

ARCH CAPITAL GROUP LTD.
Form 10-Q
May 10, 2012
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**UNITED STATES
SECURITIES AND EXCHANGE COMMISSION**

WASHINGTON, D.C. 20549

FORM 10-Q

(Mark One)

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

For the quarterly period ended March 31, 2012

Or

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

Commission file number: 001-26456

ARCH CAPITAL GROUP LTD.

(Exact name of registrant as specified in its charter)

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Bermuda

(State or other jurisdiction of incorporation or organization)

Not Applicable

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

Wessex House, 5th Floor, 45 Reid Street

Hamilton HM 12, Bermuda

(Address of principal executive offices)

(441) 278-9250

(Registrant's telephone number, including area code)

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

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

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

Large accelerated filer

Accelerated filer

Non-accelerated filer

Smaller reporting company

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

The number of the registrant's common shares (par value, \$0.0033 per share) outstanding as of May 1, 2012 was 135,451,630.

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Report of Independent Registered Public Accounting Firm

To the Board of Directors and Shareholders of

Arch Capital Group Ltd.:

We have reviewed the accompanying consolidated balance sheet of Arch Capital Group Ltd. and its subsidiaries (the Company) as of March 31, 2012, and the related consolidated statements of income for the three-month periods ended March 31, 2012 and March 31, 2011, and the consolidated statements of comprehensive income, changes in shareholders' equity and cash flows for the three-month periods ended March 31, 2012 and March 31, 2011. These interim financial statements are the responsibility of the Company's management.

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

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

We previously audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the consolidated balance sheet as of December 31, 2011, and the related consolidated statements of income, comprehensive income, changes in shareholders' equity, and cash flows for the year then ended (not presented herein), and in our report dated February 29, 2012, we expressed an unqualified opinion on those consolidated financial statements. As discussed in Note 2 to the accompanying consolidated financial statements, the Company changed its method of accounting for costs associated with acquiring or renewing insurance contracts. The accompanying December 31, 2011 consolidated balance sheet reflects this change.

/s/ PricewaterhouseCoopers LLP

New York, NY

May 10, 2012

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

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

	(Unaudited) March 31, 2012	December 31, 2011
Assets		
Investments:		
Fixed maturities available for sale, at fair value (amortized cost: \$8,989,350 and \$9,165,438)	\$ 9,221,145	\$ 9,375,604
Short-term investments available for sale, at fair value (amortized cost: \$1,110,944 and \$909,121)	1,112,249	904,219
Investment of funds received under securities lending, at fair value (amortized cost: \$42,174 and \$48,577)	41,867	48,419
Equity securities available for sale, at fair value (cost: \$295,242 and \$299,058)	318,181	299,584
Other investments available for sale, at fair value (cost: \$342,234 and \$235,381)	357,992	238,111
Investments accounted for using the fair value option	500,283	366,903
TALF investments, at fair value (amortized cost: \$297,301 and \$373,040)	313,187	387,702
Investments accounted for using the equity method	347,273	380,507
Total investments	12,212,177	12,001,049
Cash	422,806	351,699
Accrued investment income	65,643	70,739
Investment in joint venture (cost: \$100,000)	107,866	107,576
Fixed maturities and short-term investments pledged under securities lending, at fair value	50,813	56,393
Premiums receivable	700,137	501,563
Reinsurance recoverable on unpaid and paid losses and loss adjustment expenses	1,849,603	1,851,584
Contractholder receivables	762,031	748,231
Prepaid reinsurance premiums	261,619	265,696
Deferred acquisition costs, net	261,467	227,884
Receivable for securities sold	621,560	462,891
Other assets	497,061	460,052
Total Assets	\$ 17,812,783	\$ 17,105,357
Liabilities		
Reserve for losses and loss adjustment expenses	\$ 8,511,323	\$ 8,456,210
Unearned premiums	1,595,712	1,411,872
Reinsurance balances payable	137,791	133,866
Contractholder payables	762,031	748,231
Senior notes	300,000	300,000
Revolving credit agreement borrowings	100,000	100,000
TALF borrowings, at fair value (par: \$241,005 and \$310,868)	239,551	310,486
Securities lending payable	52,224	58,546
Payable for securities purchased	742,995	480,230
Other liabilities	531,700	513,842
Total Liabilities	12,973,327	12,513,283
Commitments and Contingencies		
Shareholders Equity		
Non-cumulative preferred shares	325,000	325,000
Common shares (\$0.0033 par, shares issued: 165,725,990 and 164,636,338)	552	549

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Additional paid-in capital	170,694	161,419
Retained earnings	4,954,450	4,796,655
Accumulated other comprehensive income, net of deferred income tax	234,468	153,923
Common shares held in treasury, at cost (shares: 30,284,303 and 30,277,993)	(845,708)	(845,472)
Total Shareholders' Equity	4,839,456	4,592,074
Total Liabilities and Shareholders' Equity	\$ 17,812,783	\$ 17,105,357

See Notes to Consolidated Financial Statements

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ARCH CAPITAL GROUP LTD. AND SUBSIDIARIES

CONSOLIDATED STATEMENTS OF INCOME

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

	(Unaudited) Three Months Ended March 31,	
	2012	2011
Revenues		
Net premiums written	\$ 863,611	\$ 764,278
Change in unearned premiums	(183,299)	(130,583)
Net premiums earned	680,312	633,695
Net investment income	74,297	88,307
Net realized gains	44,121	20,695
Other-than-temporary impairment losses	(1,031)	(3,258)
Less investment impairments recognized in other comprehensive income, before taxes	8	578
Net impairment losses recognized in earnings	(1,023)	(2,680)
Fee income	543	815
Equity in net income of investment funds accounted for using the equity method	24,826	29,673
Other income (loss)	(8,068)	4,567
Total revenues	815,008	775,072
Expenses		
Losses and loss adjustment expenses	395,207	493,880
Acquisition expenses	118,962	108,754
Other operating expenses	106,472	102,882
Interest expense	7,521	7,721
Net foreign exchange losses	20,688	36,912
Total expenses	648,850	750,149
Income before income taxes	166,158	24,923
Income tax expense (benefit)	1,902	(550)
Net income	164,256	25,473
Preferred dividends	6,461	6,461
Net income available to common shareholders	\$ 157,795	\$ 19,012
Net income per common share		
Basic	\$ 1.18	\$ 0.14
Diluted	\$ 1.14	\$ 0.14
Weighted average common shares and common share equivalents outstanding		
Basic	133,954,623	133,499,241
Diluted	137,814,906	140,460,516

See Notes to Consolidated Financial Statements

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

	(Unaudited) Three Months Ended March 31,	
	2012	2011
Comprehensive Income		
Net income	\$ 164,256	\$ 25,473
Other comprehensive income, net of deferred income tax		
Unrealized appreciation in value of investments:		
Unrealized holding gains arising during period	94,863	40,370
Portion of other-than-temporary impairment losses recognized in other comprehensive income, net of deferred income tax	(8)	(578)
Reclassification of net realized gains, net of income taxes, included in net income	(27,511)	(20,176)
Foreign currency translation adjustments, net of deferred income tax	13,201	1,286
Other comprehensive income	80,545	20,902
Comprehensive Income	\$ 244,801	\$ 46,375

See Notes to Consolidated Financial Statements

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ARCH CAPITAL GROUP LTD. AND SUBSIDIARIES

CONSOLIDATED STATEMENTS OF CHANGES IN SHAREHOLDERS EQUITY

(U.S. dollars in thousands)

	(Unaudited) Three Months Ended March 31,	
	2012	2011
Non-Cumulative Preferred Shares		
Balance at beginning and end of period	\$ 325,000	\$ 325,000
Common Shares		
Balance at beginning of year	549	534
Common shares issued, net	3	1
Balance at end of period	552	535
Additional Paid-in Capital		
Balance at beginning of year	161,419	110,325
Common shares issued, net	(3)	8
Exercise of stock options	1,851	4,127
Amortization of share-based compensation	7,411	5,628
Other	16	21
Balance at end of period	170,694	120,109
Retained Earnings		
Balance at beginning of year	4,796,655	4,422,553
Cumulative effect of adjustment resulting from adoption of new accounting guidance (1)		(36,217)
Balance at beginning of year, as adjusted	4,796,655	4,386,336
Dividends declared on preferred shares	(6,461)	(6,461)
Net income	164,256	25,473
Balance at end of period	4,954,450	4,405,348
Accumulated Other Comprehensive Income		
Balance at beginning of year	153,923	204,503
Change in unrealized appreciation in value of investments, net of deferred income tax	67,352	20,194
Portion of other-than-temporary impairment losses recognized in other comprehensive income, net of deferred income tax	(8)	(578)
Foreign currency translation adjustments, net of deferred income tax	13,201	1,286
Balance at end of period	234,468	225,405
Common Shares Held in Treasury, at Cost		
Balance at beginning of year	(845,472)	(549,912)
Shares repurchased for treasury	(236)	(237,450)
Balance at end of period	(845,708)	(787,362)
Total Shareholders Equity	\$ 4,839,456	\$ 4,289,035

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

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ARCH CAPITAL GROUP LTD. AND SUBSIDIARIES

CONSOLIDATED STATEMENTS OF CASH FLOWS

(U.S. dollars in thousands)

	(Unaudited) Three Months Ended March 31,	
	2012	2011
Operating Activities		
Net income	\$ 164,256	\$ 25,473
Adjustments to reconcile net income to net cash provided by operating activities:		
Net realized gains	(44,072)	(22,481)
Net impairment losses recognized in earnings	1,023	2,680
Equity in net income of investment funds accounted for using the equity method and other income	(12,030)	(355)
Share-based compensation	7,411	5,628
Changes in:		
Reserve for losses and loss adjustment expenses, net of unpaid losses and loss adjustment expenses recoverable	39,343	155,477
Unearned premiums, net of prepaid reinsurance premiums	181,735	130,136
Premiums receivable	(190,102)	(118,688)
Deferred acquisition costs, net	(32,269)	(22,056)
Reinsurance balances payable	(3,181)	(7,122)
Other liabilities	10,134	33,366
Other items, net	22,573	42,522
Net Cash Provided By Operating Activities	144,821	224,580
Investing Activities		
Purchases of:		
Fixed maturity investments	(3,593,630)	(3,151,767)
Equity securities	(33,803)	(89,790)
Other investments	(239,167)	(92,777)
Proceeds from the sales of:		
Fixed maturity investments	3,628,932	3,232,541
Equity securities	75,860	52,316
Other investments	111,149	84,967
Proceeds from redemptions and maturities of fixed maturity investments	261,660	253,898
Net purchases of short-term investments	(207,444)	(223,415)
Change in investment of securities lending collateral	6,322	(125,904)
Purchases of furniture, equipment and other assets	(6,498)	(8,082)
Net Cash Provided By (Used For) Investing Activities	3,381	(68,013)
Financing Activities		
Purchases of common shares under share repurchase program		(237,173)
Proceeds from common shares issued, net	780	2,875
Repayments of borrowings	(69,863)	(3,695)
Change in securities lending collateral	(6,322)	125,904
Other	588	714
Preferred dividends paid	(6,461)	(6,461)
Net Cash Used For Financing Activities	(81,278)	(117,836)
Effects of exchange rate changes on foreign currency cash	4,183	5,406

