

**ARCH REINSURANCE LTD. AND SUBSIDIARIES**  
**(a wholly-owned subsidiary of Arch Capital Group Ltd.)**  
**Consolidated Financial Statements**  
**December 31, 2007 and 2006**

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**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, 2007 and December 31, 2006, 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.



July 28, 2008

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

	December 31,	
	2007	2006
<b>Assets</b>		
Investments:		
Fixed maturities available for sale, at fair value (amortized cost: 2007, \$6,897,646; 2006, \$6,749,058) .....	\$6,997,548	\$6,768,315
Short-term investments available for sale, at fair value (amortized cost: 2007, \$640,779; 2006, \$902,832) .....	639,553	903,599
Short-term investment of funds received under securities lending agreements, at fair value .....	1,503,723	891,376
Other investments (cost: 2007, \$559,925; 2006, \$282,923) .....	589,669	307,082
<b>Total investments</b> .....	<u>9,730,493</u>	<u>8,870,372</u>
Cash .....	197,733	272,994
Accrued investment income .....	71,906	67,017
Fixed maturities and short-term investments pledged under securities lending agreements, at fair value .....	1,463,045	860,803
Premiums receivable .....	710,630	740,558
Funds held by reinsureds .....	74,752	82,385
Unpaid losses and loss adjustment expenses recoverable .....	1,530,842	1,504,130
Paid losses and loss adjustment expenses recoverable .....	123,027	109,173
Prepaid reinsurance premiums .....	445,450	445,772
Deferred income tax assets, net .....	55,772	63,926
Deferred acquisition costs, net .....	291,768	292,802
Receivable for securities sold .....	17,212	190,143
Other assets .....	315,343	309,537
<b>Total Assets</b> .....	<u>\$15,027,973</u>	<u>\$13,809,612</u>
<b>Liabilities</b>		
Reserve for losses and loss adjustment expenses .....	\$6,933,368	\$6,355,468
Unearned premiums .....	1,709,959	1,749,169
Reinsurance balances payable .....	293,544	287,513
Deposit accounting liabilities .....	43,506	45,107
Securities lending collateral .....	1,503,723	891,376
Payable for securities purchased .....	23,155	418,109
Other liabilities .....	360,951	317,310
<b>Total Liabilities</b> .....	<u>10,868,206</u>	<u>10,064,052</u>
<b>Commitments and Contingencies</b>		
<b>Shareholder's Equity</b>		
Common shares (\$1.00 par value, 1,250,000 shares authorized, issued: 2007 and 2006, 1,250,000) .....	1,250	1,250
Additional paid-in capital .....	1,985,175	1,973,436
Retained earnings .....	2,028,937	1,718,449
Accumulated other comprehensive income, net of deferred income tax .....	144,405	52,425
<b>Total Shareholder's Equity</b> .....	<u>4,159,767</u>	<u>3,745,560</u>
<b>Total Liabilities and Shareholder's Equity</b> .....	<u>\$15,027,973</u>	<u>\$13,809,612</u>

See Notes to Consolidated Financial Statements

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

	<b>Years Ended December 31,</b>	
	<b>2007</b>	<b>2006</b>
<b>Revenues</b>		
Net premiums written.....	\$2,853,933	\$2,979,132
Decrease in unearned premiums.....	44,330	50,146
Net premiums earned .....	2,898,263	3,029,278
Net investment income.....	452,231	370,950
Net realized gains (losses).....	28,709	(19,087)
Fee income .....	4,427	6,279
Other income.....	9,048	431
<b>Total revenues</b> .....	<b>3,392,678</b>	<b>3,387,851</b>
<b>Expenses</b>		
Losses and loss adjustment expenses .....	1,607,710	1,749,733
Acquisition expenses.....	502,787	555,009
Other operating expenses .....	323,328	278,153
Net foreign exchange losses .....	35,092	30,710
<b>Total expenses</b> .....	<b>2,468,917</b>	<b>2,613,605</b>
<b>Income Before Income Taxes</b> .....	<b>923,761</b>	<b>774,246</b>
Income tax expense .....	13,334	24,296
<b>Net Income</b> .....	<b>\$910,427</b>	<b>\$749,950</b>

