

NORDSTROM INC  
Form 10-Q  
December 03, 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 October 27, 2012

OR

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

For the transition period from \_\_\_\_\_ to \_\_\_\_\_

Commission File Number: 001-15059

NORDSTROM, INC.

(Exact name of registrant as specified in its charter)

Washington  
(State or other jurisdiction of  
incorporation or organization)

91-0515058  
(I.R.S. Employer  
Identification No.)

1617 Sixth Avenue, Seattle, Washington  
(Address of principal executive offices)  
206-628-2111

98101  
(Zip Code)

(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 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  (Do not check if a smaller reporting company) 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

Common stock outstanding as of November 28, 2012: 200,094,346 shares



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## PART I – FINANCIAL INFORMATION

## Item 1. Financial Statements (Unaudited).

## NORDSTROM, INC.

## CONDENSED CONSOLIDATED STATEMENTS OF EARNINGS

(Amounts in millions except per share amounts)

(Unaudited)

	Quarter Ended		Nine Months Ended	
	October 27, 2012	October 29, 2011	October 27, 2012	October 29, 2011
Net sales	\$2,713	\$2,383	\$8,166	\$7,328
Credit card revenues	95	95	280	283
Total revenues	2,808	2,478	8,446	7,611
Cost of sales and related buying and occupancy costs	(1,730	) (1,511	) (5,193	) (4,619
Selling, general and administrative expenses:				
Retail	(755	) (670	) (2,254	) (1,989
Credit	(46	) (57	) (152	) (171
Earnings before interest and income taxes	277	240	847	832
Interest expense, net	(38	) (31	) (118	) (92
Earnings before income taxes	239	209	729	740
Income tax expense	(93	) (82	) (278	) (293
Net earnings	\$146	\$127	\$451	\$447
Earnings per share:				
Basic	\$0.73	\$0.60	\$2.21	\$2.08
Diluted	\$0.71	\$0.59	\$2.17	\$2.04
Weighted average shares outstanding:				
Basic	200.9	210.9	204.5	215.3
Diluted	204.7	215.0	208.2	219.6

The accompanying Notes to Condensed Consolidated Financial Statements are an integral part of these financial statements.

## NORDSTROM, INC.

## CONDENSED CONSOLIDATED STATEMENTS OF COMPREHENSIVE EARNINGS

(Amounts in millions)

(Unaudited)

	Quarter Ended		Nine Months Ended	
	October 27, 2012	October 29, 2011	October 27, 2012	October 29, 2011
Net earnings	\$146	\$127	\$451	\$447
Other comprehensive earnings, net of tax	1	1	4	2
Comprehensive net earnings	\$147	\$128	\$455	\$449

The accompanying Notes to Condensed Consolidated Financial Statements are an integral part of these financial statements.



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NORDSTROM, INC.  
 CONDENSED CONSOLIDATED BALANCE SHEETS  
 (Amounts in millions)  
 (Unaudited)

	October 27, 2012	January 28, 2012	October 29, 2011
Assets			
Current assets:			
Cash and cash equivalents	\$ 1,158	\$ 1,877	\$ 1,457
Accounts receivable, net	2,088	2,033	1,995
Merchandise inventories	1,650	1,148	1,507
Current deferred tax assets, net	222	220	216
Prepaid expenses and other	115	282	147
Total current assets	5,233	5,560	5,322
Land, buildings and equipment (net of accumulated depreciation of \$4,013, \$3,791 and \$3,769)	2,551	2,469	2,471
Goodwill	175	175	200
Other assets	306	287	346
Total assets	\$8,265	\$8,491	\$8,339
Liabilities and Shareholders' Equity			
Current liabilities:			
Accounts payable	\$ 1,347	\$ 917	\$ 1,256
Accrued salaries, wages and related benefits	320	388	327
Other current liabilities	751	764	698
Current portion of long-term debt	6	506	506
Total current liabilities	2,424	2,575	2,787
Long-term debt, net	3,129	3,141	2,810
Deferred property incentives, net	488	500	511
Other liabilities	340	319	335
Commitments and contingencies			
Shareholders' equity:			
Common stock, no par value: 1,000 shares authorized; 200.7, 207.6 and 210.1 shares issued and outstanding	1,622	1,484	1,436
Retained earnings	303	517	487
Accumulated other comprehensive loss	(41	) (45	) (27
Total shareholders' equity	1,884	1,956	1,896
Total liabilities and shareholders' equity	\$8,265	\$8,491	\$8,339

The accompanying Notes to Condensed Consolidated Financial Statements are an integral part of these financial statements.

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NORDSTROM, INC.

## CONDENSED CONSOLIDATED STATEMENTS OF SHAREHOLDERS' EQUITY

(Amounts in millions except per share amounts)

(Unaudited)

	Common Stock		Retained	Accumulated Other Comprehensive	Total
	Shares	Amount	Earnings	Loss	
Balance at January 28, 2012	207.6	\$1,484	\$517	\$(45	) \$1,956
Net earnings	—	—	451	—	451
Other comprehensive earnings	—	—	—	4	4
Dividends (\$0.81 per share)	—	—	(166	) —	(166
Issuance of common stock under stock compensation plans	2.9	101	—	—	101
Stock-based compensation	0.1	37	—	—	37
Repurchase of common stock (9.9	) —		(499	) —	(499
Balance at October 27, 2012	200.7	\$1,622	\$303	\$(41	) \$1,884

	Common Stock		Retained	Accumulated Other Comprehensive	Total
	Shares	Amount	Earnings	Loss	
Balance at January 29, 2011	218.0	\$1,168	\$882	\$(29	) \$2,021
Net earnings	—	—	447	—	447
Other comprehensive earnings	—	—	—	2	2
Dividends (\$0.69 per share)	—	—	(149	) —	(149
Issuance of common stock for HauteLook acquisition	3.5	148	—	—	148
Issuance of common stock under stock compensation plans	2.9	86	—	—	86
Stock-based compensation	0.9	34	—	—	34
Repurchase of common stock (15.2	) —		(693	) —	(693
Balance at October 29, 2011	210.1	\$1,436	\$487	\$(27	) \$1,896

The accompanying Notes to Condensed Consolidated Financial Statements are an integral part of these financial statements.

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NORDSTROM, INC.  
 CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS  
 (Amounts in millions)  
 (Unaudited)

	Nine Months Ended	
	October 27, 2012	October 29, 2011
<b>Operating Activities</b>		
Net earnings	\$451	\$447
Adjustments to reconcile net earnings to net cash provided by operating activities:		
Depreciation and amortization expenses	314	273
Amortization of deferred property incentives and other, net	(47)	(41)
Deferred income taxes, net	(31)	18
Stock-based compensation expense	42	42
Tax benefit from stock-based compensation	19	17
Excess tax benefit from stock-based compensation	(20)	(19)
Provision for bad debt expense	48	82
Change in operating assets and liabilities:		
Accounts receivable	(94)	(56)
Merchandise inventories	(449)	(444)
Prepaid expenses and other assets	(28)	(62)
Accounts payable	339	331
Accrued salaries, wages and related benefits	(71)	(53)
Other current liabilities	(18)	30
Deferred property incentives	43	61
Other liabilities	9	2
Net cash provided by operating activities	507	628
<b>Investing Activities</b>		
Capital expenditures	(369)	(398)
Change in restricted cash	200	—
Change in credit card receivables originated at third parties	(10)	10
Other, net	(7)	(3)
Net cash used in investing activities	(186)	(391)
<b>Financing Activities</b>		
Proceeds from long-term borrowings, net of discounts	—	499
Principal payments on long-term borrowings	(505)	(5)
Increase (decrease) in cash book overdrafts	36	(20)
Cash dividends paid	(166)	(149)
Payments for repurchase of common stock	(506)	(693)
Proceeds from issuances under stock compensation plans	83	69
Excess tax benefit from stock-based compensation	20	19
Other, net	(2)	(6)
Net cash used in financing activities	(1,040)	(286)
Net decrease in cash and cash equivalents	(719)	(49)
Cash and cash equivalents at beginning of period	1,877	1,506
Cash and cash equivalents at end of period	\$1,158	\$1,457



Supplemental Cash Flow Information

Cash paid during the period for:

Interest (net of capitalized interest)	\$ 108	\$ 73
Income taxes	\$ 360	\$ 340

Non-cash investing activity:

Issuance of common stock for HauteLook acquisition	\$—	\$ 148
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The accompanying Notes to Condensed Consolidated Financial Statements are an integral part of these financial statements.