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Increase in cash		71,107		44,137
Cash beginning of year		351,699		362,740
Cash end of period	\$	422,806	\$	406,877

See Notes to Consolidated Financial Statements

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ARCH CAPITAL GROUP LTD. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)

1. General

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

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

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

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

2. Recent Accounting Pronouncements

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

As Previously Reported	Effect of Change	As Currently Reported
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December 31, 2010

Deferred acquisition costs, net	\$	277,861	\$	(50,583)	\$	227,278
Other assets (1)		475,911		14,366		490,277
Retained earnings		4,422,553		(36,217)		4,386,336

Three Months Ended March 31, 2011

Other operating expenses	\$	102,420	\$	462	\$	102,882
Income tax benefit		(371)		(179)		(550)
Net income		25,756		(283)		25,473

Net income per common share - basic	\$	0.14	\$		\$	0.14
Net income per common share - diluted	\$	0.14	\$		\$	0.14

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

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As of March 31, 2012, the Company had a \$300 million unsecured revolving loan and letter of credit facility and a \$500 million secured letter of credit facility (the Credit Agreement). The Credit Agreement expires on August 18, 2014. In addition, the Company had access to secured letter of credit facilities of approximately \$80 million as of March 31, 2012, which are available on a limited basis and for limited purposes (together with the secured portion of the Credit Agreement and these letter of credit facilities, the LOC Facilities). At March 31, 2012, the Company had \$473.1 million in outstanding letters of credit under the LOC Facilities, which were secured by investments with a fair value of \$555.8 million, and had \$100.0 million of borrowings outstanding under the Credit Agreement. The Company was in compliance with all covenants contained in the LOC Facilities at March 31, 2012.

Investment Commitments

The Company's investment commitments, which are primarily related to investment funds accounted for using the equity method, were approximately \$275.0 million at March 31, 2012.

4. Earnings Per Common Share

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

	Three Months Ended March 31,	
	2012	2011
Numerator:		
Net income	\$ 164,256	\$ 25,473
Preferred dividends	(6,461)	(6,461)
Net income available to common shareholders	\$ 157,795	\$ 19,012
Denominator:		
Weighted average common shares outstanding - basic	133,954,623	133,499,241
Effect of dilutive common share equivalents:		

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Nonvested restricted shares	1,012,303	1,141,668
Stock options (1)	2,847,980	5,819,607
Weighted average common shares and common share equivalents outstanding diluted	137,814,906	140,460,516
Earnings per common share:		
Basic	\$ 1.18	\$ 0.14
Diluted	\$ 1.14	\$ 0.14

(1) Certain stock options were not included in the computation of diluted earnings per share where the exercise price of the stock options exceeded the average market price and would have been anti-dilutive or where, when applying the treasury stock method to in-the-money options, the sum of the proceeds, including unrecognized compensation, exceeded the average market price and would have been anti-dilutive. For the 2012 first quarter and 2011 first quarter, the number of stock options excluded were 451,877 and 202,074, respectively.

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ARCH CAPITAL GROUP LTD. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)

5. Segment Information

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

	Three Months Ended March 31, 2012			Three Months Ended March 31, 2011		
	Insurance	Reinsurance	Total	Insurance	Reinsurance	Total
Gross premiums written (1)	\$ 688,113	\$ 379,976	\$ 1,066,656	\$ 634,583	\$ 331,013	\$ 964,566
Net premiums written	490,680	372,931	863,611	449,291	314,987	764,278
Net premiums earned	\$ 441,740	\$ 238,572	\$ 680,312	\$ 407,591	\$ 226,104	\$ 633,695
Fee income	530	13	543	778	37	815
Losses and loss adjustment expenses	(303,164)	(92,043)	(395,207)	(297,723)	(196,157)	(493,880)
Acquisition expenses, net	(73,870)	(45,092)	(118,962)	(61,415)	(47,339)	(108,754)
Other operating expenses	(73,370)	(26,123)	(99,493)	(74,629)	(21,227)	(95,856)
Underwriting income (loss)	\$ (8,134)	\$ 75,327	67,193	\$ (25,398)	\$ (38,582)	(63,980)
Net investment income			74,297			88,307
Net realized gains			44,121			20,695
Net impairment losses recognized in earnings			(1,023)			(2,680)
Equity in net income of investment funds accounted for using the equity method			24,826			29,673
Other income (loss)			(8,068)			4,567
Other expenses			(6,979)			(7,026)
Interest expense			(7,521)			(7,721)
Net foreign exchange losses			(20,688)			(36,912)
Income before income taxes			166,158			24,923
Income tax (expense) benefit			(1,902)			550
Net income			164,256			25,473
Preferred dividends			(6,461)			(6,461)
Net income available to common shareholders			\$ 157,795			\$ 19,012
Underwriting Ratios						
Loss ratio	68.6%	38.6%	58.1%	73.0%	86.8%	77.9%
Acquisition expense ratio (2)	16.6%	18.9%	17.4%	14.9%	20.9%	17.0%
Other operating expense ratio	16.6%	10.9%	14.6%	18.3%	9.4%	15.1%
Combined ratio	101.8%	68.4%	90.1%	106.2%	117.1%	110.0%

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

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

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ARCH CAPITAL GROUP LTD. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)

6. Investment Information*Available For Sale Securities*

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

	Estimated Fair Value	Gross Unrealized Gains	Gross Unrealized Losses	Cost or Amortized Cost	OTTI Unrealized Losses (2)
<u>At March 31, 2012</u>					
Fixed maturities and fixed maturities pledged under securities lending agreements (1):					
Corporate bonds	\$ 2,616,226	\$ 90,793	\$ (11,263)	\$ 2,536,696	\$ (488)
Mortgage backed securities	1,494,968	26,747	(14,777)	1,482,998	(15,444)
Municipal bonds	1,301,255	64,044	(1,381)	1,238,592	(105)
Commercial mortgage backed securities	1,124,667	35,721	(2,651)	1,091,597	(3,259)
U.S. government and government agencies	1,254,434	19,500	(4,295)	1,239,229	(207)
Non-U.S. government securities	856,535	30,517	(9,552)	835,570	
Asset backed securities	623,873	16,033	(6,132)	613,972	(3,876)
Total	9,271,958	283,355	(50,051)	9,038,654	(23,379)
Equity securities	318,181	37,649	(14,710)	295,242	
Other investments	357,992	17,119	(1,361)	342,234	
Short-term investments	1,112,249	3,570	(2,265)	1,110,944	
Total	\$ 11,060,380	\$ 341,693	\$ (68,387)	\$ 10,787,074	\$ (23,379)
<u>At December 31, 2011</u>					
Fixed maturities and fixed maturities pledged under securities lending agreements (1):					
Corporate bonds	\$ 2,596,118	\$ 79,407	\$ (29,922)	\$ 2,546,633	\$ (1,138)
Mortgage backed securities	1,592,762	27,633	(23,226)	1,588,355	(20,466)
Municipal bonds	1,430,565	77,977	(886)	1,353,474	(105)
Commercial mortgage backed securities	1,046,326	28,780	(2,904)	1,020,450	(3,259)
U.S. government and government agencies	1,451,993	34,811	(3)	1,417,185	(207)
Non-U.S. government securities	737,477	33,486	(17,684)	721,675	
Asset backed securities	576,757	14,649	(10,078)	572,186	(3,876)
Total	9,431,998	296,743	(84,703)	9,219,958	(29,051)
Equity securities	299,584	22,870	(22,344)	299,058	
Other investments	238,111	8,340	(5,610)	235,381	

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

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

(2) Represents the total other-than-temporary impairments (OTTI) recognized in accumulated other comprehensive income (AOCI). It does not include the change in fair value subsequent to the impairment measurement date. At March 31, 2012, the net unrealized loss related to securities for which a non-credit OTTI was recognized in AOCI was \$9.4 million, compared to a net unrealized loss of \$18.0 million at December 31, 2011.

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ARCH CAPITAL GROUP LTD. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)

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

	Less than 12 Months		12 Months or More		Total	
	Estimated Fair Value	Gross Unrealized Losses	Estimated Fair Value	Gross Unrealized Losses	Estimated Fair Value	Gross Unrealized Losses
At March 31, 2012						
Fixed maturities and fixed maturities pledged under securities lending agreements (1):						
Corporate bonds	\$ 446,225	\$ (7,774)	\$ 49,733	\$ (3,489)	\$ 495,958	\$ (11,263)
Mortgage backed securities	293,374	(5,324)	49,160	(9,453)	342,534	(14,777)
Municipal bonds	114,896	(935)	14,834	(446)	129,730	(1,381)
Commercial mortgage backed securities	88,471	(1,349)	14,495	(1,302)	102,966	(2,651)
U.S. government and government agencies	818,965	(4,295)			818,965	(4,295)
Non-U.S. government securities	353,794	(9,370)	4,267	(182)	358,061	(9,552)
Asset backed securities	208,215	(5,834)	4,248	(298)	212,463	(6,132)
Total	2,323,940	(34,881)	136,737	(15,170)	2,460,677	(50,051)
Equity securities	99,686	(14,241)	4,547	(469)	104,233	(14,710)
Other investments	36,620	(295)	23,934	(1,066)	60,554	(1,361)
Short-term investments	134,299	(2,265)			134,299	(2,265)
Total	\$ 2,594,545	\$ (51,682)	\$ 165,218	\$ (16,705)	\$ 2,759,763	\$ (68,387)
At December 31, 2011						
Fixed maturities and fixed maturities pledged under securities lending agreements (1):						
Corporate bonds	\$ 781,635	\$ (24,977)	\$ 47,687	\$ (4,945)	\$ 829,322	\$ (29,922)
Mortgage backed securities	255,101	(11,988)	44,606	(11,238)	299,707	(23,226)
Municipal bonds	39,156	(537)	14,988	(349)	54,144	(886)
Commercial mortgage backed securities	87,796	(1,676)	14,582	(1,228)	102,378	(2,904)
U.S. government and government agencies	7,059	(3)			7,059	(3)
Non-U.S. government securities	310,182	(16,139)	20,482	(1,545)	330,664	(17,684)
Asset backed securities	260,647	(8,197)	7,317	(1,881)	267,964	(10,078)
Total	1,741,576	(63,517)	149,662	(21,186)	1,891,238	(84,703)
Equity securities	130,045	(22,039)	1,923	(305)	131,968	(22,344)
Other investments	98,605	(3,053)	22,443	(2,557)	121,048	(5,610)
Short-term investments	189,100	(5,292)			189,100	(5,292)

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Total	\$	2,159,326	\$	(93,901)	\$	174,028	\$	(24,048)	\$	2,333,354	\$	(117,949)
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(1) In securities lending transactions, the Company receives collateral in excess of the fair value of the fixed maturities and short-term investments pledged. For purposes of this table, the Company has excluded the collateral received and reinvested and included the fixed maturities and short-term investments pledged. See Securities Lending Agreements.