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,	
	2007	2006
<b>Common Shares</b>		
Balance at beginning of year.....	\$1,250	\$1,250
<b>Balance at end of year</b> .....	<u>1,250</u>	<u>1,250</u>
<b>Additional Paid-in Capital</b>		
Balance at beginning of year.....	1,973,436	1,649,064
Contributions from parent.....	—	314,000
Amortization of share-based compensation.....	13,399	7,757
Other.....	(1,660)	2,615
<b>Balance at end of year</b> .....	<u>1,985,175</u>	<u>1,973,436</u>
<b>Retained Earnings</b>		
Balance at beginning of year.....	1,718,449	990,549
Adjustment to adopt SFAS No. 155, "Accounting for Certain Hybrid Financial Instruments—an amendment of FASB Statements No. 133 and 140".....	2,111	—
Balance at beginning of year, as adjusted.....	1,720,560	990,549
Dividends paid to parent.....	(602,050)	(22,050)
Net income.....	910,427	749,950
<b>Balance at end of year</b> .....	<u>2,028,937</u>	<u>1,718,449</u>
<b>Accumulated Other Comprehensive Income (Loss)</b>		
Balance at beginning of year.....	52,425	(1,570)
Adjustment to adopt SFAS No. 155, "Accounting for Certain Hybrid Financial Instruments—an amendment of FASB Statements No. 133 and 140".....	(2,111)	—
Balance at beginning of year, as adjusted.....	50,314	(1,570)
Change in unrealized appreciation in value of investments, net of deferred income tax.....	90,829	54,111
Foreign currency translation adjustments, net of deferred income tax.....	3,262	(116)
<b>Balance at end of year</b> .....	<u>144,405</u>	<u>52,425</u>
<b>Total Shareholder's Equity</b> .....	<u>\$4,159,767</u>	<u>\$3,745,560</u>

See Notes to Consolidated Financial Statements

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

	<b>Years Ended December 31,</b>	
	<b>2007</b>	<b>2006</b>
<b>Comprehensive Income</b>		
Net income .....	\$910,427	\$749,950
Other comprehensive income, net of deferred income tax		
Unrealized appreciation in value of investments:		
Unrealized holding gains arising during year.....	133,261	32,844
Reclassification of net realized (gains) losses, net of income taxes, included in net income .....	(42,432)	21,267
Foreign currency translation adjustments .....	3,262	(116)
Other comprehensive income .....	94,091	53,995
<b>Comprehensive Income</b> .....	<b>\$1,004,518</b>	<b>\$803,945</b>

See Notes to Consolidated Financial Statements

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

	<b>Years Ended December 31,</b>	
	<b>2007</b>	<b>2006</b>
<b>Operating Activities</b>		
Net income.....	\$910,427	\$749,950
Adjustments to reconcile net income to net cash provided by operating activities:		
Net realized (gains) losses .....	(28,480)	20,706
Other income .....	(9,048)	(431)
Share-based compensation .....	13,399	7,757
Changes in:		
Reserve for losses and loss adjustment expenses, net of unpaid losses and loss adjustment expenses recoverable .....	551,188	818,483
Unearned premiums, net of prepaid reinsurance premiums .....	(38,888)	(44,778)
Premiums receivable .....	29,928	(61,610)
Deferred acquisition costs, net .....	1,034	19,881
Funds held by reinsureds .....	7,633	85,347
Reinsurance balances payable .....	6,031	123,069
Deferred income tax assets, net .....	(3,110)	7,226
Other liabilities .....	13,215	2,454
Other items, net .....	3,942	(127,738)
<b>Net Cash Provided By Operating Activities .....</b>	<b>1,457,271</b>	<b>1,600,316</b>
<b>Investing Activities</b>		
Purchases of fixed maturity investments .....	(19,959,884)	(15,601,357)
Proceeds from sales of fixed maturity investments .....	18,453,474	13,748,081
Proceeds from redemptions and maturities of fixed maturity investments .....	644,047	513,982
Purchases of other investments .....	(542,615)	(241,703)
Proceeds from sales of other investments .....	204,026	15,192
Net purchases of short-term investments .....	289,775	(231,092)
Change in securities lending collateral .....	(612,347)	1,312
Purchases of furniture, equipment and other .....	(24,629)	(11,029)
<b>Net Cash Used For Investing Activities .....</b>	<b>(1,548,153)</b>	<b>(1,806,614)</b>
<b>Financing Activities</b>		
Change in securities lending collateral .....	612,347	(1,312)
Excess tax benefits from share-based compensation .....	4,753	4,649
Contributions from parent .....	—	314,000
Dividends paid to parent .....	(602,050)	(22,050)
<b>Net Cash Provided By Financing Activities .....</b>	<b>15,050</b>	<b>295,287</b>
Effects of exchange rate changes on foreign currency cash .....	571	43
(Decrease) increase in cash .....	(75,261)	89,032
Cash beginning of year .....	272,994	183,962
<b>Cash end of year .....</b>	<b>\$197,733</b>	<b>\$272,994</b>
Income taxes paid, net .....	\$1,725	\$39,170