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NORDSTROM, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(Dollar and share amounts in millions except per share and per option amounts)

(Unaudited)

**NOTE 1: BASIS OF PRESENTATION**

The accompanying condensed consolidated financial statements include Nordstrom, Inc. and its subsidiaries. All intercompany transactions and balances are eliminated in consolidation. The interim condensed consolidated financial statements have been prepared on a basis consistent in all material respects with the accounting policies described and applied in our 2011 Annual Report on Form 10-K ("Annual Report"), and reflect all adjustments that are, in management's opinion, necessary for the fair presentation of the results of operations, financial position and cash flows for the periods presented.

The condensed consolidated financial statements as of and for the periods ended October 27, 2012 and October 29, 2011 are unaudited. The condensed consolidated balance sheet as of January 28, 2012 has been derived from the audited consolidated financial statements included in our 2011 Annual Report. The interim condensed consolidated financial statements should be read together with the consolidated financial statements and related footnote disclosures contained in our 2011 Annual Report.

The preparation of our financial statements requires that we make estimates and judgments that affect the reported amounts of assets, liabilities, revenues and expenses, and disclosure of contingent assets and liabilities. We base our estimates on historical experience and other assumptions that we believe to be reasonable under the circumstances. Actual results may differ from these estimates.

Our business, like that of other retailers, is subject to seasonal fluctuations. Due to our Anniversary Sale in July, the holidays in December and the half-yearly sales that occur in our second and fourth quarters, our sales are typically higher in the second and fourth quarters of the fiscal year than in the first and third quarters. In 2012, our Anniversary Sale shifted to the last week of July and the first week of August to align with the historical timing of our sale event. This moved one week of event sales to the third quarter. Results for any quarter are not necessarily indicative of the results that may be achieved for a full fiscal year.

**Recent Accounting Pronouncements**

In December 2011, the Financial Accounting Standards Board ("FASB") issued Accounting Standards Update ("ASU") No. 2011-11, Disclosures about Offsetting Assets and Liabilities, which has requirements that are disclosure-only in nature. This ASU requires disclosures about offsetting and related arrangements for financial instruments and derivative instruments, including gross and net information and evaluation of the effect of netting arrangements on the statement of financial position. We do not expect the provisions of this ASU, which are effective for us beginning with the first quarter of 2013, to have a material impact on our consolidated financial statements.

**NOTE 2: HAUTELOOK**

On March 23, 2011, we acquired 100% of the outstanding equity of HauteLook, Inc., an online private sale retailer offering limited-time sale events on fashion and lifestyle brands. The terms of this acquisition included upfront consideration of \$180 in Nordstrom common stock and an "earn-out" provision ultimately settled in 2011 for \$30 in Nordstrom common stock. On the acquisition date, we recorded intangible assets of \$62 and goodwill of \$146, offset by other net liabilities of \$13. In the fourth quarter of 2011, we recognized a goodwill impairment charge of \$25, reducing the HauteLook goodwill to \$121 due to a reorganization of HauteLook, changes in expected business results and market dynamics. Additionally, as part of the reorganization, we recorded income of \$12 related to the settlement of the earn-out liability.

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NORDSTROM, INC.

## NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(Dollar and share amounts in millions except per share and per option amounts)

(Unaudited)

## NOTE 3: ACCOUNTS RECEIVABLE

The components of accounts receivable are as follows:

	October 27, 2012	January 28, 2012	October 29, 2011
Credit card receivables:			
Nordstrom VISA credit card receivables	\$1,315	\$1,347	\$1,344
Nordstrom private label card receivables	777	727	691
Total credit card receivables	2,092	2,074	2,035
Allowance for credit losses	(95	) (115	) (125
Credit card receivables, net	1,997	1,959	1,910
Other accounts receivable <sup>1</sup>	91	74	85
Accounts receivable, net	\$2,088	\$2,033	\$1,995

<sup>1</sup>Other accounts receivable consist primarily of credit and debit card receivables due from third-party financial institutions.

Activity in the allowance for credit losses for the quarter and nine months ended October 27, 2012 and October 29, 2011 is as follows:

	Quarter Ended		Nine Months Ended	
	October 27, 2012	October 29, 2011	October 27, 2012	October 29, 2011
Allowance at beginning of period	\$105	\$125	\$115	\$145
Bad debt provision	10	31	48	82
Write-offs	(25	) (37	) (86	) (119
Recoveries	5	6	18	17
Allowance at end of period	\$95	\$125	\$95	\$125

For purposes of determining impairment and recording the associated allowance for credit losses, we evaluate our credit card receivables on a collective basis as they are composed of large groups of smaller-balance homogeneous loans and, therefore, are not individually evaluated for impairment.

Under certain circumstances, we may make modifications to payment terms for a customer experiencing financial difficulties in an effort to help the customer avoid bankruptcy and to maximize our recovery of the outstanding balance. These modifications, which meet the definition of troubled debt restructurings ("TDRs"), include reduced or waived fees and finance charges, and/or reduced minimum payments. Receivables classified as TDRs were \$54, or 2.6% of our total credit card receivables as of October 27, 2012, \$58, or 2.8% of our total credit card receivables as of January 28, 2012 and \$62, or 3.1% of our total credit card receivables as of October 29, 2011. As with other aged receivables in our portfolio, the allowance for credit losses related to receivables classified as TDRs is primarily based on our historical aging and delinquency trends and write-off experience, with qualitative consideration of factors affecting the credit quality of our portfolio, including amounts of and trends in TDRs.

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NORDSTROM, INC.

## NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(Dollar and share amounts in millions except per share and per option amounts)

(Unaudited)

## Credit Quality

The primary indicators of the credit quality of our credit card receivables are aging and delinquency, particularly the levels of account balances delinquent 30 days or more as these are the accounts most likely to be written off. The following table illustrates the aging and delinquency status of our credit card receivables:

	October 27, 2012		January 28, 2012		October 29, 2011			
	Balance	% of Total	Balance	% of Total	Balance	% of Total		
Current	\$1,960	93.7	% \$1,928	93.0	% \$1,899	93.3	%	
1 – 29 days delinquent	89	4.2	% 92	4.4	% 80	3.9	%	
30+ days delinquent:								
30 – 59 days delinquent	17	0.9	% 20	1.0	% 21	1.1	%	
60 – 89 days delinquent	11	0.5	% 13	0.6	% 15	0.7	%	
90 days or more delinquent	15	0.7	% 21	1.0	% 20	1.0	%	
Total 30+ days delinquent	43	2.1	% 54	2.6	% 56	2.8	%	
Total credit card receivables	\$2,092	100.0	% \$2,074	100.0	% \$2,035	100.0	%	
Receivables not accruing finance charges	\$10		\$15		\$18			
Receivables 90 days or more delinquent and still accruing finance charges	\$9		\$11		\$11			

We also evaluate credit quality using FICO credit scores. The following table illustrates the distribution of our credit card receivables across FICO score ranges:

FICO Score Range <sup>1</sup>	October 27, 2012		January 28, 2012		October 29, 2011			
	Balance	% of Total	Balance	% of Total	Balance	% of Total		
801+	\$335	16.0	% \$307	14.8	% \$331	16.3	%	
720 – 800	755	36.1	% 741	35.7	% 728	35.7	%	
660 – 719	571	27.3	% 572	27.6	% 545	26.8	%	
600 – 659	258	12.3	% 270	13.0	% 253	12.4	%	
001 – 599	101	4.8	% 120	5.8	% 115	5.7	%	
Other <sup>2</sup>	72	3.5	% 64	3.1	% 63	3.1	%	
Total credit card receivables	\$2,092	100.0	% \$2,074	100.0	% \$2,035	100.0	%	

<sup>1</sup>Credit scores for our cardholders are updated at least every 60 days. Amounts listed in the table reflect the most recently obtained credit scores as of the dates indicated.

<sup>2</sup>Other consists of amounts not yet posted to customers' accounts and receivables from customers for whom FICO scores are temporarily unavailable.