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At March 31, 2012, on a lot level basis, approximately 920 security lots out of a total of approximately 4,340 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. At December 31, 2011, on a lot level basis, approximately 1,150 security lots out of a total of approximately 4,520 security lots were in an unrealized loss position and the largest single unrealized loss from a single lot in the Company's fixed maturity portfolio was \$3.0 million.

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

Maturity	March 31, 2012		December 31, 2011	
	Estimated Fair Value	Amortized Cost	Estimated Fair Value	Amortized Cost
Due in one year or less	\$ 470,608	\$ 457,213	\$ 486,986	\$ 476,734
Due after one year through five years	3,128,343	3,047,581	2,850,578	2,793,982
Due after five years through 10 years	2,210,672	2,138,648	2,532,834	2,441,800
Due after 10 years	218,827	206,645	345,755	326,451
	6,028,450	5,850,087	6,216,153	6,038,967
Mortgage backed securities	1,494,968	1,482,998	1,592,762	1,588,355
Commercial mortgage backed securities	1,124,667	1,091,597	1,046,326	1,020,450
Asset backed securities	623,873	613,972	576,757	572,186
Total	\$ 9,271,958	\$ 9,038,654	\$ 9,431,998	\$ 9,219,958

Securities Lending Agreements

The Company operates a securities lending program under which certain of its fixed income portfolio securities are loaned to third parties, primarily major brokerage firms, for short periods of time through a lending agent. The Company maintains legal control over the securities it lends, retains the earnings and cash flows associated with the loaned securities and receives a fee from the borrower for the temporary use of the securities. At March 31, 2012, the fair value and amortized cost of fixed maturities and short-term investments pledged under securities lending agreements were \$50.8 million and \$49.3 million, respectively, compared to \$56.4 million and \$54.5 million at December 31, 2011, respectively. At March 31, 2012, the portfolio of collateral backing the Company's securities lending program included approximately \$6.2 million fair value of sub-prime securities, compared to \$7.3 million at December 31, 2011.

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ARCH CAPITAL GROUP LTD. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)

Fair Value Option

The Company elected to carry certain fixed maturity securities, equity securities and other investments (primarily term loans) at fair value under the fair value option afforded by accounting guidance regarding the fair value option for financial assets and liabilities. Changes in fair value of investments accounted for using the fair value option are included in Net realized gains (losses). The primary reasons for electing the fair value option were to reflect economic events in earnings on a timely basis and address simplification and cost-benefit considerations.

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

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

	March 31, 2012	December 31, 2011
Fixed maturities	\$ 250,805	\$ 147,779
Equity securities	52,766	87,403
Other investments (par: \$201,216 and \$138,062)	196,712	131,721
Investments accounted for using the fair value option	500,283	366,903
Securities sold but not yet purchased (1)	(18,831)	(27,178)
TALF investments	313,187	387,702
TALF borrowings	(239,551)	(310,486)
Net assets accounted for using the fair value option	\$ 555,088	\$ 416,941

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

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

	Three Months Ended March 31,	
	2012	2011
Fixed maturities	\$ 73,450	\$ 85,144
Term loan investments (1)	2,299	151
Equity securities	1,664	1,547
Short-term investments	372	678
Other (2)	3,193	6,903
Gross investment income	80,978	94,423
Investment expenses	(6,681)	(6,116)
Net investment income	\$ 74,297	\$ 88,307

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

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

Net Realized Gains (Losses)

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

	Three Months Ended March 31,	
	2012	2011
Available for sale securities:		
Gross gains on investment sales	\$ 48,012	\$ 71,717
Gross losses on investment sales	(17,936)	(47,750)
Change in fair value of assets and liabilities accounted for using the fair value option:		
Fixed maturities	8,217	90
Equity securities	3,387	3,434

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Other investments	3,753	127
TALF investments	1,224	1,652
TALF borrowings	1,071	(147)
Derivative instruments (1)	(4,669)	(11,320)
Other	1,062	2,892
Net realized gains	\$ 44,121	\$ 20,695

(1) See Note 8 for information on the Company's derivative instruments.

Table of Contents**ARCH CAPITAL GROUP LTD. AND SUBSIDIARIES****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)*****Other-Than-Temporary Impairments***

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

	Three Months Ended	
	March 31,	
	2012	2011
Fixed maturities:		
Mortgage backed securities	\$ 746	\$ 1,118
Asset backed securities		10
Corporate bonds	196	359
Total	942	1,487
Investment of funds received under securities lending agreements	81	856
Equity securities		337
Total OTTI recognized in earnings	\$ 1,023	\$ 2,680

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

- Mortgage backed securities – the Company utilized underlying data provided by asset managers, cash flow projections and additional information from credit agencies in order to determine an expected recovery value for each security. The analysis includes expected cash flow projections under base case and stress case scenarios which modify the expected default expectations and loss severities and slow down prepayment assumptions. The significant inputs in the models include the expected default rates, delinquency rates and foreclosure costs. The expected recovery values were reduced on a number of mortgage backed securities, primarily as a result of increases in expected default expectations and foreclosure costs. The amortized cost basis of the mortgage backed securities were adjusted down, if required, to the expected recovery value calculated in the OTTI review process;
- Investment of funds received under securities lending agreements – the Company utilized analysis from its securities lending program manager in order to determine an expected recovery value for certain collateral backing the Company's securities lending program which was invested in sub-prime securities. The analysis provided expected cash flow projections for the securities using similar criteria as described in the mortgage backed securities section above. The amortized cost basis of the investment of funds received under securities lending agreements was adjusted down, if required, to the expected recovery value calculated in the OTTI review process;

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- Corporate bonds – the Company reviewed the business prospects, credit ratings, estimated loss given default factors, foreign currency impacts and information received from asset managers and rating agencies for certain corporate bonds. The amortized cost basis of the corporate bonds were adjusted down, if required, to the expected recovery value calculated in the OTTI review process.

The Company believes that the \$23.4 million of OTTI included in accumulated other comprehensive income at March 31, 2012 on the securities which were considered by the Company to be impaired was due to market and sector-related factors (*i.e.*, not credit losses). At March 31, 2012, the Company did not intend to sell

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these securities, or any other securities which were in an unrealized loss position, and determined that it is more likely than not that the Company will not be required to sell such securities before recovery of their cost basis.

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

	Three Months Ended March 31,	
	2012	2011
Balance at start of period	\$ 66,545	\$ 86,040
Credit loss impairments recognized on securities not previously impaired	212	2,006
Credit loss impairments recognized on securities previously impaired	811	674
Reductions for increases in cash flows expected to be collected that are recognized over the remaining life of the security		
Reductions for securities sold during the period	(482)	(3,862)
Balance at end of period	\$ 67,086	\$ 84,858

Restricted Assets

The Company is required to maintain assets on deposit, which primarily consist of fixed maturities, with various regulatory authorities to support its insurance and reinsurance operations. The Company's insurance and reinsurance subsidiaries maintain assets in trust accounts as collateral for insurance and reinsurance transactions with affiliated companies and also have investments in segregated portfolios primarily to provide collateral or guarantees for letters of credit to third parties. See Note 3, Commitments and Contingencies Letter of Credit and Revolving Credit Facilities, for further details. The following table details the value of the Company's restricted assets:

	March 31, 2012	December 31, 2011
Assets used for collateral or guarantees:		
Affiliated transactions	\$ 4,521,655	\$ 4,321,535
Third party agreements	693,371	757,669
Deposits with U.S. regulatory authorities	279,537	288,458
Deposits with non-U.S. regulatory authorities	221,179	169,733
Trust funds	64,398	60,558
Total restricted assets	\$ 5,780,140	\$ 5,597,953

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ARCH CAPITAL GROUP LTD. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)

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).

The levels in the hierarchy are defined as follows:

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

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

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

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

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

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

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ARCH CAPITAL GROUP LTD. AND SUBSIDIARIES

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The independent pricing sources obtain market quotations and actual transaction prices for securities that have quoted prices in active markets. Each source has its own proprietary method for determining the fair value of securities that are not actively traded. In general, these methods involve the use of matrix pricing in which the independent pricing source uses observable market inputs including, but not limited to, investment yields, credit risks and spreads, benchmarking of like securities, broker-dealer quotes, reported trades and sector groupings to determine a reasonable fair value. In addition, pricing vendors use model processes, such as an Option Adjusted Spread model, to develop prepayment and interest rate scenarios. The Option Adjusted Spread model is commonly used to estimate fair value for securities such as mortgage backed and asset backed securities. In certain circumstances, when fair values are unavailable from these independent pricing sources, quotes are obtained directly from broker-dealers who are active in the corresponding markets. Such quotes are subject to the validation procedures noted above. Of the \$12.13 billion of financial assets and liabilities measured at fair value at March 31, 2012, approximately \$927.3 million, or 7.6%, were priced using non-binding broker-dealer quotes. Of the \$11.97 billion of financial assets and liabilities measured at fair value at December 31, 2011, approximately \$1.19 billion, or 9.9%, were priced using non-binding broker-dealer quotes.

