater than 0.35 to 1 and shareholders' equity in excess of \$1.95 billion plus 25% of future aggregate net income for each quarterly period (not including any future net losses) beginning after June 30, 2006 and 25% of future aggregate proceeds from the issuance of common or preferred equity and that Arch Re Ltd. and its principal insurance and reinsurance subsidiaries maintain at least a "B++" rating from A.M. Best. In addition, Arch Re Ltd. and certain of its subsidiaries which are party to the Credit Agreement are required to maintain minimum shareholder's equity levels. ACGL was in compliance with all covenants contained in the Credit Agreement at December 31, 2009. The Credit Agreement expires on August 30, 2011.

Including the secured letter of credit portion of the Credit Agreement, ACGL has access to letter of credit facilities for up to a total of \$1.45 billion. ACGL also has access to other letter of credit facilities, some of which are available on a limited basis and for limited purposes (together with the secured portion of the Credit Agreement and these letter of credit facilities, the "LOC Facilities"). The principal purpose of the LOC Facilities is to issue, as required, evergreen standby letters of credit in favor of primary insurance or reinsurance counterparties with which the Company has entered into reinsurance arrangements to ensure that such counterparties are permitted to take credit for reinsurance obtained from Arch Re Ltd. and its 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 ACGL was in compliance with at December 31, 2009. At such date, the Company had approximately \$775.7 million in outstanding letters of credit under the LOC Facilities, which were secured by investments totaling \$907.6 million. In May 2008, ACGL borrowed \$100.0 million under the Credit Agreement at an ACGL-selected variable interest rate that is based on 1 month, 3 month or 6 month reset option terms and their corresponding term LIBOR rates plus 27.5 basis points. The proceeds from such borrowings, which are repayable in August 2011, were contributed as additional share capital to Arch Re Ltd. and used to fund the investment in Gulf Re (see Note 5).

ARCH REINSURANCE LTD. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

TALF Program

TALF provides secured financing for asset-backed securities backed by certain types of consumer and small business loans and for legacy commercial mortgage-backed securities. TALF financing is non-recourse to the Company, except in certain limited instances, and is collateralized by the purchased securities and provides financing for the purchase price of the securities, less a ‘haircut’ that varies based on the type of collateral. The Company can deliver the collateralized securities to a special purpose vehicle created by the FRBNY in full defeasance of the borrowings.

As of December 31, 2009, the Company had \$250.3 million of securities under TALF, consisting of 13 individual TALF investments, which are reflected as “TALF investments, at market value” and \$217.6 million of secured financing from the FRBNY which is reflected as “TALF borrowings, at market value.” The maturity dates for the TALF borrowings range from July 2012 to September 2014, with interest rates that range from approximately 1.2% to 3.9% based on either variable or fixed interest rates depending on the related TALF investments. See Note 6, “Investment Information—TALF Program,” for additional information.

Leases and Purchase Obligations

At December 31, 2009, the future minimum rental commitments, exclusive of escalation clauses and maintenance costs and net of rental income, for all of the Company’s operating leases with remaining non-cancelable terms in excess of one year are as follows:

2010.....	\$15,029
2011.....	15,221
2012.....	13,363
2013.....	12,356
2014.....	11,361
Thereafter.....	65,495
Total.....	<u><u>\$132,825</u></u>

All of these leases are for the rental of office space, with expiration terms that range from 2011 to 2024. Rental expense, net of income from subleases, was approximately \$16.0 million and \$16.6 million for 2009 and 2008, respectively.

The Company has also entered into certain agreements which commit the Company to purchase goods or services, primarily related to software and computerized systems. Such purchase obligations were approximately \$22.0 million and \$28.5 million at December 31, 2009 and 2008, respectively.

Employment Arrangements

At December 31, 2009, the Company has entered into employment agreements with certain of its executive officers for periods extending up to June 8, 2014. Such employment arrangements provide for compensation in the form of base salary, annual bonus, share-based awards, participation in the Company’s employee benefit programs and the reimbursements of expenses.