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NORDSTROM, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(Dollar and share amounts in millions except per share and per option amounts)

(Unaudited)

## NOTE 4: DEBT AND CREDIT FACILITIES

## Debt

A summary of our long-term debt is as follows:

	October 27, 2012	January 28, 2012	October 29, 2011
<b>Secured</b>			
Series 2007-2 Class A Notes, one-month LIBOR plus 0.06% per year, due April 2012	—	\$454	\$454
Series 2007-2 Class B Notes, one-month LIBOR plus 0.18% per year, due April 2012	—	46	46
Series 2011-1 Class A Notes, 2.28%, due October 2016	\$325	325	—
Mortgage payable, 7.68%, due April 2020	48	51	52
Other	10	12	13
	383	888	565
<b>Unsecured</b>			
Senior notes, 6.75%, due June 2014, net of unamortized discount	400	399	399
Senior notes, 6.25%, due January 2018, net of unamortized discount	648	648	648
Senior notes, 4.75%, due May 2020, net of unamortized discount	498	498	498
Senior notes, 4.00%, due October 2021, net of unamortized discount	499	499	499
Senior debentures, 6.95%, due March 2028	300	300	300
Senior notes, 7.00%, due January 2038, net of unamortized discount	344	343	343
Other	63	72	64
	2,752	2,759	2,751
Total long-term debt	3,135	3,647	3,316
Less: current portion	(6	) (506	) (506
Total due beyond one year	\$3,129	\$3,141	\$2,810

In April 2012, we retired our Series 2007-2 Class A & B Notes ("the Notes") totaling \$500, which had been secured by our restricted receivables. The Notes were retired using cash that had been accumulated monthly into a restricted account beginning in December 2011. Prior to the retirement, the accumulated cash was included in our condensed consolidated balance sheet in prepaid expenses and other.

## Credit Facilities

As of October 27, 2012, we had total short-term borrowing capacity available for general corporate purposes of \$800. Of the total capacity, we had \$600 under our commercial paper program, which is backed by our unsecured revolving credit facility ("revolver") that expires in June 2016, and \$200 under our 2007-A Variable Funding Note ("2007-A VFN") that expires in January 2013. For the nine months ended October 27, 2012, we had no issuances under our commercial paper program and no borrowings under our revolver or our 2007-A VFN.

The revolver requires that we maintain a leverage ratio, defined as Adjusted Debt to Earnings before Interest, Income Taxes, Depreciation, Amortization and Rent ("EBITDAR"), of less than four times. As of October 27, 2012, we are in

compliance with this covenant.

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NORDSTROM, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(Dollar and share amounts in millions except per share and per option amounts)

(Unaudited)

## NOTE 5: FAIR VALUE MEASUREMENTS

We disclose our financial assets and liabilities that are measured at fair value in our condensed consolidated balance sheets on a recurring basis, by level within the fair value hierarchy as defined by applicable accounting standards:

Level 1: Quoted market prices in active markets for identical assets or liabilities

Level 2: Other observable market-based inputs or unobservable inputs that are corroborated by market data

Level 3: Unobservable inputs that cannot be corroborated by market data that reflect the reporting entity's own assumptions

We did not have any financial assets or liabilities that were measured at fair value on a recurring basis as of October 27, 2012 or January 28, 2012. The following table presents our financial assets and liabilities that were measured at fair value on a recurring basis as of October 29, 2011, by level within the fair value hierarchy:

	Fair Value Hierarchy	October 29, 2011
Assets:		
Interest rate swap	Level 2	\$64
Liabilities:		
HauteLook earn-out liability	Level 3	\$39
Interest Rate Swap		

The estimated fair value of our interest rate swap agreements (collectively, the "swap") was a \$64 asset as of October 29, 2011. In January 2012, we sold our interest rate swap. During 2011, before the sale of our swap, we estimated the fair value of our interest rate swap based upon observable market-based inputs for identical or comparable arrangements from reputable third-party brokers, adjusted for credit risk. As such, these were considered Level 2 fair value measurements.

## HauteLook Earn-out

The estimated fair value of our HauteLook earn-out was a \$39 liability as of October 29, 2011. On November 23, 2011, we settled the earn-out provisions for \$30 and have no remaining liability related to the earn-out. During 2011, before the settlement, we estimated the fair value of the HauteLook earn-out liability using a valuation model based on our expectations of HauteLook's future performance, estimates of volatility around those expectations and the risk-adjusted discount rate. As such, this was considered a Level 3 fair value measurement.

## Other

Financial instruments not measured at fair value on a recurring basis include cash and cash equivalents, accounts receivable, accounts payable and debt. The carrying value of cash and cash equivalents, accounts receivable, net and accounts payable approximate fair value due to their short-term nature. The estimated fair value of our long-term debt, including current maturities and the remaining fair value adjustment from our previous effective fair value hedge, was \$3,746 as of October 27, 2012, compared with a carrying value of \$3,135. We estimated the fair value of long-term debt using quoted market prices of the same or similar issues, and as such, this is considered a Level 1 fair value measurement.

We also measure certain non-financial assets at fair value on a non-recurring basis, primarily goodwill and long-lived tangible and intangible assets, in connection with periodic evaluations for potential impairment. We recorded no impairment charges for these assets for the nine months ended October 27, 2012 and October 29, 2011.

## NOTE 6: CONTINGENT LIABILITIES

We are subject from time to time to various claims and lawsuits arising in the ordinary course of business, including lawsuits alleging violations of state and/or federal wage and hour and other employment laws, privacy and other

consumer-based claims. Some of these lawsuits purport or may be determined to be class or collective actions and seek substantial damages or injunctive relief, or both, and some may remain unresolved for several years. We believe the recorded reserves in our condensed consolidated financial statements are adequate in light of the probable and estimable liabilities. As of the date of this report, we do not believe any currently identified claim, proceeding or litigation, either alone or in the aggregate, will have a material impact on our results of operations, financial position or cash flows. Since these matters are subject to inherent uncertainties, our view of them may change in the future.

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NORDSTROM, INC.

## NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(Dollar and share amounts in millions except per share and per option amounts)

(Unaudited)

## NOTE 7: SHAREHOLDERS' EQUITY

In May 2011, our Board of Directors authorized a program (the "2011 Program") to repurchase up to \$750 of our outstanding common stock, through February 2, 2013. In February 2012, our Board of Directors authorized a new program (the "2012 Program") to repurchase up to \$800 of our outstanding common stock, through February 1, 2014, in addition to the remaining amount available for repurchase under the 2011 Program. For the nine months ended October 27, 2012, we repurchased 9.9 shares of our common stock for an aggregate purchase price of \$499 and had \$612 in remaining share repurchase capacity. The actual number and timing of future share repurchases, if any, will be subject to market and economic conditions and applicable Securities and Exchange Commission rules.

## NOTE 8: STOCK-BASED COMPENSATION

The following table summarizes our stock-based compensation expense:

	Quarter Ended		Nine Months Ended	
	October 27, 2012	October 29, 2011	October 27, 2012	October 29, 2011
Stock options	\$8	\$8	\$29	\$26
HauteLook stock compensation	2	3	7	9
Performance share units	1	3	3	4
Employee stock purchase plan	—	—	1	1
Other	—	—	2	2
Total stock-based compensation expense, before income tax benefit	\$11	\$14	\$42	\$42
Income tax benefit	(3	) (5	) (14	) (16
Total stock-based compensation expense, net of income tax benefit	\$8	\$9	\$28	\$26

During the nine months ended October 27, 2012 and October 29, 2011, we granted 2.9 and 2.7 options with estimated weighted average grant-date fair values per option of \$15 in each period.

## NOTE 9: EARNINGS PER SHARE

The computation of earnings per share is as follows:

	Quarter Ended		Nine Months Ended	
	October 27, 2012	October 29, 2011	October 27, 2012	October 29, 2011
Net earnings	\$146	\$127	\$451	\$447
Basic shares	200.9	210.9	204.5	215.3
Dilutive effect of stock options and other	3.8	4.1	3.7	4.3
Diluted shares	204.7	215.0	208.2	219.6
Earnings per basic share	\$0.73	\$0.60	\$2.21	\$2.08
Earnings per diluted share	\$0.71	\$0.59	\$2.17	\$2.04
Anti-dilutive stock options and other	2.4	3.8	4.8	4.0

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NORDSTROM, INC.

## NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(Dollar and share amounts in millions except per share and per option amounts)

(Unaudited)

## NOTE 10: SEGMENT REPORTING

The following tables set forth information for our reportable segments:

	Retail	Credit	Corporate/Other	Total
Quarter Ended October 27, 2012				
Net sales	\$2,657	—	\$56	\$2,713
Credit card revenues	—	\$95	—	95
Earnings (loss) before interest and income taxes	342	25	(90)	) 277
Interest expense, net	—	(6)	) (32)	) (38)
Earnings (loss) before income taxes	342	19	(122)	) 239
Quarter Ended October 29, 2011				
Net sales	\$2,350	—	\$33	\$2,383
Credit card revenues	—	\$95	—	95
Earnings (loss) before interest and income taxes	307	22	(89)	) 240
Interest expense, net	—	(2)	) (29)	) (31)
Earnings (loss) before income taxes	307	20	(118)	) 209
Nine Months Ended October 27, 2012				
Net sales	\$8,296	—	\$(130)	) \$8,166
Credit card revenues	—	\$280	—	280
Earnings (loss) before interest and income taxes	1,160	52	(365)	) 847
Interest expense, net	—	(19)	) (99)	) (118)
Earnings (loss) before income taxes	1,160	33	(464)	) 729
Goodwill	175	—	—	175
Nine Months Ended October 29, 2011				
Net sales	\$7,427	—	\$(99)	) \$7,328
Credit card revenues	—	\$283	—	283
Earnings (loss) before interest and income taxes	1,061	60	(289)	) 832
Interest expense, net	—	(9)	) (83)	) (92)
Earnings (loss) before income taxes	1,061	51	(372)	) 740
Goodwill	200	—	—	200

The following table summarizes net sales within our reportable segments:

	Quarter Ended		Nine Months Ended	
	October 27, 2012	October 29, 2011	October 27, 2012	October 29, 2011
Nordstrom full-line stores	\$1,730	\$1,595	\$5,560	\$5,257
Direct	248	178	799	568
Nordstrom	1,978	1,773	6,359	5,825
Nordstrom Rack	613	528	1,747	1,478

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Other retail <sup>1</sup>	66	49	190	124
Total Retail segment	2,657	2,350	8,296	7,427
Corporate/Other	56	33	(130	) (99
Total net sales	\$2,713	\$2,383	\$8,166	\$7,328

<sup>1</sup>Other retail includes our HauteLook online private sale subsidiary, our Jeffrey stores and our treasure&bond store.

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Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations.  
(Dollar and share amounts in millions except per share and per square foot amounts)

CAUTIONARY STATEMENT

Certain statements in this Quarterly Report on Form 10-Q contain or may suggest "forward-looking" information (as defined in the Private Securities Litigation Reform Act of 1995) that involve risks and uncertainties, including, but not limited to, anticipated financial outlook for the fiscal year ending February 2, 2013, anticipated annual same-store sales rate, anticipated Return on Invested Capital and trends in our operations. Such statements are based upon the current beliefs and expectations of the company's management and are subject to significant risks and uncertainties. Actual future results may differ materially from historical results or current expectations depending upon factors including, but not limited to:

- the impact of economic and market conditions and the resultant impact on consumer spending patterns,
- our ability to respond to the business environment, fashion trends and consumer preferences, including changing expectations of service and experience in stores and online,
- effective inventory management,
- successful execution of our growth strategy, including possible expansion into new markets, technological investments and acquisitions, our ability to realize the anticipated benefits from such growth initiatives, and the timely completion of construction associated with newly planned stores, relocations and remodels, all of which may be impacted by the financial health of third parties,
- our ability to manage the change in our business/financial model as we increase our investment in e-commerce and our online business,
- our ability to maintain relationships with our employees and to effectively attract, develop and retain our future leaders,
- successful execution of our multi-channel strategy, including planning, procurement and allocation capabilities,
- our compliance with applicable banking and related laws and regulations impacting our ability to extend credit to our customers,
- impact of the current regulatory environment and financial system and health care reforms,
- the impact of any systems failures, cybersecurity and/or security breaches, including any security breaches that result in the theft, transfer or unauthorized disclosure of customer, employee or company information or our compliance with information security and privacy laws and regulations in the event of such an incident,
- our compliance with employment laws and regulations and other laws and regulations applicable to us, including the outcome of claims and litigation and resolution of tax matters,
- compliance with debt covenants and availability and cost of credit,
- our ability to safeguard our brand and reputation,
- successful execution of our information technology strategy,
- our ability to maintain our relationships with vendors,
- trends in personal bankruptcies and bad debt write-offs,
- changes in interest rates,
- efficient and proper allocation of our capital resources,
- weather conditions, natural disasters, health hazards or other market disruptions, or the prospects of these events and the impact on consumer spending patterns,
- disruptions in our supply chain,
- the geographic locations of our stores,
- the effectiveness of planned advertising, marketing and promotional campaigns,
- our ability to control costs and
- the timing and amounts of share repurchases by the company, if any, or any share issuances by the company, including issuances associated with option exercises or other matters.

These and other factors, including those factors described in Part I, "Item 1A. Risk Factors" in our 2011 Annual Report on Form 10-K, could affect our financial results and cause actual results to differ materially from any forward-looking information we may provide. We undertake no obligation to update or revise any forward-looking

statements to reflect subsequent events, new information or future circumstances.

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Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations.  
(Continued) (Dollar and share amounts in millions except per share and per square foot amounts)

OVERVIEW

Our third quarter marked the twelfth consecutive quarter of total company same-store sales increases, reflecting our ongoing efforts to improve the customer experience across all channels. Third quarter results were impacted by a timing shift of our Anniversary Sale, moving one week of the event from the second quarter into the third quarter. To provide a better indication of our performance, we look to our combined second and third quarter same-store sales increase of 7.3%.

Our focus on delivering a differentiated experience to our customers continues to create multiple growth opportunities. Our customers have a growing number of ways to shop, with expectations increasingly centered on speed and convenience. Given our customer's expanding view of service, we are making strategic investments to improve the experience across all channels. In e-commerce, we continue to build upon our online capabilities by expanding merchandise selection, enhancing the website and mobile experience and expediting check-out and delivery. These investments helped drive the 38% third quarter sales growth in our Direct channel. This was a notable increase on top of last year's 33% growth when we launched free shipping and returns online in the third quarter of 2011.

We also continue to grow through new stores and other initiatives and believe we can leverage our strong operating model and increase market share through expansion into both new and existing markets. During the first nine months of the year, we opened one Nordstrom full-line store, opened thirteen Nordstrom Rack stores and relocated three Nordstrom Rack stores. We also announced our plans to expand into Canada with four full-line stores. In addition, we have plans to increase our Rack stores to over 230 by the end of 2016. At the same time, our core store business remains strong and we have continued to elevate the customer experience. As an example, we now have mobile point-of-sale devices at all of our Rack stores to increase the speed at check-out, which in turn will drive incremental volume.

Strategic partnerships also help us build capabilities and increase our relevance. In the third quarter we began carrying merchandise from Topshop, an internationally renowned brand with trend-leading fashion at affordable prices, in fourteen of our stores and online.

Our credit business contributes to an improved customer experience through our product offerings, serving customers from our call centers and our Fashion Rewards program. This program plays an important part in strengthening and building customer relationships. Fashion Rewards members shop more frequently and spend more on average than non-members. With the launch of our enhanced program earlier this year, we generated increases in new accounts, Fashion Reward members' spend and Nordstrom card penetration compared with last year. We now have 3.1 million active members, a 22% increase over last year. During the third quarter, our delinquency and write-off trends continued to improve and were well below the same period in 2011.

Our focus on enhancing the customer experience, through e-commerce, store expansion and new markets, provides us with multiple growth opportunities, enabling us to deliver sustainable, profitable growth. Our overall goals remain to achieve high single-digit total sales growth and mid-teens Return on Invested Capital ("ROIC"), as we believe these measures correlate strongly with shareholder return. We are currently on track to achieve these long-term financial goals and in 2012 expect to produce the highest earnings before interest and income taxes ("EBIT") dollar results in our history.

RESULTS OF OPERATIONS

Our reportable segments are Retail and Credit. Our Retail segment includes our Nordstrom branded full-line stores and website, our Nordstrom Rack stores and our other retail channels including HauteLook, our Jeffrey stores and our treasure&bond store. For purposes of discussion and analysis of our results of operations, we combine our Retail segment results with revenues and expenses in the "Corporate/Other" column of our segment reporting footnote (collectively, the "Retail Business"). We analyze our results of operations through earnings before interest and income taxes for our Retail Business and earnings before income taxes for our Credit segment, while interest expense and income taxes are discussed on a total company basis.



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Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations.  
(Continued) (Dollar and share amounts in millions except per share and per square foot amounts)

## Retail Business

## Summary

The following table summarizes the results of our Retail Business for the quarter and nine months ended October 27, 2012, compared with the quarter and nine months ended October 29, 2011:

	Quarter Ended		October 29, 2011		
	October 27, 2012		October 29, 2011		
	Amount	% of net sales	Amount	% of net sales	
Net sales	\$2,713	100.0	% \$2,383	100.0	%
Cost of sales and related buying and occupancy costs	(1,706	) 62.9	% (1,495	) (62.7	%)
Gross profit	1,007	37.1	% 888	37.3	%
Selling, general and administrative expenses	(755	) (27.9	%) (670	) (28.1	%)
Earnings before interest and income taxes	\$252	9.3	% \$218	9.1	%
	Nine Months Ended		October 29, 2011		
	October 27, 2012		October 29, 2011		
	Amount	% of net sales	Amount	% of net sales	
Net sales	\$ 8,166	100.0	% \$ 7,328	100.0	%
Cost of sales and related buying and occupancy costs	(5,117	) 62.7	% (4,567	) (62.3	%)
Gross profit	3,049	37.3	% 2,761	37.7	%
Selling, general and administrative expenses	(2,254	) (27.6	%) (1,989	) (27.1	%)
Earnings before interest and income taxes	17.0	% 3.0	% 9.6	%	
Combined ratio	90.6	% 87.7	% 89.1	%	

(1) Certain amounts included in the gross premiums written of each segment are related to intersegment transactions. Accordingly, the sum of gross premiums written for each segment does not agree to the total gross premiums written as shown in the table above due to the elimination of intersegment transactions in the total. The insurance segment and reinsurance segment results include \$1.5 million and \$26.8 million, respectively, of gross and net premiums written and \$2.4 million and \$31.1 million, respectively, of net premiums earned assumed through intersegment transactions.