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

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

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

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

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The following table presents the Company's financial assets and liabilities measured at fair value by level at March 31, 2012:

	Estimated Fair Value	Quoted Prices in Active Markets for Identical Assets (Level 1)	Fair Value Measurement Using: Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
<u>Assets measured at fair value:</u>				
Available for sale securities:				
Fixed maturities and fixed maturities pledged under securities lending agreements (1):				
Corporate bonds	\$ 2,616,226	\$	\$ 2,519,571	\$ 96,655
Mortgage backed securities	1,494,968		1,494,968	
Municipal bonds	1,301,255		1,301,255	
Commercial mortgage backed securities	1,124,667		1,124,667	
U.S. government and government agencies	1,254,434	1,254,434		
Non-U.S. government securities	856,535		856,535	
Asset backed securities	623,873		623,873	
Total	9,271,958	1,254,434	7,920,869	96,655
Equity securities	318,181	316,977	1,204	
Other investments	357,992		351,777	6,215
Short-term investments	1,112,249	976,446	135,803	
Fair value option:				
Investments accounted for using the fair value option:				
Corporate bonds	195,320		195,320	
Non-U.S. government bonds	55,485		55,485	
Equity securities	52,766	52,766		
Other investments	196,712		196,712	
Total	500,283	52,766	447,517	
TALF investments	313,187		313,187	
Total assets measured at fair value	\$ 11,873,850	\$ 2,600,623	\$ 9,170,357	\$ 102,870
<u>Liabilities measured at fair value:</u>				
Fair value option:				
TALF borrowings	\$ 239,551	\$	\$ 239,551	\$
Securities sold but not yet purchased (2)	18,831	18,831		
Total liabilities measured at fair value	\$ 258,382	\$ 18,831	\$ 239,551	\$

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

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

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ARCH CAPITAL GROUP LTD. AND SUBSIDIARIES

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

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

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

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

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ARCH CAPITAL GROUP LTD. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)

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

	Fair Value Measurements Using: Significant Unobservable Inputs (Level 3)			
	Corporate Bonds	Other Investments		Total
Three Months Ended March 31, 2012				
Balance at beginning of period	\$ 92,091	\$ 5,124	\$	97,215
Total gains or (losses) (realized/unrealized)				
Included in earnings (1)	2,331	81		2,412
Included in other comprehensive income	2,273	1,091		3,364
Purchases, issuances and settlements				
Purchases				
Issuances				
Sales				
Settlements	(40)	(81)		(121)
Transfers in and/or out of Level 3				
Balance at end of period	\$ 96,655	\$ 6,215	\$	102,870
Three Months Ended March 31, 2011				
Balance at beginning of period	\$ 153,509	\$ 7,858	\$	161,367
Total gains or (losses) (realized/unrealized)				
Included in earnings (1)	5,771	321		6,092
Included in other comprehensive income	10,098	617		10,715
Purchases, issuances and settlements				
Purchases				
Issuances				
Sales		(595)		(595)
Settlements	(333)			(333)
Transfers in and/or out of Level 3				
Balance at end of period	\$ 169,045	\$ 8,201	\$	177,246

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

The amount of total gains for the 2012 first quarter included in earnings attributable to the change in unrealized gains or losses relating to assets still held at March 31, 2012 was \$2.4 million. The amount of total gains for the 2011 first quarter included in earnings attributable to the change in unrealized gains or losses relating to assets still held at March 31, 2011 was \$5.8 million.

Financial Instruments Disclosed, But Not Carried, At Fair Value

The Company uses various financial instruments in the normal course of its business. The carrying values of cash, accrued investment income, receivable for securities sold, certain other assets, payable for securities purchased and certain other liabilities approximated their fair values at March 31, 2012, due to their respective short maturities. As these financial instruments are not actively traded, their respective fair values are classified within Level 2.

At March 31, 2012, the Company's senior notes are carried at their cost of \$300.0 million and have a fair value of \$357.8 million. The fair values of these securities were obtained from a third party pricing service and are based on observable market inputs. As such, the fair values of the senior notes are classified within Level 2.

Table of Contents**ARCH CAPITAL GROUP LTD. AND SUBSIDIARIES****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)****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 fair value. The fair values of those derivatives are based on quoted market prices. All realized and unrealized contract gains and losses are reflected in the Company's results of operations. The Company utilizes exchange traded U.S. Treasury note, Eurodollar and other futures contracts and commodity futures to manage portfolio duration or replicate investment positions in its portfolios. Certain of the Company's corporate bonds are managed in a global bond portfolio which incorporates the use of foreign currency forward contracts which are intended to provide an economic hedge against foreign currency movements on the portfolio's non-U.S. Dollar denominated holdings. The Company routinely utilizes other foreign currency forward contracts, currency options, index futures contracts and other derivatives as part of its total return objective.

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

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

	Asset Derivatives		Liability Derivatives	
	Estimated Fair Value	Notional Value	Estimated Fair Value	Notional Value
<u>At March 31, 2012</u>				
Futures contracts	\$ 702	\$ 255,496	\$ (403)	\$ 231,924
Foreign currency forward contracts	11,228	295,154	(4,542)	351,657
TBAs	214,376	201,600	(255,536)	237,500
Other	480	13,784	(648)	131,969
Total	\$ 226,786		\$ (261,129)	
<u>At December 31, 2011</u>				
Futures contracts	\$ 771	\$ 364,035	\$ (145)	\$ 16,275
Foreign currency forward contracts	11,937	352,992	(6,558)	253,733
TBAs	23,661	23,000	(2,178)	2,000
Other	4,005	187,613	(2,048)	309,931
Total	\$ 40,374		\$ (10,929)	

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

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

Derivatives not designated as hedging instruments	Three Months Ended March 31,	
	2012	2011
Futures contracts	\$ (2,021)	\$ (1,401)
Foreign currency forward contracts	(1,881)	(13,926)
TBA's	323	1,606
Other	(1,090)	2,401
Total	\$ (4,669)	\$ (11,320)

9. 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 March 31, 2012, the Company was not a party to any litigation or arbitration which is expected by management to have a material adverse effect on the Company's results of operations and financial condition and liquidity.

10. Income Taxes

ACGL is incorporated under the laws of Bermuda and, under current Bermuda law, is not obligated to pay any taxes in Bermuda based upon income or capital gains. The Company has received a written undertaking from the Minister of Finance in Bermuda under the Exempted Undertakings Tax Protection Act 1966 that, in the event that any legislation is enacted in Bermuda imposing any tax computed on profits, income, gain or appreciation on any capital asset, or any tax in the nature of estate duty or inheritance tax, such tax will not be applicable to ACGL or any of its operations until March 31, 2035. This undertaking does not, however, prevent the imposition of taxes on any person ordinarily resident in Bermuda or any company in respect of its ownership of real property or leasehold interests in Bermuda.

ACGL and its non-U.S. subsidiaries will be subject to U.S. federal income tax only to the extent that they derive U.S. source income that is subject to U.S. withholding tax or income that is effectively connected with the conduct of a trade or business within the U.S. and is not exempt from U.S. tax under an applicable income tax treaty with the U.S. ACGL and its non-U.S. subsidiaries will be subject to a withholding tax on dividends from U.S. investments and interest from certain U.S. payors (subject to reduction by any applicable income tax treaty). ACGL and its non-U.S. subsidiaries intend to conduct their operations in a manner that will not cause them to be treated as engaged in a trade or business in the United States and, therefore, will not be required to pay U.S. federal income taxes (other than U.S. excise taxes on insurance and reinsurance premium and withholding taxes on dividends and certain other U.S. source investment income). However, because there is uncertainty as to the activities which constitute being engaged in a trade or business within the United States, there can be no assurances that the U.S. Internal

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Revenue Service will not contend successfully that ACGL or its non-U.S. subsidiaries are engaged in a trade or business in the United States. If ACGL or any of its non-U.S. subsidiaries were subject to U.S. income tax, ACGL's shareholders' equity and earnings could be materially adversely affected. ACGL has subsidiaries and branches that operate in various jurisdictions around the world that are subject to tax in the jurisdictions in which they operate. The significant jurisdictions in which ACGL's subsidiaries and branches are subject to tax are the United States, United Kingdom, Ireland, Canada, Switzerland and Denmark.

The Company's income tax provision resulted in an effective tax rate on income before income taxes of 1.1% for the 2012 first quarter, compared to (2.2)% for the 2011 first quarter. The Company's effective tax rate,

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ARCH CAPITAL GROUP LTD. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)

which is based upon the expected annual effective tax rate, may fluctuate from period to period based on the relative mix of income or loss reported by jurisdiction and the varying tax rates in each jurisdiction. The Company had a net deferred tax asset of \$97.6 million at March 31, 2012, compared to \$80.7 million at December 31, 2011. In addition, the Company paid \$2.8 million in income taxes, net of recoveries, for the 2012 first quarter, compared to \$3.7 million for the 2011 period.

The United States also imposes an excise tax on insurance and reinsurance premiums paid to non-U.S. insurers or reinsurers with respect to risks located in the United States. The Company incurs federal excise taxes on certain of its reinsurance transactions, including amounts ceded through intercompany transactions. The Company incurred \$2.0 million of federal excise taxes in the 2012 first quarter, compared to \$2.5 million in the 2011 first quarter. Such amounts are reflected as acquisition expenses in the Company's consolidated statements of income.

11. Subsequent Events

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

In addition, on April 10, 2012, the Company completed the acquisition of the credit and surety reinsurance operations of Ariel Reinsurance Company Ltd. (Ariel Re) based in Zurich, Switzerland. The former Ariel Re credit and surety team joined the Zurich branch office of Arch Reinsurance Europe Underwriting Limited. The results of such acquired operations will be reflected in the Company's results beginning in the 2012 second quarter.

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

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

Arch Capital Group Ltd. (ACGL and, together with its subsidiaries, we or us) is a Bermuda public limited liability company with approximately \$5.24 billion in capital at March 31, 2012 and, through operations in Bermuda, the United States, Europe and Canada, writes insurance and reinsurance on a worldwide basis. While we are positioned to provide a full range of property and casualty insurance and reinsurance lines, we focus on writing specialty lines of insurance and reinsurance. It is our belief that our underwriting platform, our experienced management team and our strong capital base that is unencumbered by significant pre-2002 risks have enabled us to establish a strong presence in the insurance and reinsurance markets.

Current Outlook

The broad market environment continues to show improvement across the board. From a rate standpoint, almost all lines of business moved into positive territory in the 2012 first quarter with rate increases slightly above loss cost trends. In our insurance business, rates were up approximately 2% on a weighted basis. We experienced favorable rate movement on primary lines such as general liability, umbrella liability, auto liability and workers' compensation. Two exceptions to the overall rate trends were in large account healthcare which experienced rate reductions and executive assurance which remained flat during the 2012 first quarter. However, even with this improvement in the rate environment, additional rate increases are needed in many lines in order for us to achieve adequate returns given the current interest rate environment. In our reinsurance business, rates continued to improve significantly, on a risk adjusted basis, in property and property catastrophe business, with the best increases to date reflected in international, catastrophe exposed businesses. Such improvements were driven, in part, by the impact of the higher level of catastrophic activity in 2010 and 2011. All other lines remained basically unchanged although our reinsurance operations benefited from the underlying rate increases in primary lines noted above. Our underwriting teams continue to execute a disciplined strategy by emphasizing small and medium-sized accounts over large accounts and focusing more on short-tail business.