WTM Re Transaction and Related Contingencies

On May 5, 2000, the Company sold the prior reinsurance operations of Arch Re U.S. pursuant to an agreement entered into as of January 10, 2000 with White Mountains Reinsurance Company of America, formerly known as Folksamerica Reinsurance Company, and a related holding company (collectively, “WTM

ARCH REINSURANCE LTD. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

Re”). WTM Re assumed Arch Re U.S.’s liabilities under the reinsurance agreements transferred in the asset sale and Arch Re U.S. transferred to WTM Re assets estimated in an aggregate amount equal in book value to the book value of the liabilities assumed. The WTM Re transaction was structured as a transfer and assumption agreement (and not reinsurance) and, accordingly, the loss reserves (and any related reinsurance recoverables) relating to the transferred business are not included as assets or liabilities on the Company’s balance sheet. WTM Re assumed Arch Re U.S.’s rights and obligations under the reinsurance agreements transferred in the asset sale. The reinsureds under such agreements were notified that WTM Re had assumed Arch Re U.S.’s obligations and that, unless the reinsureds object to the assumption, Arch Re U.S. will be released from its obligations to those reinsured. None of such reinsureds objected to the assumption. However, Arch Re U.S. will continue to be liable under those reinsurance agreements if the notice is found not to be an effective release by the reinsureds. WTM Re has agreed to indemnify the Company for any losses arising out of the reinsurance agreements transferred to WTM Re in the asset sale. However, in the event that WTM Re refuses or is unable to perform its obligations to the Company, Arch Re U.S. may incur losses relating to the reinsurance agreements transferred in the asset sale. WTM Re’s A.M. Best rating was “A-” (Excellent) at December 31, 2009. WTM Re reported policyholders’ surplus of \$832.0 million at December 31, 2009.

Under the terms of the agreement, in 2000, the Company had also purchased reinsurance protection covering the Company’s transferred aviation business to reduce the net financial loss to WTM Re on any large commercial airline catastrophe to \$5.4 million, net of reinstatement premiums. Although the Company believes that any such net financial loss will not exceed \$5.4 million, the Company has agreed to reimburse WTM Re if a loss is incurred that exceeds \$5.4 million for aviation losses under certain circumstances prior to May 5, 2003. The Company also made representations and warranties to WTM Re about the Company and the business transferred to WTM Re for which the Company retains exposure for certain periods, and made certain other agreements. In addition, the Company retained its tax and employee benefit liabilities and other liabilities not assumed by WTM Re, including all liabilities not arising under reinsurance agreements transferred to WTM Re in the asset sale and all liabilities (other than liabilities arising under reinsurance agreements) arising out of or relating to a certain managing underwriting agency. Although WTM Re has not asserted that any amount is currently due under any of the indemnities provided by the Company under the asset purchase agreement, WTM Re has previously indicated a potential indemnity claim under the agreement in the event of the occurrence of certain future events. Based on all available information, the Company has denied the validity of any such potential claim.

Loans to ACGL

As of December 31, 2009, Arch Re Ltd. had loan facilities in effect whereby it agreed to advance to ACGL, from time to time, as a loan, amounts up to and including, in the aggregate, \$255.0 million, on or prior to December 31, 2010. Such loans to ACGL are interest free and repayable upon demand. During 2009 and 2008 Arch Re Ltd. loaned a total of \$500.0 million and \$505.0 million, respectively, to ACGL under such loan facility agreements, which were subsequently forgiven and considered dividend payments to ACGL. The amounts advanced and outstanding from ACGL at December 31, 2009 under the terms of the loan facilities were nil.

13. Share Capital

Authorized and Issued

The authorized share capital of the Company consists of 2,625,000 common shares, par value of \$1.00 per share, at December 31, 2009 and 2008, respectively. The issued share capital of the Company consists of 2,560,423 common shares, par value of \$1.00 per share at December 31, 2009 and 2008, respectively. Common shares of 1,310,423 were issued in 2008 to ACGL.

ARCH REINSURANCE LTD. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

Long Term Incentive and Share Award Plans

Certain of the Company's employees participate in ACGL's long-term incentive and share award plans. The share-based compensation expenses incurred under such plans are included in the Company's results of operations.