See Notes to Consolidated Financial Statements

## **1. Organization**

Arch Reinsurance Ltd. (the “Company”) is a Bermuda limited liability company which provides insurance and reinsurance on a worldwide basis. The Company was 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. The Company 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.

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 the Company. During 2002 to 2006, additional capital contributions were made to the Company by ACGL following capital raising activities. In addition, 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 the Company, with the remaining 13.4% of Arch-U.S. and its subsidiaries contributed to the Company on December 30, 2005. During 2007, the Company paid \$602.1 million of dividends to ACGL which were used to fund ACGL’s share repurchase program and other corporate purposes.

## **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 the Company 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. All significant intercompany transactions and balances have been eliminated in consolidation. The preparation of financial statements in conformity with GAAP requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates and assumptions.

### ***(b) Premium Revenues and Related Expenses***

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

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

inception due to the ability of the reinsured to commute or cancel coverage during the term of the policy. The remaining annual installments are included as premiums written at each successive anniversary date within the multi-year term.

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

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

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

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

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

Acquisition expenses and other expenses that vary with, and are directly related to, the acquisition of business related to the Company's underwriting operations are deferred and amortized over the period in which the related premiums are earned. Acquisition expenses, net of ceding commissions received from unaffiliated reinsurers, consist principally of commissions, brokerage and taxes paid to obtain the Company's business. Other operating expenses also include expenses that vary with, and are directly related to, the acquisition of business. Deferred acquisition costs, which are based on the related unearned premiums, are carried at their estimated realizable value and take into account anticipated losses and loss adjustment expenses, based on historical and current experience, and anticipated investment income. A premium deficiency is recognized if the sum of anticipated losses and loss adjustment expenses, unamortized acquisition costs and maintenance costs and anticipated investment income exceed unearned premiums. A premium deficiency is recognized by charging any unamortized acquisition costs to expense to the extent required in order to eliminate the deficiency. If the premium deficiency exceeds unamortized acquisition costs then a liability is accrued for the excess deficiency.

No premium deficiency charges were recorded by the Company during the years ended December 31, 2007 or 2006.

***(c) Deposit Accounting***

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

***(d) Retroactive Accounting***

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

***(e) Reinsurance Ceded***

In the normal course of business, the Company purchases reinsurance to increase capacity and to limit the impact of individual losses and events on its underwriting results by reinsuring certain levels of risk with other insurance enterprises or reinsurers. The Company uses pro rata, excess of loss and facultative reinsurance contracts. Reinsurance ceding commissions are recognized as income on a pro rata basis over the period of risk. The portion of such commissions that will be earned in the future is deferred and reported as a reduction to acquisition costs. The accompanying consolidated statement of income reflects premiums and losses and loss adjustment expenses and acquisition costs, net of reinsurance ceded (see Note 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.