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

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

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

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

Natural Catastrophe Risk

We monitor our natural catastrophe risk globally for all perils and regions, in each case, where we believe there is significant exposure. Our models employ both proprietary and vendor-based systems and include cross-line correlations for property, marine, offshore energy, aviation, workers compensation and personal accident. Currently, we seek to limit our 1-in-250 year return period net probable maximum pre-tax loss from a severe catastrophic event in any geographic zone to approximately 25% of total shareholders' equity. We reserve the right to change this threshold at any time. Based on in-force exposure estimated as of April 1, 2012, our modeled peak zone catastrophe exposure is a windstorm affecting the Gulf of Mexico, with a net probable maximum pre-tax loss of \$860 million, followed by windstorms affecting the Northeastern U.S. and Florida Tri-County with net probable maximum pre-tax losses of \$826 million and \$608 million, respectively. Based on in-force exposure estimated as of January 1, 2012, our modeled peak zone exposure was a windstorm affecting the Gulf of Mexico, with a net probable maximum pre-tax loss of \$881 million, followed by windstorms affecting the Northeastern U.S. and Florida Tri-County with net probable maximum pre-tax losses of \$842 million and \$638 million, respectively. Our exposures to other perils, such as U.S. earthquake and international events, are less than the exposures arising from U.S. windstorms and hurricanes. As of April 1, 2012, our modeled peak zone earthquake exposure (New Madrid earthquake) represented less than 50% of our peak zone catastrophe exposure, and our modeled peak zone international exposure (Japan earthquake) is substantially less than both our peak zone windstorm and earthquake exposures. Net probable maximum pre-tax loss estimates are net of expected reinsurance recoveries, before income tax and before excess reinsurance reinstatement premiums. Loss estimates are reflective of the zone indicated and not the entire portfolio. Since hurricanes and windstorms can affect more than one zone and make multiple landfalls, our loss estimates include clash estimates from other zones.

The loss estimates shown above do not represent our maximum exposures and it is highly likely that our actual incurred losses would vary materially from the modeled estimates. There can be no assurances that we will not suffer a net loss greater than 25% of our total shareholders' equity from one or more catastrophic events due to several factors, including the inherent uncertainties in estimating the frequency and severity of such events and the margin of error in making such determinations resulting from potential inaccuracies and inadequacies in the data provided by clients and brokers, the modeling techniques and the application of such techniques or as a result of a decision to change the percentage of shareholders' equity exposed to a single catastrophic event. Actual losses may also increase if our reinsurers fail to meet their obligations to us or the reinsurance protections purchased by us are exhausted or are otherwise unavailable. See Risk Factors Risk Relating to Our Industry and Management's Discussion and Analysis of Financial Condition and Results of Operations Natural and Man-Made Catastrophic Events in our 2011 Form 10-K.

Financial Measures

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

Book Value per Common Share

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

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Book value per common share was \$33.33 at March 31, 2012, compared to \$31.76 at December 31, 2011. The 4.9% change for the 2012 first quarter was generated through operating results and total return on investments for the period. We adopted new accounting guidance effective January 1, 2012 concerning the accounting for costs associated with acquiring or renewing insurance contracts. This guidance was adopted retrospectively and has been applied to all prior period financial information. The adoption of the new accounting guidance reduced the reported book value per common share by \$0.27 at December 31, 2011. See Note 2, Recent Accounting Pronouncements, of the notes accompanying our consolidated financial statements for additional information.

Operating Return on Average Common Equity

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

Our Operating ROAE was 10.4% for the 2012 first quarter, compared to 0.7% for the 2011 first quarter. The higher Operating ROAE for the 2012 first quarter resulted from improved underwriting results which reflected a lower level of catastrophic events than in the 2011 period.

Total Return on Investments

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

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

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At March 31, 2012, the benchmark return index had an average credit quality of Aa1 by Moody's, an estimated duration of 3.44 years and included weightings to the following indices:

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

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

	Arch Portfolio (1)	Benchmark Return
Pre-tax total return (before investment expenses):		
2012 first quarter	1.87%	1.56%
2011 first quarter	1.50%	0.92%

(1) Our investment expenses were approximately 0.23% and 0.22% of average invested assets for the 2012 first quarter and 2011 first quarter, respectively.

For the 2012 first quarter, total return on our portfolio reflected tightening credit spreads on our investment grade and high yield fixed income portfolios and favorable returns on our equities and alternative assets. These returns more than offset the effect of modestly higher U.S. Treasury yields. Our portfolio outperformed the benchmark return by 31 basis points for the 2012 first quarter, due in part to an overweighting in certain sector allocations to the benchmark return. Excluding foreign exchange, total return was 1.60% for the 2012 first quarter, compared to 1.14% for the 2011 first quarter.

Comment on Non-GAAP Financial Measures

Throughout this filing, we present our operations in the way we believe will be the most meaningful and useful to investors, analysts, rating agencies and others who use our financial information in evaluating the performance of our company. This presentation includes the use of after-tax operating income available to common shareholders, which is defined as net income available to common shareholders, excluding net

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realized gains or losses, net impairment losses recognized in earnings, equity in net income or loss of investment funds accounted for using the equity method and net foreign exchange gains or losses, net of income taxes. The presentation of after-tax operating income available to common shareholders is a non-GAAP financial measure as defined in Regulation G. The reconciliation of such measure to net income available to common shareholders (the most directly comparable GAAP financial measure) in accordance with Regulation G is included under Results of Operations below.

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

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

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

RESULTS OF OPERATIONS

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

	Three Months Ended	
	March 31,	
	2012	2011
After-tax operating income available to common shareholders	\$ 113,660	\$ 7,576
Net realized gains, net of tax	40,873	21,585
Net impairment losses recognized in earnings, net of tax	(1,023)	(2,680)
Equity in net income of investment funds accounted for using the equity method, net of tax	24,826	29,673
Net foreign exchange losses, net of tax	(20,541)	(37,142)
Net income available to common shareholders	\$ 157,795	\$ 19,012

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The increase in after-tax operating income in the 2012 first quarter compared to the 2011 period primarily resulted from improved underwriting results which reflected a lower level of catastrophic loss activity. Our 2012 first quarter results included losses for current year catastrophic events of \$23.0 million, net of reinsurance and reinstatement premiums, compared to \$178.7 million in the 2011 first quarter.

Segment Information

We classify our businesses into two underwriting segments – insurance and reinsurance – and corporate and other (non-underwriting). Management measures segment performance based on underwriting income or loss. We do not manage our assets by segment and, accordingly, investment income is not allocated to each underwriting segment. In addition, other revenue and expense items are not evaluated by segment.

Insurance Segment

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

	2012	Three Months Ended March 31,		% Change
		2011		
Gross premiums written	\$ 688,113	\$ 634,583		8.4
Net premiums written	490,680	449,291		9.2
Net premiums earned	\$ 441,740	\$ 407,591		8.4
Fee income	530	778		
Losses and loss adjustment expenses	(303,164)	(297,723)		
Acquisition expenses, net	(73,870)	(61,415)		
Other operating expenses	(73,370)	(74,629)		
Underwriting loss	\$ (8,134)	\$ (25,398)		n/m

Underwriting Ratios			% Point Change
Loss ratio	68.6%	73.0%	(4.4)
Acquisition expense ratio (1)	16.6%	14.9%	1.7
Other operating expense ratio	16.6%	18.3%	(1.7)
Combined ratio	101.8%	106.2%	(4.4)

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

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

Premiums Written.

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

	2012		Three Months Ended March 31,		2011	
	Amount	%	Amount	%	Amount	%
Programs	\$ 81,616	17	\$ 74,396	17		
Property, energy, marine and aviation	79,819	16	76,418	17		
Professional liability	70,561	14	59,385	13		
Executive assurance	68,378	14	56,068	12		
National accounts	35,438	7	40,191	9		
Construction	33,653	7	31,509	7		
Casualty	26,973	5	30,134	7		
Travel and accident	22,836	5	21,501	5		
Lenders products	22,415	5	21,074	5		
Surety	12,134	2	9,734	2		
Healthcare	10,635	2	9,117	2		
Other (1)	26,222	6	19,764	4		
Total	\$ 490,680	100	\$ 449,291	100		

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

Increases in professional liability, executive assurance and program business were partially offset by reductions in casualty lines. The growth in professional liability premiums primarily reflected new business written in small and medium sized accounts in the U.K. while the increase in executive assurance business primarily resulted from small and medium sized accounts in the U.K. and the U.S. The increase in program business primarily reflected growth in existing accounts. The reduction in casualty lines was due, in part, to the loss of one account in the national accounts line.

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

	Three Months Ended March 31,			
	2012		2011	
	Amount	%	Amount	%
Property, energy, marine and aviation	\$ 78,494	18	\$ 73,599	18
Programs	73,998	17	67,018	16
Professional liability	63,256	14	67,400	17
Executive assurance	58,766	13	54,570	13
Lenders products	32,153	7	18,236	4
Construction	31,808	7	28,391	7
Casualty	29,065	7	28,427	7
National accounts	19,136	4	21,162	5
Travel and accident	16,713	4	15,599	4
Surety	10,560	2	9,779	2
Healthcare	8,898	2	8,652	2
Other (1)	18,893	5	14,758	5
Total	\$ 441,740	100	\$ 407,591	100

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

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

Losses and Loss Adjustment Expenses.

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

	Three Months Ended March 31,	
	2012	2011
Current year	68.7%	76.8%
Prior period reserve development	(0.1)%	(3.8)%
Loss ratio	68.6%	73.0%

Current Year Loss Ratio.

The insurance segment's current year loss ratio was 8.1 points lower in the 2012 first quarter compared to the 2011 first quarter, due in part to a lower level of catastrophic event activity. The 2012 first quarter loss ratio reflected 1.2 points of catastrophic activity, primarily related to U.S. storm activity, compared to 10.1 points in the 2011 first quarter, which was related to the Japanese earthquake and tsunami, New Zealand earthquake and other events. The level of large non-catastrophic loss activity was similar in both periods.

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Prior Period Reserve Development.