On May 11, 2007, following shareholder approval, ACGL adopted the 2007 Employee Share Purchase Plan (the "ESPP"). The purpose of the ESPP is to give employees of ACGL and its subsidiaries an opportunity to purchase ACGL common shares ("common shares") through payroll deductions, thereby encouraging employees to share in the economic growth and success of ACGL and its subsidiaries. The ESPP is designed to qualify as an "employee share purchase plan" under Section 423 of the Code. A total of 750,000 common shares are reserved for issuance under the plan. The ESPP provides for consecutive six-month offering periods (or other periods of not more than 27 months as determined by the compensation committee) under which participating employees can elect to have up to 20% of their total compensation withheld and applied to the purchase of common shares at the end of the period. Unless otherwise determined by the compensation committee before an offering period commences, (1) the purchase price will be 85% of the fair market value of the common shares at the beginning of the offering period; and (2) the maximum number of common shares that may be purchased by an employee in any offering period is 3,000 shares. In addition, applicable Code limitations specify, in general, that a participant's right to purchase stock under the plan cannot accumulate at a rate in excess of \$25,000 (based on the value at the beginning of the applicable offering periods) per calendar year.

On May 11, 2007, following shareholder approval, ACGL adopted the 2007 Long Term Incentive and Share Award Plan (the "2007 Plan"). The 2007 Plan is intended to provide for competitive compensation opportunities, to encourage long-term service, to recognize individual contributions and reward achievement of performance goals and to promote the creation of long-term value for shareholders by aligning the interests of such persons with those of shareholders. The 2007 Plan will provide for the grant to eligible employees and directors stock options, stock appreciation rights, restricted shares, restricted share units payable in common shares or cash, share awards in lieu of cash awards, dividend equivalents and other share-based awards.

Following shareholder approval on May 11, 2007, the 2005 Long Term Incentive and Share Award Plan (the "2005 Plan"), whose terms are substantially similar to the 2007 Plan, was merged into the 2007 Plan. As of the effective date, the 1,533,527 remaining common shares available for issuance under the 2005 Plan were transferred into the 2007 Plan. No additional grants will be made thereafter under the 2005 Plan.

Grants which were outstanding at May 11, 2007 under the 2005 Plan will continue in accordance with their original terms (subject to such amendments as the compensation committee determines appropriate, consistent with the terms of the 2005 Plan), and the common shares with respect to such outstanding grants will be issued or transferred under the 2007 Plan. The number of common shares reserved for issuance under the 2007 Plan, subject to anti-dilution adjustments in the event of certain changes in our capital structure, is equal to the sum of (i) 2,500,000 and (ii) the number of common shares subject to outstanding grants under the 2005 Plan as of the effective date as well as common shares remaining available for issuance under the 2005 Plan but not subject to previously exercised or vested grants as of the effective date, except that no more than 2,000,000 common shares may be issued as incentive stock options under Section 422 of the Code. At December 31, 2009, approximately 2,066,759 common shares are available for grant under the 2007 Plan.

In June 2002, following shareholder approval, ACGL adopted the 2002 Long Term Incentive and Share Award Plan (the "2002 Plan"). An aggregate of 3,165,830 common shares has been reserved for issuance under the 2002 Plan. The 2002 Plan provides for the grant to eligible employees of stock options, stock appreciation rights, restricted shares, restricted share units payable in common shares or cash, share awards in lieu of cash

ARCH REINSURANCE LTD. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

awards, dividend equivalents and other share-based awards. As of December 31, 2009, approximately 18,584 common shares are available for grant under the 2002 Plan.

The Company may withhold, or require a participant to remit, an amount sufficient to satisfy any federal, state or local withholding tax requirements associated with awards under ACGL's share award plans. This includes the authority to withhold or receive shares or other property and to make cash payments in respect thereof.

Stock Options and Stock Appreciation Rights

ACGL generally issues stock options and stock appreciation rights to the Company's eligible employees with exercise prices equal to the fair market values of ACGL's common shares on the grant dates. Such grants generally vest over a three year period with one-third vesting on the first, second and third anniversaries of the grant date. Option awards have a 10 year contractual life. Refer to Note 2(k) for details related to the Company's accounting for stock options.

The Company recorded after-tax share-based compensation expense of \$3.1 million related to stock option awards for the year ended December 31, 2009, net of a tax benefit of \$1.2 million, compared to \$4.8 million related to stock option awards for the year ended December 31, 2008, net of a tax benefit of \$2.0 million. As of December 31, 2009, there was approximately \$4.7 million of unrecognized compensation cost related to nonvested stock options. Such cost is expected to be recognized over a weighted average period of 1.71 years.