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



The following tables set forth the insurance segment's net premiums written and earned by major line of business, together with net premiums written by client location:

INSURANCE SEGMENT (U.S. dollars in thousands)	(Unaudited) Three Months Ended June 30, 2006		2005	
	Amount	% of Total	Amount	% of Total
<b>Net premiums written (1)</b>				
Property, marine and aviation	\$ 74,712	18.2	\$ 68,090	18.2
Construction and surety	66,717	16.3	48,362	12.9
Casualty	66,643	16.3	72,502	19.4
Professional liability	63,555	15.5	56,757	15.2
Programs	56,512	13.8	58,524	15.7
Executive assurance	53,841	13.2	44,503	11.9
Healthcare	14,199	3.5	12,626	3.4
Other	13,123	3.2	12,308	3.3
Total	\$ 409,302	100.0	\$ 373,672	100.0
<b>Net premiums earned (1)</b>				
Property, marine and aviation	\$ 54,783	14.2	\$ 55,534	15.7
Construction and surety	67,967	17.6	56,448	15.9
Casualty	61,121	15.9	73,687	20.8
Professional liability	65,639	17.0	50,495	14.3
Programs	57,478	14.9	53,154	15.0
Executive assurance	49,707	12.9	34,658	9.8
Healthcare	17,869	4.6	16,339	4.6
Other	11,313	2.9	13,771	3.9
Total	\$ 385,877	100.0	\$ 354,086	100.0
<b>Net premiums written by client location (1)</b>				
United States	\$ 343,923	84.0	\$ 325,850	87.2
Europe	39,886	9.8	29,195	7.8
Other	25,493	6.2	18,627	5.0
Total	\$ 409,302	100.0	\$ 373,672	100.0

(1) Insurance segment results include premiums written and earned assumed through intersegment transactions of nil and \$0.5 million, respectively, for the 2006 second quarter and \$0.7 million and \$1.2 million, respectively, for the 2005 second quarter. Insurance segment results exclude premiums written and earned ceded through intersegment transactions of \$10.9 million and \$12.3 million, respectively, for the 2006 second quarter and \$12.8 million and \$14.7 million, respectively, for the 2005 second quarter.

INSURANCE SEGMENT (U.S. dollars in thousands)	(Unaudited) Six Months Ended June 30, 2006		2005	
	Amount	% of Total	Amount	% of Total
<b>Net premiums written (1)</b>				
Construction and surety	\$ 147,346	18.3	\$ 110,802	15.9
Property, marine and aviation	143,358	17.8	110,182	15.8
Professional liability	126,009	15.6	103,658	14.9
Casualty	117,393	14.6	136,301	19.6
Programs	117,046	14.5	111,791	16.1
Executive assurance	99,432	12.3	68,520	9.8
Healthcare	32,314	4.0	29,062	4.2
Other	23,658	2.9	25,464	3.7
Total	\$ 806,556	100.0	\$ 695,780	100.0
<b>Net premiums earned (1)</b>				
Construction and surety	\$ 134,670	17.6	\$ 107,112	15.9
Property, marine and aviation	117,751	15.4	99,083	14.7
Professional liability	119,684	15.6	97,297	14.4
Casualty	123,929	16.2	142,953	21.2
Programs	114,867	15.0	108,465	16.0
Executive assurance	99,783	13.0	59,293	8.8
Healthcare	34,546	4.5	33,339	4.9
Other	20,901	2.7	27,580	4.1
Total	\$ 766,131	100.0	\$ 675,122	100.0
<b>Net premiums written by client location (1)</b>				
United States	\$ 668,388	82.9	\$ 611,774	87.9
Europe	87,466	10.8	56,301	8.1
Other	50,702	6.3	27,705	4.0
Total	\$ 806,556	100.0	\$ 695,780	100.0

(1) Insurance segment results include premiums written and earned assumed through intersegment transactions of \$0.8 million and \$1.4 million, respectively, for the six months ended June 30, 2006 and \$1.5 million and \$2.4 million, respectively, for the six months ended June 30, 2005. Insurance segment results exclude premiums written and earned ceded through intersegment transactions of \$22.4 million and \$25.1 million, respectively, for the six months ended June 30, 2006 and \$26.8 million and \$31.1 million, respectively, for the six months ended June 30, 2005.

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

REINSURANCE SEGMENT (U.S. dollars in thousands)	(Unaudited) Three Months Ended June 30, 2006		2005	
	Amount	% of Total	Amount	% of Total
<b>Net premiums written (1)</b>				
Casualty (2)	\$ 176,116	45.7	\$ 160,646	45.9
Property excluding property catastrophe	88,785	23.0	81,341	23.2
Other specialty	64,493	16.7	74,988	21.4
Property catastrophe	33,786	8.8	9,361	2.7
Marine and aviation	20,626	5.4	18,089	5.2
Other	1,450	0.4	5,631	1.6
Total	\$ 385,256	100.0	\$ 350,056	100.0
<b>Net premiums earned (1)</b>				
Casualty (2)	\$ 183,474	44.6	\$ 176,399	45.7
Property excluding property catastrophe	81,668	19.8	87,488	22.7
Other specialty	70,970	17.2	68,545	17.8
Property catastrophe	49,481	12.0	21,768	5.6
Marine and aviation	23,701	5.8	20,619	5.3
Other	2,279	0.6	10,987	2.9
Total	\$ 411,573	100.0	\$ 385,806	100.0
<b>Net premiums written (1)</b>				
Pro rata	\$ 288,439	74.9	\$ 305,842	87.4
Excess of loss	96,817	25.1	44,214	12.6
Total	\$ 385,256	100.0	\$ 350,056	100.0
<b>Net premiums earned (1)</b>				
Pro rata	\$ 321,438	78.1	\$ 294,526	76.3
Excess of loss	90,135	21.9	91,280	23.7
Total	\$ 411,573	100.0	\$ 385,806	100.0
<b>Net premiums written by client location (1)</b>				
United States	\$ 228,677	59.4	\$ 185,116	52.9
Europe	111,663	29.0	109,970	31.4
Bermuda	23,843	6.2	17,314	5.0
Canada	8,649	2.2	20,721	5.9
Asia and Pacific	7,419	1.9	9,829	2.8
Other	5,005	1.3	7,106	2.0
Total	\$ 385,256	100.0	\$ 350,056	100.0

(1) Reinsurance segment results include premiums written and earned assumed through intersegment transactions of \$10.9 million and \$12.3 million, respectively, for the 2006 second quarter and \$12.8 million and \$14.7 million, respectively, for the 2005 second quarter. Reinsurance segment results exclude premiums written and earned ceded through intersegment transactions of nil and \$0.5 million, respectively, for the 2006 second quarter and \$0.7 million and \$1.2 million, respectively, for the 2005 second quarter.

(2) Includes professional liability and executive assurance business.