2012 first quarter: The insurance segment's net favorable development of \$0.5 million, or 0.1 points, reflected favorable development in short-tail lines which were substantially offset by increases in specialty casualty and executive assurance reserves. Favorable development in short-tail lines primarily consisting of reductions in property (including special risk other than marine) reserves from the 2007 to 2011 accident years (*i.e.*, the year in which a loss occurred) of \$2.3 million, \$3.0 million, \$4.0 million, \$5.6 million and \$2.0 million, respectively. The favorable development in property lines was primarily due to a lack of claims activity in the more recent years. The 2012 first quarter results included favorable development in travel and accident business of \$2.1 million from the 2010 accident year, along with \$2.9 million of favorable development on healthcare reserves spread across all accident years. The adverse development in specialty casualty reserves included \$4.0 million, \$3.4 million and \$3.1 million in the 2004, 2005 and 2008 accident years. Such amounts primarily resulted from an increase in loss picks in reaction to recent claims development. The adverse development in executive assurance reserves included \$2.1 million, \$5.0 million and \$2.5 million in the 2007 to 2009 accident years. Such amounts were primarily due to a small number of international D&O claims.

2011 first quarter: The insurance segment's net favorable development of \$15.4 million, or 3.8 points, reflected favorable development in short-tail lines primarily consisting of reductions in property (including special risk other than marine) reserves from the 2008 and 2009 accident years of \$2.9 million and \$6.9 million, respectively, and \$13.1 million from the 2010 accident year. Such amount included \$6.2 million of favorable development on the 2010 named catastrophic events. The favorable development in property lines was primarily due to better than expected claims emergence. Such amounts were partially offset by adverse development in professional liability reserves from the 2009 and 2010 accident years of \$3.7 million and \$2.6 million, respectively, due to a slight increase in the frequency of claims reported, and in casualty reserves from the 2010 accident year of \$6.3 million, primarily due to development on an energy casualty claim.

Underwriting Expenses.

The insurance segment's underwriting expense ratio was 33.2% in the 2012 first quarter, compared to 33.2% in the 2011 first quarter. The acquisition expense ratio was 16.6% in the 2012 first quarter, compared to 14.9% in the 2011 first quarter. The 2012 first quarter acquisition expense ratio included an increase of 1.0 points related to development in certain prior year loss reserves. The other operating expense ratio was 16.6% for the 2012 first quarter, compared to 18.3% for the 2011 first quarter. The lower 2012 first quarter operating expense ratio primarily resulted from the higher level of net premiums earned in the period.

Table of Contents*Reinsurance Segment*

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

	2012		Three Months Ended March 31, 2011		% Change
Gross premiums written	\$	379,976	\$	331,013	14.8
Net premiums written		372,931		314,987	18.4
Net premiums earned	\$	238,572	\$	226,104	5.5
Fee income		13		37	
Losses and loss adjustment expenses		(92,043)		(196,157)	
Acquisition expenses, net		(45,092)		(47,339)	
Other operating expenses		(26,123)		(21,227)	
Underwriting income (loss)	\$	75,327	\$	(38,582)	n/m

Loss ratio	38.6%	86.8%	(48.2)
Other operating expense ratio	10.9%	9.4%	1.5

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

Premiums Written.

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

	2012		Three Months Ended March 31, 2011	
	Amount	%	Amount	%
Other specialty	\$ 95,462	26	\$ 77,645	25
Property catastrophe	86,574	23	66,961	21
Property excluding property catastrophe (1)	75,493	20	71,150	22
Casualty (2)	83,960	23	71,361	23
Marine and aviation	25,617	7	24,164	8
Other	5,825	1	3,706	1
Total	\$ 372,931	100	\$ 314,987	100

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Pro rata	\$	124,746	33	\$	105,492	33
Excess of loss		248,185	67		209,495	67
Total	\$	372,931	100	\$	314,987	100

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

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The growth in net premiums written reflected increases in all lines of business, primarily in other specialty, professional liability and property catastrophe business. The higher level of other specialty business primarily resulted from U.K. motor writings while growth in professional liability reflected a small number of new accounts. Substantial rate improvements in global property catastrophe markets allowed the reinsurance segment to participate in a more meaningful way around the world in areas such as Australia and New Zealand.

In April 2012, we completed the acquisition of the credit and surety reinsurance operations of Ariel Reinsurance Company Ltd. (Ariel Re) based in Zurich, Switzerland. The former Ariel Re credit and surety team joined the Zurich branch office of Arch Reinsurance Europe Underwriting Limited. In addition, our Bermuda reinsurer was successful in signing a mortgage reinsurance quota share contract in the 2012 second quarter. The results of the credit and surety reinsurance and the mortgage reinsurance quota share contract will be reflected in our results beginning in the 2012 second quarter.

Net Premiums Earned.

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

	Three Months Ended March 31,			
	2012		2011	
	Amount	%	Amount	%
Property catastrophe	\$ 61,863	26	\$ 51,642	23
Property excluding property catastrophe (1)	61,632	26	63,006	28
Other specialty	46,148	19	38,969	17
Casualty (2)	45,943	19	48,494	21
Marine and aviation	21,449	9	21,626	10
Other	1,537	1	2,367	1
Total	\$ 238,572	100	\$ 226,104	100
Pro rata	\$ 99,925	42	\$ 106,653	47
Excess of loss	138,647	58	119,451	53
Total	\$ 238,572	100	\$ 226,104	100

(1) Includes facultative business.

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

Net premiums written, irrespective of the class of business, are generally earned on a pro rata basis over the terms of the underlying policies or reinsurance contracts. Net premiums earned reflect changes in net premiums written over the previous five quarters, including the mix and type of business written.

Table of Contents*Losses and Loss Adjustment Expenses.*

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

	Three Months Ended March 31,	
	2012	2011
Current year	60.7%	106.0%
Prior period reserve development	(22.1)%	(19.2)%
Loss ratio	38.6%	86.8%

Current Year Loss Ratio.

The reinsurance segment's current year loss ratio was 45.3 points lower in the 2012 first quarter compared to the 2011 first quarter, primarily due to the lower level of current year catastrophic event activity. The 2012 first quarter loss ratio reflected 7.4 points related to current year catastrophic activity, primarily related to U.S. storm activity, while the 2011 first quarter ratio included 60.8 points of catastrophic activity, which was related to the Japanese earthquake and tsunami, New Zealand earthquake and other events. The 2012 first quarter loss ratio included 5.1 points related to the Costa Concordia and Elgin oil platform events while the 2011 first quarter loss ratio did not include substantial large non-catastrophic loss activity.

Prior Period Reserve Development.

2012 first quarter: The reinsurance segment's net favorable development of \$52.8 million, or 22.1 points, reflected favorable development of \$21.5 million on property catastrophe and property other than property catastrophe reserves, including \$6.9 million and \$8.3 million from the 2010 and 2011 underwriting years, respectively. In addition, there was \$20.7 million of favorable development on casualty reserves, including \$1.8 million, \$4.9 million, \$3.7 million, \$4.5 million, \$4.0 million and \$3.3 million for the 2004 to 2009 underwriting years (*i.e.*, all premiums and losses attributable to contracts having an inception or renewal date within the given twelve-month period), respectively, partially offset by adverse development in the 2010 underwriting year of \$2.5 million which was due, in part, to increases in loss selections based on the reinsurance segment's view of the insurance environment. The 2012 first quarter loss ratio also benefited from \$9.7 million of favorable development on other specialty business, including \$2.5 million and \$5.9 million from the 2010 and 2011 underwriting years. Such amounts were primarily due to better than expected claims emergence.

2011 first quarter: The reinsurance segment's net favorable development of \$43.4 million, or 19.2 points, reflected \$17.4 million of favorable development in property catastrophe and property other than property catastrophe reserves, including \$15.1 million from the 2010 underwriting year. Such amount included \$10.6 million of favorable development on the 2010 named catastrophic events. In addition, there was \$14.4 million of favorable development on casualty reserves, including \$4.9 million, \$4.5 million, \$4.5 million and \$4.7 million for the 2002 to 2005 underwriting years, respectively, partially offset by adverse development in the 2010 underwriting year of \$6.0 million. The 2011 first quarter loss ratio also benefited from \$6.2 million of favorable development on other specialty business, including \$2.6 million and \$2.5 million from the 2008 and 2009 underwriting years, respectively. The reductions in reserves were primarily due to better than expected claims emergence.

Underwriting Expenses.

The underwriting expense ratio for the reinsurance segment was 29.8% in the 2012 first quarter, compared to 30.3% in the 2011 first quarter. The acquisition expense ratio for the 2012 first quarter was 18.9%, compared to 20.9% for the 2011 first quarter. The comparison of the 2012 first quarter and 2011 first quarter acquisition expense ratios is influenced by, among other things, the mix and type of business written and earned and the

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level of ceding commission income. The operating expense ratio for the 2012 first quarter was 10.9%, compared to 9.4% in the 2011 first quarter. The other operating expense ratio in the 2012 first quarter reflected a higher level of incentive compensation costs related to better than expected experience on business written in prior underwriting years along with expenses related to new business opportunities.

Other Income or Expense Items

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

	Three Months Ended March 31,	
	2012	2011
Fixed maturities	\$ 73,450	\$ 85,144
Term loan investments (1)	2,299	151
Equity securities	1,664	1,547
Short-term investments	372	678
Other (2)	3,193	6,903
Gross investment income	80,978	94,423
Investment expenses	(6,681)	(6,116)
Net investment income	\$ 74,297	88,307

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

(2) Amounts include dividends on investment funds and other items. The 2011 first quarter amount includes an initial dividend of \$5.5 million received on an investment fund.

The pre-tax investment income yield, calculated based on amortized cost, was 2.52% for the 2012 first quarter, compared to 2.72% for the 2011 fourth quarter and 3.06% for the 2011 first quarter. The decline in yields reflects the effects of lower prevailing interest rates available in the market and our investment focus which puts a priority on total return. Yields on future investment income may vary based on financial market conditions, investment allocation decisions and other factors.

Other Income (Loss). We record income or loss from our investments in Aeolus LP and Gulf Reinsurance Limited (Gulf Re) using the equity method on a three month lag basis based on the availability of their financial statements. We recorded a loss of \$8.1 million on such investments in the 2012 first quarter, compared to \$4.6 million of income in the 2011 first quarter. The 2012 first quarter amount included a loss of \$8.6 million related to Aeolus LP. As of March 31, 2012, the carrying value of this investment (after taking into account the \$83.1 million in cumulative cash distributions received) was \$10.7 million with no unfunded capital commitments. Aeolus LP operates as an unrated reinsurance platform that provides collateralized property catastrophe protection to insurers and reinsurers on both an ultimate net loss and industry loss warranty basis.