For purposes of determining estimated market value, ACGL has computed the estimated market values of share-based compensation related to stock options using the Black-Scholes option valuation model and has applied the assumptions set forth in the following table. As described above, stock options generally vest over a three year period with one-third vesting on the first, second and third anniversaries of the grant date. For options granted during 2008 and 2009, the expected life assumption was based on an expected term analysis which incorporated ACGL's historical share option exercise experience. ACGL based its estimate of expected volatility for options granted during 2008 and 2009 on daily historical trading data of its common shares from September 20, 2002, the date marking the completion of ACGL's transition as a worldwide insurance and reinsurance company through the last day of the applicable period.

	Years Ended December 31,	
	2009	2008
Dividend yield.....	0.0%	0.0%
Expected volatility	26.2%	20.4%
Risk free interest rate	2.6%	3.4%
Expected option life	5.8 years	5.7 years

The Black-Scholes option pricing model requires the input of highly subjective assumptions. Because ACGL's employee stock options have characteristics significantly different from those of traded options, and because changes in the subjective input assumptions can materially affect the fair value estimate in management's opinion, the existing models may not provide a reliable single measure of the fair value of its employee stock options. In addition, management will continue to assess the assumptions and methodologies used to calculate the estimated fair value of share-based compensation. Circumstances may change and additional data may become available over time, which may result in changes to these assumptions and methodologies, and which could materially impact ACGL's fair value determination.

ARCH REINSURANCE LTD. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

A summary of option activity under ACGL's Long term Incentive and Share Award Plans during the year ended December 31, 2009 related to the Company is presented below:

	Year Ended	
	December 31, 2009	
	Number of Options	Weighted Average Exercise Price
Outstanding, beginning of year	2,227,268	\$41.99
Granted	243,080	\$57.83
Exercised	(331,711)	\$28.57
Forfeited or expired	(23,565)	\$65.69
Outstanding, end of period	2,115,072	\$45.65
Exercisable, end of period	1,671,869	\$41.00

The weighted average grant-date fair value of options granted during the years ended December 31, 2009 and 2008 was \$17.79 and \$19.07, respectively. The aggregate intrinsic value of options exercised during 2009 and 2008 was approximately \$13.3 million and \$13.2 million, respectively, and represents the difference between the exercise price of the option and the closing market price of ACGL's common shares on the exercise dates.

The aggregate intrinsic value of outstanding and exercisable stock options issued to the Company's employees at December 31, 2009 was \$54.8 million and \$51.1 million, respectively. The weighted average remaining contractual life of the outstanding and exercisable stock options issued to the Company's employees at December 31, 2009 was 5.19 years and 4.27 years, respectively. During 2009, the Company recognized a tax benefit of \$3.7 million from the exercise of stock options by its officers.

Restricted Common Shares and Restricted Units

ACGL also issues restricted share and unit awards to the Company's eligible employees, for which the fair value is equal to the fair market values of ACGL's common shares on the grant dates. Compensation equal to the fair market value of the shares at the measurement date is amortized and charged to income over the requisite service period, which is generally the vesting period. Restricted share and unit awards generally vest over a three year period with one-third vesting on the first, second and third anniversaries of the grant date. Refer to Note 2(k) for details related to the Company's accounting for restricted share and unit awards.

The Company recorded \$10.0 million of share-based compensation expense, net of a tax benefit of \$4.0 million, related to restricted share awards for 2009, compared to \$9.3 million, net of a tax benefit of \$3.8 million, for 2008. As of December 31, 2009 there were \$8.9 million and \$7.0 million, respectively, of unrecognized compensation costs related to unvested restricted share and unit awards which are expected to be recognized over a weighted average period of 1.84 years and 1.44 years, respectively.

ARCH REINSURANCE LTD. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

A summary of restricted share activity under ACGL’s Long Term Incentive and Share Award Plans for 2009 related to the Company is presented below:

	Restricted Common Shares	Restricted Unit Awards
Non-Vested Shares:		
Unvested balance, beginning of year	187,583	296,629
Awarded	215,813	30,905
Released	(125,353)	(144,737)
Forfeited	(7,316)	(4,994)
Unvested balance, end of year.....	270,727	177,803
Weighted Average Grant Date Fair Value:		
Unvested balance, beginning of year	\$66.14	
Awarded	\$57.68	
Released	\$63.65	
Forfeited	\$62.57	
Unvested balance, end of year.....	\$60.65	

During 2009 and 2008, ACGL granted an aggregate of 246,718 and 238,081 restricted share and restricted unit awards, respectively, to the Company’s officers with weighted average grant date fair values of \$57.78 and \$69.21, respectively. During 2009 and 2008, the aggregate fair value of restricted shares and units that vested was \$16.8 million and \$9.4 million, respectively. The aggregate intrinsic value of restricted units outstanding and exercisable at December 31, 2009 was \$12.7 million and \$199,000, respectively.