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REINSURANCE SEGMENT (U.S. dollars in thousands)	(Unaudited) Six Months Ended June 30, 2006		2005	
	Amount	% of Total	Amount	% of Total
<b>Net premiums written (1)</b>				
Casualty (2)	\$ 339,104	39.3	\$ 371,515	44.9
Property excluding property catastrophe	195,567	22.7	169,536	20.5
Other specialty	157,757	18.3	166,017	20.1
Property catastrophe	104,122	12.1	53,924	6.5
Marine and aviation	61,978	7.2	48,118	5.8
Other	3,193	0.4	18,639	2.2
Total	\$ 861,721	100.0	\$ 827,749	100.0
<b>Net premiums earned (1)</b>				
Casualty (2)	\$ 354,671	44.7	\$ 389,660	51.1
Property excluding property catastrophe	161,288	20.3	144,983	19.0
Other specialty	128,889	16.3	119,299	15.7
Property catastrophe	98,587	12.4	46,529	6.1
Marine and aviation	47,351	6.0	42,610	5.6
Other	2,134	0.3	18,757	2.5
Total	\$ 792,920	100.0	\$ 761,838	100.0
<b>Net premiums written (1)</b>				
Pro rata	\$ 560,973	65.1	\$ 625,489	75.6
Excess of loss	300,748	34.9	202,260	24.4
Total	\$ 861,721	100.0	\$ 827,749	100.0
<b>Net premiums earned (1)</b>				
Pro rata	\$ 616,726	77.8	\$ 572,138	75.1
Excess of loss	176,194	22.2	189,700	24.9
Total	\$ 792,920	100.0	\$ 761,838	100.0
<b>Net premiums written by client location (1)</b>				
United States	\$ 505,992	58.7	\$ 444,530	53.7
Europe	238,926	27.7	265,465	32.1
Bermuda	67,682	7.9	44,378	5.4
Canada	18,205	2.1	42,057	5.1
Asia and Pacific	13,808	1.6	15,399	1.8
Other	17,108	2.0	15,920	1.9
Total	\$ 861,721	100.0	\$ 827,749	100.0

(1) Reinsurance segment results include premiums written and earned assumed through intersegment transactions of \$22.4 million and \$25.1 million, respectively, for the six months ended June 30, 2006 and \$26.8 million and \$31.1 million, respectively, for the six months ended June 30, 2005. Reinsurance segment results exclude premiums written and earned ceded through intersegment transactions of \$0.8 million and \$1.4 million, respectively, for the six months ended June 30, 2006 and \$1.5 million and \$2.4 million, respectively, for the six months ended June 30, 2005.

(2) Includes professional liability and executive assurance business.



## 5. Reinsurance

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

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

(U.S. dollars in thousands)	(Unaudited) Three Months Ended June 30, 2006		(Unaudited) Six Months Ended June 30, 2006	
	2006	2005	2006	2005
<b>Premiums Written</b>				
Direct	\$ 635,250	\$ 559,357	\$ 1,236,949	\$ 1,057,682
Assumed	501,024	381,396	1,067,139	863,763
Ceded	(341,716 )	(217,025 )	(635,811 )	(397,916 )
Net	\$ 794,558	\$ 723,728	\$ 1,668,277	\$ 1,523,529
<b>Premiums Earned</b>				
Direct	\$ 609,486	\$ 535,780	\$ 1,184,904	\$ 1,025,591
Assumed	477,244	401,109	896,521	792,500
Ceded	(289,280 )	(196,997 )	(522,374 )	(381,131 )
Net	\$ 797,450	\$ 739,892	\$ 1,559,051	\$ 1,436,960
<b>Losses and Loss Adjustment Expenses</b>				
Direct	\$ 485,740	\$ 326,084	\$ 867,845	\$ 626,798
Assumed	249,357	228,112	495,966	449,474
Ceded	(272,842 )	(110,278 )	(433,378 )	(206,818 )
Net	\$ 462,255	\$ 443,918	\$ 930,433	\$ 869,454

The Company monitors the financial condition of its reinsurers and attempts to place coverages only with substantial, financially sound carriers. At June 30, 2006 and December 31, 2005, approximately 94.0% and 92.6%, respectively, of the Company's reinsurance recoverables on paid and unpaid losses (not including prepaid reinsurance premiums) of \$1.68 billion and \$1.47 billion, respectively, were due from carriers which had an A.M. Best rating of A- or better. At June 30, 2006 and December 31, 2005, the largest reinsurance recoverables from any one carrier were less than 5.9% and 5.6%, respectively, of the Company's total shareholders' equity.

## 6. Deposit Accounting

Certain assumed reinsurance contracts are deemed, under GAAP, not to transfer insurance risk, and are accounted for using the deposit method of accounting. However, it is possible that the Company could incur financial losses on such contracts. For those contracts that contain an element of underwriting risk, the estimated profit margin is deferred and amortized over the contract period and such amount is included in the Company's underwriting results. When the estimated profit margin is explicit, the margin is reflected as fee income and any adverse financial results on such contracts are reflected as incurred losses. The Company recorded fee income on such contracts of \$2.3 million and nil, respectively, for the 2006 second quarter and 2005 second quarter, and \$2.6 million and \$0.1 million, respectively, for the six months ended June 30, 2006 and 2005. When the estimated profit margin is implicit, the margin is reflected as an offset to paid losses and any adverse financial results on such contracts are reflected as incurred losses. The Company recorded an offset to paid losses on such contracts of \$0.7 million and \$2.1 million, respectively, for the 2006 second quarter and 2005 second quarter, and \$1.3 million and \$3.8 million, respectively, for the six months ended June 30, 2006 and 2005. On a notional basis, the amount of premiums from those contracts that contain an element of underwriting risk was \$5.3 million and \$3.5 million, respectively, for the 2006 second quarter and 2005 second quarter, and \$11.3 million and \$9.6 million, respectively, for the six months ended June 30, 2006 and 2005.

In making any determination to account for a contract using the deposit method of accounting, the Company is required to make many estimates and judgments under GAAP. The accounting principles governing the deposit method of accounting are currently under review by the FASB.

## 7. Investment Information

The following table summarizes the Company's invested assets:

(U.S. dollars in thousands)	(Unaudited) June 30, 2006	December 31, 2005
Fixed maturities available for sale, at fair value	\$ 5,948,595	\$ 5,280,987
Fixed maturities pledged under securities lending agreements, at fair value (1)	740,966	862,766
Total fixed maturities	6,689,561	6,143,753
Short-term investments available for sale, at fair value	973,671	681,887
Short-term investments pledged under securities lending agreements, at fair value (1)	935	1,100
Other investments, at fair value	132,046	70,233
Total invested assets (1)	\$ 7,796,213	\$ 6,896,973

(1) In securities lending transactions, the Company receives collateral in excess of the market value of the fixed maturities and short-term investments pledged under securities lending agreements. For purposes of this table, the Company has excluded \$762.2 million and \$893.4 million, respectively, of collateral received which is reflected as short-term investment of funds received under securities lending agreements, at fair value and included \$741.9 million and \$863.9 million, respectively, of fixed maturities and short-term investments pledged under securities lending agreements, at fair value at June 30, 2006 and December 31, 2005.



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

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

(U.S. dollars in thousands)	Estimated Fair Value	Gross Unrealized Gains	Gross Unrealized Losses	Amortized Cost
<b>June 30, 2006 (unaudited):</b>				
U.S. government and government agencies	\$ 1,940,850	\$ 763	\$ (50,964 )	\$ 1,991,051
Corporate bonds	1,488,335	1,761	(24,715 )	1,511,289
Mortgage backed securities	780,215	694	(4,367 )	783,888
Municipal bonds	707,514	1,922	(11,845 )	717,437
Asset backed securities	663,842	208	(4,041 )	667,675
Commercial mortgage backed securities	578,815	101	(9,192 )	587,906
Non-U.S. government securities	529,990	6,810	(8,152 )	531,332
Total	\$ 6,689,561	\$ 12,259	\$ (113,276 )	\$ 6,790,578
<b>December 31, 2005:</b>				
U.S. government and government agencies	\$ 2,106,866	\$ 18,152	\$ (10,001 )	\$ 2,098,715
Corporate bonds	1,595,559	2,663	(10,345 )	1,603,241
Municipal bonds	623,822	5,039	(4,006 )	622,789
Asset backed securities	591,401	194	(3,348 )	594,555
Commercial mortgage backed securities	469,984	292	(5,292 )	474,984
Non-U.S. government securities	379,328	3,756	(20,483 )	396,055
Mortgage backed securities	376,793	653	(1,576 )	377,716
Total	\$ 6,143,753	\$ 30,749	\$ (55,051 )	\$ 6,168,055

The credit quality distribution of the Company's fixed maturities and fixed maturities pledged under securities lending agreements are shown below:

(U.S. dollars in thousands) Rating (1)	(Unaudited) June 30, 2006 Estimated Fair Value	% of Total	December 31, 2005 Estimated Fair Value	% of Total
AAA	\$ 5,306,966	79.3	\$ 4,692,579	76.4
AA	665,400	10.0	654,129	10.6
A	490,960	7.3	538,570	8.8
BBB	108,021	1.6	146,325	2.4
BB	22,469	0.4	24,472	0.4
B	55,758	0.8	53,178	0.9
Lower than B	7,283	0.1	7,388	0.1
Not rated	32,704	0.5	27,112	0.4
Total	\$ 6,689,561	100.0	\$ 6,143,753	100.0

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

**Securities Lending Agreements**

The Company participates in a securities lending program under which certain of its fixed income portfolio securities are loaned to third parties, primarily major brokerage firms, for short periods of time through a lending agent. Such securities have been reclassified as Fixed maturities and short-term investments pledged under securities lending agreements, at fair value. The Company maintains control over the securities it lends, retains the earnings and cash flows associated with the loaned securities and receives a fee from the borrower for the temporary use of the securities. Collateral received, primarily in the form of cash, is required at a rate of 102% of the market value of the loaned securities (or 105% of the market value of the loaned securities when the collateral and loaned securities are denominated in non-U.S. currencies) including accrued investment income and is monitored and maintained by the lending agent. Such collateral is reinvested and is reflected as Short-term investment of funds received under securities lending agreements, at fair value. At June 30, 2006, the fair value and amortized cost of fixed maturities and short-term investments pledged under securities lending agreements were \$741.9 million and \$767.9 million, respectively, while collateral received totaled \$762.2 million at fair value and amortized cost. At December 31, 2005, the fair value and amortized cost of fixed maturities and short-term investments pledged under securities lending agreements were \$863.9 million and \$858.4 million, respectively, while collateral received totaled \$893.4 million at fair value and amortized cost.