Equity in Net Income of Investment Funds Accounted for Using the Equity Method. We use the equity method on certain investments (which primarily invest in fixed maturity securities) due to the ownership structure of these investment funds, where we do not have a controlling interest and are not the primary beneficiary. In applying the equity method, these investments are initially recorded at cost and are subsequently adjusted based on our proportionate share of the net income or loss of the funds (which include changes in the market value of the underlying securities in the funds). Such investments, which are typically structured as limited partnerships, are generally recorded on a one month lag with some investments reported on a three month lag based on the availability of reports from the investment funds. Certain of these funds employ leverage to achieve a higher rate of return on their assets under management. While leverage presents opportunities for increasing the total return of such investments, it may increase losses as well. Fluctuations in the carrying value of the investment funds accounted for using the equity method may increase the volatility of our reported results

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of operations. Investment funds accounted for using the equity method (excluding our investment in Aeolus LP) totaled \$336.5 million at March 31, 2012, compared to \$345.3 million at December 31, 2011. At March 31, 2012, our portfolio included \$337.5 million of investments in bank loan funds, of which \$121.3 million are reflected in the investment funds accounted for using the equity method.

We recorded \$24.8 million of equity in net income related to investment funds accounted for using the equity method in the 2012 first quarter, compared to \$29.7 million of equity in net income for the 2011 first quarter. Income in the 2012 first quarter resulted, in part, from positive returns on two funds, one that invests in a portfolio of loans and another public-private investment fund (PPIF) that invests in high quality U.S. residential and commercial mortgages.

Net Realized Gains or Losses. We recorded net realized gains of \$44.1 million for the 2012 first quarter, compared to net realized gains of \$20.7 million for the 2011 first quarter. Currently, our portfolio is actively managed to maximize total return within certain guidelines. In assessing returns under this approach, we include net investment income, net realized gains and losses and the change in unrealized gains and losses generated by our investment portfolio. The effect of financial market movements on the investment portfolio will directly impact net realized gains and losses as the portfolio is adjusted and rebalanced. Net realized gains or losses from the sale of fixed maturities primarily resulted from our decisions to reduce credit exposure, to change duration targets, to rebalance our portfolios or due to relative value determinations. In addition, net realized gains or losses include changes in the fair value of assets and liabilities accounted for using the fair value option. See note 6, Investment Information Net Realized Gains (Losses), of the notes accompanying our consolidated financial statements for additional information.

Total return on our portfolio under management for the 2012 first quarter was 1.87%, compared to 1.50% for the 2011 first quarter. Excluding foreign exchange, total return was 1.60% for the 2012 first quarter, compared to 1.14% for the 2011 first quarter. For the 2012 first quarter, total return on our portfolio reflected tightening credit spreads on our investment grade and high yield fixed income portfolios and favorable returns on our equities and alternative assets. These returns more than offset the effect of modestly higher U.S. Treasury yields. Total return is calculated on a pre-tax basis and before investment expenses.

Net Impairment Losses Recognized in Earnings. On a quarterly basis, we perform reviews of our available for sale investments to determine whether declines in fair value below the cost basis are considered other-than-temporary in accordance with applicable accounting guidance regarding the recognition and presentation of other-than-temporary impairments. The process of determining whether a security is other-than-temporarily impaired requires judgment and involves analyzing many factors. These factors include (i) an analysis of the liquidity, business prospects and overall financial condition of the issuer, (ii) the time period in which there was a significant decline in value, (iii) the significance of the decline, and (iv) the analysis of specific credit events. We evaluate the unrealized losses of our equity securities by issuer and determine if we can forecast a reasonable period of time by which the fair value of the securities would increase and we would recover our cost. If we are unable to forecast a reasonable period of time in which to recover the cost of our equity securities, we record a net impairment loss in earnings equivalent to the entire unrealized loss. For the 2012 first quarter, we recorded \$1.0 million of credit related impairments in earnings, compared to \$2.7 million for the 2011 first quarter. The OTTI recorded in the 2012 first quarter primarily resulted from reductions in estimated recovery values on certain mortgage backed securities following the review of such securities. See note 6, Investment Information Other-Than-Temporary Impairments, of the notes accompanying our consolidated financial statements for additional information.

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Other Expenses. Other expenses, which are included in our other operating expenses and part of corporate and other (non-underwriting), were \$7.0 million for the 2012 first quarter, compared to \$7.0 million for the 2011 first quarter. Such amounts primarily represent certain holding company costs necessary to support our worldwide insurance and reinsurance operations, share based compensation expense and costs associated with operating as a publicly traded company.

Net Foreign Exchange Gains or Losses. Net foreign exchange losses for the 2012 first quarter of \$20.7 million consisted of net unrealized losses of \$20.2 million and net realized losses of \$0.5 million, compared to net foreign exchange losses for the 2011 first quarter of \$36.9 million which consisted of net unrealized losses of \$37.0 million and net realized gains of \$0.1 million. The 2012 first quarter net foreign exchange losses primarily resulted from the weakening of the U.S. Dollar against the Euro, British Pound Sterling and other major foreign currencies during the period.

Net unrealized foreign exchange gains or losses result from the effects of revaluing our net insurance liabilities required to be settled in foreign currencies at each balance sheet date. Historically, we have held investments in foreign currencies which are intended to mitigate our exposure to foreign currency fluctuations in our net insurance liabilities. However, changes in the value of such investments due to foreign currency rate movements are reflected as a direct increase or decrease to shareholders' equity and are not included in the consolidated statements of income. As a result of the current financial and economic environment as well as the potential for additional investment returns, we may not match a portion of our projected liabilities in foreign currencies with investments in the same currencies, which could increase our exposure to foreign currency fluctuations and increase the volatility in our shareholders' equity.

CRITICAL ACCOUNTING POLICIES, ESTIMATES AND RECENT ACCOUNTING PRONOUNCEMENTS

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

FINANCIAL CONDITION, LIQUIDITY AND CAPITAL RESOURCES

Financial Condition

Investable Assets

The finance and investment committee of our board of directors establishes our investment policies and sets the parameters for creating guidelines for our investment managers. The finance and investment committee reviews the implementation of the investment strategy on a regular basis. Our current approach stresses preservation of capital, market liquidity and diversification of risk. While maintaining our emphasis on preservation of capital and liquidity, we expect our portfolio to become more diversified and, as a result, we may expand into areas which are not currently part of our investment strategy. Our Chief Investment Officer administers the investment portfolio, oversees our investment

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managers, formulates investment strategy in conjunction with our finance and investment committee and directly manages certain portions of our fixed income and equity portfolios.

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The following table summarizes our invested assets:

	March 31, 2012	December 31, 2011
Fixed maturities available for sale, at fair value	\$ 9,221,145	\$ 9,375,604
Fixed maturities, at fair value (1)	250,805	147,779
Fixed maturities pledged under securities lending agreements, at fair value (2)	50,813	56,393
Total fixed maturities	9,522,763	9,579,776
Short-term investments available for sale, at fair value	1,112,249	904,219
Cash	422,806	351,699
Equity securities available for sale, at fair value	318,181	299,584
Equity securities, at fair value (1)	52,766	87,403
Other investments available for sale, at fair value	357,992	238,111
Other investments, at fair value (1)	196,712	131,721
TALF investments, at fair value (3)	313,187	387,702
Investments accounted for using the equity method (4)	347,273	380,507
Total cash and investments	12,643,929	12,360,722
Securities sold but not yet purchased (5)	(18,831)	(27,178)
Securities transactions entered into but not settled at the balance sheet date	(121,435)	(17,339)
Total investable assets	\$ 12,503,663	\$ 12,316,205

(1) Represents securities which are carried at fair value under the fair value option and reflected as investments accounted for using the fair value option on our balance sheet. Changes in the carrying value of such securities are recorded in net realized gains or losses.

(2) This table excludes the collateral received and reinvested and includes the fixed maturities and short-term investments pledged under securities lending agreements, at fair value.

(3) The Federal Reserve's Term Asset-Backed Securities Loan Facility (TALF) provides secured financing for certain asset-backed securities and legacy commercial mortgage-backed securities. TALF financing is non-recourse to us, is collateralized by the purchased securities and provides financing for the purchase price of the securities, less a haircut that varies based on the type of collateral. We can deliver the collateralized securities to the Federal Reserve in full defeasance of the loan.

(4) Changes in the carrying value of investment funds accounted for using the equity method are recorded as equity in net income (loss) of investments funds accounted for using the equity method rather than as an unrealized gain or loss component of accumulated other comprehensive income.

(5) Represents our obligation to deliver equity securities that we did not own at the time of sale. Such amounts are included in other liabilities on our balance sheet.

At March 31, 2012, our fixed income portfolio, which includes fixed maturity securities and short-term investments, had average credit quality ratings from Standard & Poor's Rating Services (S&P)/Moody's Investors Service (Moody's) of AA/Aa2 and an average yield to maturity (imbedded book yield), before investment expenses, of 2.76%. At December 31, 2011, our fixed income portfolio had average credit quality ratings from S&P/Moody's of AA+/Aa1 and an average yield to maturity of 2.98%. Our investment portfolio had an average effective duration of 2.75 years at March 31, 2012, compared to 2.99 years at December 31, 2011. At March 31, 2012, approximately \$8.22 billion, or 67%, of our total investments and cash was internally managed, compared to \$7.9 billion, or 66%, at December 31, 2011.

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The following table summarizes our fixed maturities by type:

	Estimated Fair Value	Gross Unrealized Gains	Gross Unrealized Losses	Cost or Amortized Cost	OTTI Unrealized Losses (2)
At March 31, 2012					
Fixed maturities and fixed maturities pledged under securities lending agreements (1):					
Corporate bonds	\$ 2,811,546	\$ 90,793	\$ (11,263)	\$ 2,732,016	\$ (488)
Mortgage backed securities	1,494,968	26,747	(14,777)	1,482,998	(15,444)
Municipal bonds	1,301,255	64,044	(1,381)	1,238,592	(105)
Commercial mortgage backed securities	1,124,667	35,721	(2,651)	1,091,597	(3,259)
U.S. government and government agencies	1,254,434	19,500	(4,295)	1,239,229	(207)
Non-U.S. government securities	912,020	30,517	(9,552)	891,055	
Asset backed securities	623,873	16,033	(6,132)	613,972	(3,876)
Total	\$ 9,522,763	\$ 283,355	\$ (50,051)	\$ 9,289,459	\$ (23,379)
At December 31, 2011					
Fixed maturities and fixed maturities pledged under securities lending agreements (1):					
Corporate bonds	\$ 2,719,052	\$ 79,407	\$ (29,922)	\$ 2,669,567	\$ (1,138)
Mortgage backed securities	1,592,762	27,633	(23,226)	1,588,355	(20,466)
Municipal bonds	1,430,565	77,977	(886)	1,353,474	(105)
Commercial mortgage backed securities	1,046,326	28,780	(2,904)	1,020,450	(3,259)
U.S. government and government agencies	1,451,993	34,811	(3)	1,417,185	(207)
Non-U.S. government securities	762,321	33,486	(17,684)	746,519	
Asset backed securities	576,757	14,649	(10,078)	572,186	(3,876)
Total	\$ 9,579,776	\$ 296,743	\$ (84,703)	\$ 9,367,736	\$ (29,051)

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

(2) Represents the total other-than-temporary impairments (OTTI) recognized in accumulated other comprehensive income (AOCI). It does not include the change in fair value subsequent to the impairment measurement date. At March 31, 2012, the net unrealized loss related to securities for which a non-credit OTTI was recognized in AOCI was \$9.4 million, compared to a net unrealized loss of \$18.0 million at December 31, 2011.