The issuance of share-based awards and amortization thereon has no effect on the Company’s shareholder’s equity.

14. Retirement Plans

For purposes of providing employees with retirement benefits, the Company maintains defined contribution retirement plans. Contributions are based on the participants’ eligible compensation. For 2009 and 2008, the Company expensed approximately \$15.5 million and \$16.0 million, respectively, related to these retirement plans.

15. Statutory Information

Arch Re Ltd. and its insurance and reinsurance subsidiaries are subject to insurance and/or reinsurance laws and regulations in the jurisdictions in which they operate. These regulations include certain restrictions on the amount of dividends or other distributions available to shareholders without prior approval of the insurance regulatory authorities.

Bermuda

Under The Insurance Act 1978, as amended, and related regulations of Bermuda (the “Insurance Act”), Arch Re Ltd. is registered as a Class 4 insurer and is required to annually prepare and file statutory financial statements and a statutory financial return with the Bermuda Monetary Authority (“BMA”). The Insurance Act also requires Arch Re Ltd. to maintain minimum share capital of \$1.0 million, to meet minimum liquidity ratios and a minimum solvency margin equal to the greatest of (A) \$100 million, (B) 50% of net premiums written (being gross premiums written less any premiums ceded by Arch Re Ltd., but Arch Re Ltd. may not deduct

ARCH REINSURANCE LTD. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

more than 25% of gross premiums when computing net premiums written), and (C) 15% of net discounted aggregated losses and loss expense provisions and other insurance reserves. At December 31, 2009 and 2008, such requirements were met.

Arch Re Ltd. is also required to file a new risk based capital model called the Bermuda Solvency Capital Requirement (“BSCR”) model that measures risks and determines enhanced capital requirements and a target capital level (defined as 120% of the enhanced capital requirements). In addition, all Class 4 Bermuda insurers must prepare and file with the BMA audited GAAP basis annual financial statements, which must be made publicly available. Declarations of dividends from retained earnings and distributions from additional paid-in-capital are subject to these requirements being met. For all applicable periods presented herein, Arch Re Ltd. satisfied these requirements

At December 31, 2009 and 2008, as determined under Bermuda law, Arch Re Ltd. had statutory capital of \$2.23 billion and \$2.21 billion, respectively, and statutory capital and surplus of \$4.26 billion and \$3.34 billion, respectively. Such amounts include interests in U.S. insurance and reinsurance subsidiaries. Arch Re Ltd. recorded statutory net income of \$940.3 million and \$349.8 million for 2009 and 2008, respectively. The primary difference between net income and capital and surplus presented under Bermuda statutory accounting principles and net income and shareholder’s equity presented in accordance with U.S. GAAP relates to deferred acquisition costs.

The Bermuda Companies Act 1981 (the “Companies Act”) limits Arch Re Ltd.’s ability to pay dividends and distributions to shareholders if there are reasonable grounds for believing that: (a) Arch Re Ltd. is, or would after the payment be, unable to pay its liabilities as they become due; or (b) the realizable value of Arch Re Ltd. assets would thereby be less than the aggregate of its liabilities and its issued share capital and share premium accounts. Under the Insurance Act, Arch Re Ltd. is restricted with respect to the payment of dividends. Arch Re Ltd. is prohibited from declaring or paying in any financial year dividends of more than 25% of its total statutory capital and surplus (as shown on its previous financial year’s statutory balance sheet) unless it files, at least seven days before payment of such dividends, with the BMA an affidavit stating that it will continue to meet the required margins. In addition, Arch Re Ltd. 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. Accordingly, Arch Re Ltd. can pay approximately \$1.07 billion to ACGL during 2010 without providing an affidavit to the BMA, as discussed above.