**Investment-Related Derivatives**

The Company's investment strategy allows for the use of derivative securities. Derivative instruments may be used to enhance investment performance, replicate investment positions or manage market exposures and duration risk that would be allowed under the Company's investment guidelines if implemented in other ways. In the 2006 first quarter, the Company began using exchange traded Treasury note futures as part of the management of its stock index fund discussed below. The notional value of the net short position for Treasury note futures was \$17.1 million at June 30, 2006. The Company also began using equity futures to replicate equity investment positions in the 2006 first quarter. The fair values of those derivatives are based on quoted market prices. The notional value of the net long position for equity futures was \$69.8 million at June 30, 2006. The Company recorded net realized losses of \$1.8 million and \$1.2 million, respectively, for the 2006 second quarter and six months ended June 30, 2006 related to changes in the fair value of all futures contracts. At June 30, 2006, the carrying value and fair value of all futures contracts was a liability of \$0.2 million.

**Other Investments**

The following table details the Company's other investments:

(U.S. dollars in thousands)	(Unaudited) June 30, 2006		December 31, 2005	
	Estimated Fair Value	Cost	Estimated Fair Value	Cost
Equity securities	\$ 66,245	\$ 60,779	\$ 27,900	\$ 25,899
Investment funds	51,193	51,485	28,719	28,746
Privately held securities	14,608	6,872	13,614	5,194
Total	\$ 132,046	\$ 119,136	\$ 70,233	\$ 59,839

Other investments include (i) equity securities consisting of the Company's investments in certain stock index funds and other preferred stocks; (ii) investment funds consisting of senior secured floating rate loans and a mezzanine fund that invests in mezzanine debt and equity investments and in second lien and senior secured bank loans; and (iii) privately held securities. The Company's investment commitments related to its other investments totaled approximately \$7.5 million and \$8.4 million, respectively, at June 30, 2006 and December 31, 2005.

**Restricted Assets**

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

(U.S. dollars in thousands)	(Unaudited) June 30, 2006	December 31, 2005
Deposits with U.S. regulatory authorities	\$ 203,015	\$ 173,313
Deposits with non-U.S. regulatory authorities	17,786	17,029
Assets used for collateral or guarantees	678,128	745,084
Trust funds	81,075	69,468
Total restricted assets	\$ 980,004	\$ 1,004,894

In addition, Arch Reinsurance Ltd. ( Arch Re Bermuda ) maintains assets in trust accounts as collateral for insurance and reinsurance transactions with affiliated companies. At June 30, 2006 and December 31, 2005, such amounts approximated \$3.05 billion and \$2.77 billion, respectively.

**Net Investment Income**

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

(U.S. dollars in thousands)	(Unaudited) Three Months Ended June 30,		(Unaudited) Six Months Ended June 30,	
	2006	2005	2006	2005
Fixed maturities	\$ 77,163	\$ 54,634	\$ 146,587	\$ 105,570
Short-term investments	12,160	878	21,947	1,475
Other	3,967	379	7,851	740
Gross investment income	93,290	55,891	176,385	107,785
Investment expenses	(2,787 )	(2,231 )	(5,556 )	(4,209 )
Net investment income	\$ 90,503	\$ 53,660	\$ 170,829	\$ 103,576

**Net Realized Gains (Losses)**

Net realized gains (losses) were as follows:

(U.S. dollars in thousands)	(Unaudited) Three Months Ended June 30,		(Unaudited) Six Months Ended June 30,	
	2006	2005	2006	2005
Fixed maturities	\$ (33,492 )	\$ 2,753	\$ (37,645 )	\$ 2,473
Other investments	414	(1,305 )	3,142	(1,451 )
Other	876	657	(1,082 )	1,544
Net realized gains (losses)	\$ (32,202 )	\$ 2,105	\$ (35,585 )	\$ 2,566

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

For the 2006 second quarter and six months ended June 30, 2006, net realized losses on the Company's fixed maturities of \$33.5 million and \$37.6 million, respectively, included a provision of \$11.1 million and \$16.5 million, respectively, for declines in the market value of investments held in the Company's available for sale portfolio which were considered to be other-than-temporary, based on reviews performed during the periods. The declines in market value on such securities were primarily due to the current interest rate environment. For the 2005 second quarter and six months ended June 30, 2005, the Company did not consider any declines in the market value of investments to be other-than-temporary. The balance of \$22.4 million and \$21.1 million, respectively, in net realized losses on the Company's fixed maturities in the 2006 second quarter and six months ended June 30, 2006 resulted from the sale of securities, compared to net realized gains from the sale of fixed maturities of \$2.8 million and \$2.5 million, respectively, in the 2005 second quarter and six months ended June 30, 2005. In the 2006 and 2005 periods presented, net realized gains or losses from the sale of fixed maturities resulted from the Company's decisions to reduce credit exposure, changes in duration targets, relative value determinations and sales related to rebalancing the portfolio.

**8. Earnings Per Common Share**

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

(U.S. dollars in thousands, except share data)	(Unaudited) Three Months Ended June 30, 2006		(Unaudited) Six Months Ended June 30, 2006	
		2005		2005
<b>Basic earnings per common share:</b>				
Net income	\$ 142,887	\$ 125,992	\$ 275,177	\$ 241,884
Preferred dividends	(5,039 )		(7,706 )	
Net income available to common shareholders	137,848	125,992	267,471	241,884
Divided by:				
Weighted average common shares outstanding (1)	73,188,101	34,563,565	73,044,473	34,464,740
Basic earnings per common share	\$ 1.88	\$ 3.65	\$ 3.66	\$ 7.02
<b>Diluted earnings per common share:</b>				
Net income	\$ 142,887	\$ 125,992	\$ 275,177	\$ 241,884
Preferred dividends	(5,039 )		(7,706 )	
Net income available to common shareholders	137,848	125,992	267,471	241,884
Divided by:				
Weighted average common shares outstanding (1)	73,188,101	34,563,565	73,044,473	34,464,740
Effect of dilutive securities:				
Series A convertible preference shares		37,327,502		37,329,441
Warrants		51,530		50,020
Nonvested restricted shares	457,097	413,040	453,448	421,222
Stock options	2,510,240	2,056,916	2,516,898	1,984,305
Weighted average common shares and common share equivalents outstanding diluted	76,155,438	74,412,553	76,014,819	74,249,728
Diluted earnings per common share	\$ 1.81	\$ 1.69	\$ 3.52	\$ 3.26

(1) For the 2005 second quarter and six months ended June 30, 2005, basic weighted average common shares and common share equivalents outstanding excluded 37,327,502 and 37,329,441 series A convertible preference shares, respectively. Such shares were included in the diluted weighted average common shares and common share equivalents outstanding. During the 2005 fourth quarter, all remaining series A convertible preference shares were converted into an equal number of common shares.

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. The number of excluded stock options were 996,643 and 9,368, respectively, for the 2006 and 2005 second quarters and 752,430 and 19,765, respectively, for the six months ended June 30, 2006 and 2005.