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

Rating (1)	March 31, 2012		December 31, 2011	
	Estimated Fair Value	% of Total	Estimated Fair Value	% of Total
U.S. government and government agencies (2)	\$ 2,850,031	29.9	\$ 3,154,480	32.9
AAA	3,420,490	35.9	3,229,161	33.7
AA	1,383,663	14.5	1,425,249	14.9
A	917,925	9.6	884,957	9.2
BBB	398,645	4.2	412,566	4.3
BB	157,427	1.7	140,029	1.5
B	172,360	1.8	165,003	1.7
Lower than B	125,134	1.3	114,672	1.2
Not rated	97,088	1.1	53,659	0.6
Total	\$ 9,522,763	100.0	\$ 9,579,776	100.0

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

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

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

Severity of Unrealized Loss	March 31, 2012			December 31, 2011		
	Estimated Fair Value	Gross Unrealized Losses	% of Total Gross Unrealized Losses	Estimated Fair Value	Gross Unrealized Losses	% of Total Gross Unrealized Losses
0-10%	\$ 2,388,080	\$ (33,646)	67.2	\$ 1,692,722	\$ (44,803)	52.9
10-20%	50,548	(8,275)	16.6	144,523	(20,222)	23.9
20-30%	18,343	(6,114)	12.2	38,749	(11,709)	13.8
30-40%	3,677	(1,908)	3.8	14,596	(7,413)	8.8
40-50%				619	(445)	0.5
50-80%	29	(108)	0.2	29	(111)	0.1
Total	\$ 2,460,677	\$ (50,051)	100.0	\$ 1,891,238	\$ (84,703)	100.0

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

Severity of Unrealized Loss	March 31, 2012			December 31, 2011		
	Estimated Fair Value	Gross Unrealized Losses	% of Total Gross Unrealized Losses	Estimated Fair Value	Gross Unrealized Losses	% of Total Gross Unrealized Losses
0-10%	\$ 109,678	\$ (3,519)	7.0	\$ 143,782	\$ (6,418)	7.6
10-20%	31,293	(5,662)	11.3	33,926	(5,484)	6.5
20-30%	15,558	(5,348)	10.7	26,733	(8,042)	9.5
30-40%	2,662	(1,314)	2.6	13,558	(6,905)	8.2
40-50%				619	(445)	0.5
50-80%	29	(108)	0.2	29	(110)	0.1
Total	\$ 159,220	\$ (15,951)	31.8	\$ 218,647	\$ (27,404)	32.4

At March 31, 2012, below-investment grade securities comprised approximately 5.9% of our fixed maturities and fixed maturities pledged under securities lending agreements, compared to 5.0% at December 31, 2011. In accordance with our investment strategy, we invest in high yield fixed income securities which are included in Corporate bonds. Upon issuance, these securities are typically rated below investment grade (i.e., rating assigned by the major rating agencies of BB or less). At March 31, 2012, corporate bonds represented 40% of the total below investment grade securities at fair value, mortgage backed securities represented 47% of the total and 13% were in other classes. At December 31, 2011, corporate bonds represented 46% of the total below investment grade securities at fair value, mortgage backed securities represented 46% of the total and 8% were in other classes. Unrealized losses include the impact of foreign exchange movements on certain securities denominated in foreign currencies and, as such, the amount of securities in an unrealized loss position fluctuates due to foreign currency movements.

We determine estimated recovery values for our fixed maturities and fixed maturities pledged under securities lending agreements following a review of the business prospects, credit ratings, estimated loss given default factors and information received from asset managers and rating agencies for each security. For structured securities, we utilize underlying data, where available, for each security provided by asset managers and additional information from credit agencies in order to determine an expected recovery value for each security. The analysis provided by the asset managers includes expected cash flow projections under base case and stress case scenarios which modify expected default expectations and loss severities and slow down prepayment assumptions. In the tables above, securities at March 31, 2012 which were in an unrealized loss position of greater than 20% of amortized cost were primarily in asset backed and mortgage backed securities where the fair value for the securities was lower than our expected recovery value.

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The following table summarizes our top ten exposures to fixed income corporate issuers by fair value at March 31, 2012, excluding guaranteed amounts and covered bonds:

	Estimated Fair Value	Credit Rating (1)
General Electric Co.	\$ 45,315	AA+/Aa2
Abbey National Treasury Svcs	31,335	A+/A1
Caterpillar Inc.	31,290	A/A2
Total SA	29,032	Aa-/Aa1
Royal Dutch Shell PLC	28,213	AA/Aa1
National Australia Bank Ltd.	27,879	Aa-/Aa2
Coca-Cola Company	26,579	A+/Aa3
Verizon Communications Inc.	26,078	A-/A3
HSBC Holdings PLC	25,925	A/A3
Berkshire Hathaway Inc.	25,281	A/A2
Total	\$ 296,927	

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

Our portfolio includes investments, such as mortgage-backed securities, which are subject to prepayment risk. At March 31, 2012, our investments in mortgage-backed securities (MBS), excluding commercial mortgage-backed securities, amounted to approximately \$1.49 billion, or 12.0% of total investable assets, compared to \$1.59 billion, or 12.9%, at December 31, 2011. As with other fixed income investments, the fair value of these securities fluctuates depending on market and other general economic conditions and the interest rate environment. Changes in interest rates can expose us to changes in the prepayment rate on these investments. In periods of declining interest rates, mortgage prepayments generally increase and MBS are prepaid more quickly, requiring us to reinvest the proceeds at the then current market rates. Conversely, in periods of rising rates, mortgage prepayments generally fall, preventing us from taking full advantage of the higher level of rates. However, current economic conditions may curtail prepayment activity as refinancing becomes more difficult, thus limiting prepayments on MBS.

Since 2007, the residential mortgage market in the U.S. has experienced a variety of difficulties. During this time, delinquencies and losses with respect to residential mortgage loans generally have increased and may continue to increase, particularly in the sub-prime sector. In addition, during this period, residential property values in many states have declined or remained stable, after extended periods during which those values appreciated. A continued decline or an extended flattening in those values may result in additional increases in delinquencies and losses on residential mortgage loans generally, especially with respect to second homes and investment properties, and with respect to any residential mortgage loans where the aggregate loan amounts (including any subordinate loans) are close to or greater than the related property values. These developments may have a significant adverse effect on the prices of loans and securities, including those in our investment portfolio. The situation continues to have wide ranging consequences, including downward pressure on economic growth and the potential for increased insurance and reinsurance exposures, which could have an adverse impact on our results of operations, financial condition, business and operations. Our portfolio includes commercial mortgage backed securities (CMBS). At March 31, 2012, CMBS constituted approximately \$1.12 billion, or 9.0% of total investable assets, compared to \$1.05 billion, or 8.5%, at December 31, 2011. The commercial real estate market has experienced price deterioration, which could lead to increased delinquencies and defaults on commercial real estate mortgages.

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The following table provides information on our MBS and CMBS at March 31, 2012, excluding amounts guaranteed by the U.S. government and TALF investments:

	Issuance Year	Amortized Cost	Average Credit Quality	Total	Estimated Fair Value % of Amortized Cost	% of Investable Assets
Non-agency MBS:	2003	\$ 2,378	AAA	\$ 2,402	101.0%	0.0%
	2004	14,472	BBB	13,455	93.0%	0.1%
	2005	46,202	B	42,140	91.2%	0.3%
	2006	57,247	BBB	52,964	92.5%	0.4%
	2007	47,338	CCC-	45,215	95.5%	0.4%
	2008	6,911	CCC-	6,781	98.1%	0.1%
	2009(6)	32,481	AAA	35,086	108.0%	0.3%
	2010(6)	30,612	AAA	29,732	97.1%	0.2%
	2012(6)	53,666	AAA	54,049	100.7%	0.4%
Total non-agency MBS		\$ 291,307	BBB+	\$ 281,824	96.7%	2.3%
Non-agency CMBS:	1998	3,479	AAA	3,536	101.6%	0.0%
	2002	9,245	AAA	9,228	99.8%	0.1%
	2003	38,287	AAA	39,293	102.6%	0.3%
	2004	27,757	AAA	27,775	100.1%	0.2%
	2005	49,205	AAA	49,507	100.6%	0.4%
	2006	4,255	BBB+	4,131	97.1%	0.0%
	2007	74,617	AA	80,269	107.6%	0.6%
	2008	24,925	AA+	24,692	99.1%	0.2%
	2010	255,803	AAA	263,230	102.9%	2.1%
	2011	197,548	AAA	208,547	105.6%	1.7%
	2012	31,857	AAA	32,006	100.5%	0.3%
Total non-agency CMBS		\$ 716,978	AAA	\$ 742,214	103.5%	5.9%

	Non-Agency MBS Re-REMICs	All Other	Non-Agency CMBS (1)
Additional Statistics:			
Weighted average loan age (months)	69	68	46
Weighted average life (months) (2)	30	61	36
Weighted average loan-to-value % (3)	70.1%	67.9%	64.4%
Total delinquencies (4)	20.5%	19.4%	4.0%
Current credit support % (5)	42.6%	11.4%	28.7%

- (1) Loans defeased with government/agency obligations represented approximately 2.7% of the collateral underlying our CMBS holdings.
- (2) The weighted average life for MBS is based on the interest rates in effect at March 31 2012. The weighted average life for CMBS reflects the average life of the collateral underlying our CMBS holdings.
- (3) The range of loan-to-values is 31% to 87% on MBS and 31% to 95% on CMBS.
- (4) Total delinquencies includes 60 days and over.

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(5) Current credit support % represents the % for a collateralized mortgage obligation (CMO) or CMBS class/tranche from other subordinate classes in the same CMO or CMBS deal.

(6) Primarily represents Re-REMICs with an average credit quality of AAA from Fitch Ratings.

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The following table provides information on our asset backed securities (ABS), excluding TALF investments, at March 31, 2012:

	Amortized Cost	Average Credit Quality	Total	Estimated Fair Value % of Amortized Cost	% of Investable Assets
Sector:					
Credit cards (1)	\$ 238,068	AAA	\$		