Ireland

Arch Re Ltd.’s Ireland subsidiary, Arch Re Europe, was licensed and authorized by the Irish Financial Services Regulatory Authority (“IFSRA”) as a non-life reinsurer in October 2008 and as a life reinsurer in November 2009. Irish authorized reinsurers, such as Arch Re Europe, are also subject to the general body of Irish laws and regulations including the provisions of the Companies Acts 1963-2006. Arch Re Europe must file and submit its annual audited financial statements and related reports to the Registrar of Companies (“Registrar”) under the Companies Acts 1963-2006 together with an annual return of certain core corporate information. Changes to core corporate information during the year must also be notified to the Registrar. These requirements are in addition to the regulatory returns required to be filed annually with IFSRA. Arch Re Europe is required to maintain reserves, particularly in respect of underwriting liabilities and a solvency margin as provided for in the European Communities (Reinsurance) Regulations, 2006, related guidance and the European Communities Insurance Accounts Regulations, 1996. Assets constituting statutory reserves must comply with certain principles including obligations to secure sufficiency, liquidity, security, quality, profitability and currency matching of investments. Statutory reserves must be actuarially certified annually.

Under Irish company law, Arch Re Europe is permitted to make distributions only out of profits available for distribution. A company’s profits available for distribution are its accumulated, realized profits, so far as not

ARCH REINSURANCE LTD. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

previously utilized by distribution or capitalization, less its accumulated, realized losses, so far as not previously written off in a reduction or reorganization of capital duly made. Further, IFSRA has powers to intervene if a dividend payment were to lead to a breach of regulatory capital requirements.

United States

The Company's U.S. insurance and reinsurance subsidiaries file financial statements prepared in accordance with statutory accounting practices prescribed or permitted by insurance regulators. Statutory net income and statutory surplus, as reported to the insurance regulatory authorities, differ in certain respects from the amounts prepared in accordance with GAAP. The main differences between statutory net income and GAAP net income relate to deferred acquisition costs and deferred income taxes. In addition to deferred acquisition costs and deferred income tax assets, other differences between statutory surplus and GAAP shareholder's equity are unrealized appreciation or decline in value of investments and non-admitted assets.

Combined statutory surplus of the Company's U.S. insurance and reinsurance subsidiaries was \$850.5 million and \$766.0 million at December 31, 2009 and 2008, respectively. The Company's U.S. insurance and reinsurance subsidiaries had combined statutory net income of \$74.5 million and \$46.2 million for 2009 and 2008, respectively.

The Company's U.S. insurance and reinsurance subsidiaries are subject to insurance laws and regulations in the jurisdictions in which they operate. The ability of the Company's regulated insurance subsidiaries to pay dividends or make distributions is dependent on their ability to meet applicable regulatory standards. These regulations include restrictions that limit the amount of dividends or other distributions, such as loans or cash advances, available to shareholders without prior approval of the insurance regulatory authorities. Dividends or distributions, if any, made by the Company's U.S. regulated insurance and reinsurance subsidiaries to non-insurance affiliates would result in an increase in available capital at Arch-U.S., the Company's U.S. holding company.

United Kingdom

The Company's European insurance operations are conducted on two platforms: Arch Insurance Company Europe and Arch Syndicate 2012 (collectively, the insurance operations are referred to as "Arch Insurance Europe"). Arch Insurance Company Europe was licensed and authorized by the Financial Services Authority ("FSA") to underwrite all classes of general insurance in the U.K. in May 2004. In April 2009, the Company received approval in principle from the Lloyd's Franchise Board and the FSA to establish a managing agent and syndicate at Lloyd's of London. Arch Underwriting at Lloyd's Ltd is the managing agent of Arch Syndicate 2012 and is responsible for the daily management of Arch Syndicate 2012. The operations of AUAL and related Arch Syndicate 2012 and its corporate member, Arch Syndicate Investments Ltd, are subject to the byelaws and regulations made by (or on behalf of) the Council of Lloyd's, and requirements made under those byelaws.

Arch Insurance Europe must file annual audited financial statements in accordance with United Kingdom Generally Accepted Accounting Principles ("U.K. GAAP") with Companies House under the Companies Act 1985 (as amended). In addition, Arch Insurance Europe is required to file regulatory returns with the FSA, which regulates insurance and reinsurance companies operating from the U.K. The financial statements required to be submitted to Companies House form the basis for the regulatory return required to be submitted to the FSA. The FSA's capital adequacy and solvency regulations require a margin of capital to be determined by the Company's own individual capital assessment ("ICA") to value capital adequacy. The model the company uses to determine the capital requirement is reviewed and approved by the FSA who then issue an individual capital guidance ("ICG"). For Arch Insurance Europe, the ICG is the same as its own ICA.

ARCH REINSURANCE LTD. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

Under U.K. law, all U.K. companies are restricted from declaring a dividend to their shareholders unless they have “profits available for distribution.” The calculation as to whether a company has sufficient profits is based on its accumulated realized profits minus its accumulated realized losses. U.K. insurance regulatory laws do not prohibit the payment of dividends, but the FSA requires that insurance companies maintain certain solvency margins and may restrict the payment of a dividend by Arch Insurance Europe. Dividends or distributions, if any, made by Arch Insurance Company Europe would result in an increase in available capital at Arch Re Europe, a subsidiary of the Arch Re Ltd.. Shareholder’s equity of Arch Insurance Europe under U.K. GAAP at December 31, 2009 was £67.2 million, or approximately \$108.5 million, compared to £58.2 million, or approximately \$83.7 million, at December 31, 2008. Arch Insurance Europe had U.K. GAAP net income of £2.5 million, or approximately \$4.0 million, for 2009, compared to £0.5 million, or approximately \$0.7 million, for 2008.

16. Legal Proceedings

The Company, in common with the insurance industry in general, is subject to litigation and arbitration in the normal course of its business. As of December 31, 2009, 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.

17. Business Combination

As discussed in Note 1, on December 31, 2008, ACGL contributed 100% of its investment in Arch Insurance Company Europe to Arch Re Ltd.. Prior to this time, Arch Insurance Company Europe and Arch Re Ltd. were sister companies, organized as direct subsidiaries of ACGL. As the entities were under common control prior to the contribution, the transaction was accounted for using the pooling method in accordance with FASB guidance regarding business combinations, and, as such, the accompanying financial statements and notes to the consolidated financial statements include the operations of Arch Insurance Company Europe for all periods presented as if the transaction occurred prior to January 1, 2008.

The following table presents the consolidation of select balance sheet amounts of the Company and Arch Insurance Company Europe, along with the necessary elimination entries for intercompany transactions between the Company and Arch Insurance Company Europe, at December 31, 2008:

	December 31, 2008			
	The Company	Arch Insurance Company Europe	Eliminations	Consolidated
Total Assets	\$14,020,503	\$1,081,867	(\$535,817)	\$14,566,553
Total Liabilities	\$10,308,754	\$998,187	(\$535,817)	\$10,771,124
Total Shareholder’s Equity	3,711,749	83,680	—	3,795,429
Total Liabilities and Shareholder’s Equity	\$14,020,503	\$1,081,867	(\$535,817)	\$14,566,553

ARCH REINSURANCE LTD. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

The following table presents the consolidation of select income statement amounts of the Company and Arch Insurance Company Europe for the year ended December 31, 2008:

	Year Ended December 31, 2008		
	The Company	Arch Insurance Company Europe	Consolidated
Total Revenues (1)	\$2,901,616	\$59,651	\$2,961,267
Total Expenses (2)	\$2,548,047	\$61,291	\$2,609,338
Net Income (Loss)	\$341,171	(\$2,124)	\$339,047

- (1) The Company's total revenues include \$290.4 million of premiums earned assumed through transactions with Arch Insurance Company Europe. Arch Insurance Company Europe's total revenues are net of the \$290.4 million of ceded premiums earned through transactions with the Company. The impact of these transactions eliminate when the revenues of the two entities are combined to arrive at the consolidated total revenues.
- (2) The Company's total expenses include \$218.0 million of losses and loss adjustment expenses and \$84.7 million of acquisition expenses assumed through transactions with Arch Insurance Company Europe. Arch Insurance Company Europe's total expenses are net of the \$218.0 million of losses and loss adjustment expenses and \$84.7 million of acquisition expenses ceded through transactions with the Company. The impact of these transactions eliminate when the expenses of the two entities are combined to arrive at the consolidated total expenses.

18. Subsequent Events

The Company has completed its subsequent events evaluation for the period subsequent to the balance sheet date of December 31, 2009 through April 23, 2010, the date the consolidated financial statements were available to be issued.