## 9. 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 assurance from the Minister of Finance in Bermuda under the Exempted Undertakings Tax Protection Act of 1966 that, in the event that any legislation is enacted in Bermuda imposing any tax computed on profits, income, gain or appreciation on any capital asset, or any tax in the nature of estate duty or inheritance tax, such tax will not be applicable to ACGL or any of its operations until March 28, 2016. This assurance 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 will be subject to U.S. federal income tax only to the extent that it derives 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 will be subject to a withholding tax on dividends from U.S. investments and interest from certain U.S. taxpayers. ACGL does not consider itself (or its non-U.S. subsidiaries) to be engaged in a trade or business within the U.S. and, consequently, does not expect it or such non-U.S. subsidiaries to be subject to direct U.S. income taxation. However, because there is uncertainty as to the activities which constitute being engaged in a trade or business within the United States, there can be no assurances that the U.S. Internal Revenue Service will not contend successfully that ACGL or its non-U.S. subsidiaries are engaged in a trade or business in the United States. If ACGL or any of its non-U.S. subsidiaries were subject to U.S. income tax, ACGL's shareholders' equity and earnings could be materially adversely affected. ACGL's U.S. subsidiaries are subject to U.S. income taxes on their worldwide income. ACGL's U.K. subsidiaries are subject to U.K. corporation tax on their worldwide income.

ACGL changed its legal domicile from the United States to Bermuda in November 2000. Some U.S. insurance companies have been lobbying Congress to pass legislation intended to eliminate certain perceived tax advantages of U.S. insurance companies with Bermuda affiliates resulting principally from reinsurance between or among U.S. insurance companies and their Bermuda affiliates. This legislation, if passed, and other changes in U.S. tax laws, regulations and interpretations thereof to address these issues could materially adversely affect the Company.

The Company's income tax provision resulted in an effective tax rate on income before income taxes of 9.1% and 5.8%, respectively, for the 2006 and 2005 second quarters, and 8.6% and 6.7%, respectively, for the six months ended June 30, 2006 and 2005. The Company's effective tax rate, which is based upon the expected annual effective tax rate, may fluctuate from period to period based on the relative mix of income reported by jurisdiction due primarily to the varying tax rates in each jurisdiction. The Company's remaining valuation allowance related to its deferred income tax assets is \$1.4 million at June 30, 2006.

**10. Transactions with Related Parties**

In connection with the Company's information technology initiative in 2002, the Company entered into arrangements with two software companies, which provide document management systems and information and research tools to insurance underwriters, in which John Pasquesi, Vice Chairman of ACG's board of directors, holds a minority ownership interest. One of the agreements was terminated in July 2005, and the other arrangement is variable based on usage. The Company made payments under such arrangement of approximately \$0.2 million and \$0.3 million, respectively, for the 2006 second quarter and six months ended June 30, 2006, compared to \$0.1 million and \$0.2 million, respectively, for the 2005 second quarter and six months ended June 30, 2005.

**11. Contingencies Relating to the Sale of Prior Reinsurance Operations**

On May 5, 2000, the Company sold the prior reinsurance operations of Arch Reinsurance Company ( Arch Re U.S. ) pursuant to an agreement entered into as of January 10, 2000 with Folksamerica Reinsurance Company and Folksamerica Holding Company (collectively, Folksamerica ). Folksamerica Reinsurance Company assumed Arch Re U.S.'s liabilities under the reinsurance agreements transferred in the asset sale and Arch Re U.S. transferred to Folksamerica Reinsurance Company assets estimated in an aggregate amount equal in book value to the book value of the liabilities assumed. The Folksamerica transaction was structured as a transfer and assumption agreement (and not reinsurance) and, accordingly, the loss reserves (and any related reinsurance recoverables) relating to the transferred business are not included as assets or liabilities on the Company's balance sheet. Folksamerica assumed Arch Re U.S.'s rights and obligations under the reinsurance agreements transferred in the asset sale. The reinsureds under such agreements were notified that Folksamerica had assumed Arch Re U.S.'s obligations and that, unless the reinsureds object to the assumption, Arch Re U.S. would be released from its obligations to those reinsured. None of such reinsureds objected to the assumption. However, Arch Re U.S. will continue to be liable under those reinsurance agreements if the notice is found not to be an effective release by the reinsureds. Folksamerica has agreed to indemnify the Company for any losses arising out of the reinsurance agreements transferred to Folksamerica Reinsurance Company in the asset sale. However, in the event that Folksamerica refuses or is unable to perform its obligations to the Company, Arch Re U.S. may incur losses relating to the reinsurance agreements transferred in the asset sale. Folksamerica's A.M. Best rating was A- (Excellent) at June 30, 2006.

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

## 12. Debt and Financing Arrangements

### *Senior Notes*

On May 4, 2004, ACGL completed a public offering of \$300 million principal amount of 7.35% senior notes ( Senior Notes ) due May 1, 2034 and received net proceeds of \$296.4 million. ACGL used \$200 million of the net proceeds to repay all amounts outstanding under a revolving credit agreement. The Senior Notes are ACGL's senior unsecured obligations and rank equally with all of its existing and future senior unsecured indebtedness. Interest payments on the Senior Notes are due on May 1st and November 1st of each year. ACGL may redeem the Senior Notes at any time and from time to time, in whole or in part, at a make-whole redemption price. Interest expense on the Senior Notes was approximately \$5.5 million for the 2006 and 2005 second quarters, and \$11.0 million for the six months ended June 30, 2006 and 2005.

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

On November 29, 2005, the Company entered into a five-year agreement, as amended on April 18, 2006, ( Credit Agreement ) for a \$300 million unsecured revolving loan and letter of credit facility and a \$500 million secured letter of credit facility. The \$300 million unsecured revolving loan is also available for the issuance of unsecured letters of credit up to \$100 million for Arch Re U.S. Borrowings of revolving loans may be made by ACGL and Arch Re U.S. at a variable rate based on LIBOR or an alternative base rate at the option of the Company. Secured letters of credit are available for issuance on behalf of the Company's U.S.-domiciled insurance and reinsurance subsidiaries and, following the amendment in April 2006, Arch Insurance Company (Europe) Limited.

Issuance of letters of credit and borrowings under the Credit Agreement are subject to the Company's compliance with certain covenants and conditions, including absence of a material adverse change. These covenants require, among other things, that the Company maintain a debt to shareholders' equity ratio of not greater than 0.35 to 1 and shareholders' equity in excess of \$1.5 billion plus 25% of future aggregate net income for each semi-annual period (not including any future net losses) beginning after June 30, 2005 and 25% of future aggregate proceeds from the issuance of common or preferred equity, that the Company maintain minimum unencumbered cash and investment grade securities in the amount of \$300 million and that the Company's principal insurance and reinsurance subsidiaries maintain at least a B++ rating from A.M. Best. In addition, certain of the Company's subsidiaries which are parties to the Credit Agreement are required to maintain minimum shareholders' equity levels. The Company was in compliance with all covenants contained in the Credit Agreement at June 30, 2006. The Credit Agreement expires on November 29, 2010.

Including the secured letter of credit portion of the Credit Agreement and another letter of credit facility (together, the LOC Facilities ), the Company has access to letter of credit facilities for up to a total of \$1.0 billion. The principal purpose of the LOC Facilities is to issue, as required, evergreen standby letters of credit in favor of primary insurance or reinsurance counterparties with which it has entered into reinsurance arrangements to ensure that such counterparties are permitted to take credit for reinsurance obtained from the Company's reinsurance subsidiaries in United States jurisdictions where such subsidiaries are not licensed or otherwise admitted as an insurer, as required under insurance regulations in the United States, and to comply with requirements of Lloyd's of London in connection with qualifying quota share and other arrangements. The amount of letters of credit issued is driven by, among other things, the timing and payment of catastrophe losses, loss development of existing reserves, the payment pattern of such reserves, the further expansion of the Company's business and the loss experience of such business. When issued, certain letters of credit are secured by a portion of the Company's investment portfolio. In addition, the LOC Facilities also require the maintenance of certain covenants, which the Company was in compliance with at June 30, 2006. At such date, the Company had approximately \$549.4 million in outstanding letters of credit under the LOC Facilities, which were secured by investments totaling \$602.3 million. The other letter of credit facility was amended and restated in January 2006. It is anticipated that the LOC Facilities will be renewed (or replaced) on expiry, but such renewal (or



replacement) will be subject to the availability of credit from banks which the Company utilizes. In addition to letters of credit, the Company has and may establish insurance trust accounts in the U.S. and Canada to secure its reinsurance amounts payable as required.

### 13. Commitments and Contingencies

#### *Variable Interest Entities*

The Company concluded that, under FASB Interpretation No. 46R ( FIN 46R ), Consolidation of Variable Interest Entities, that it is required to consolidate the assets, liabilities and results of operations (if any) of a certain managing general agency in which one of its subsidiaries has an investment. Such agency ceased producing business in 1999 and is currently running-off its operations. Based on current information, there are no assets or liabilities of such agency required to be reflected on the face of the Company's consolidated financial statements that are not, or have not been previously, otherwise reflected therein.

On December 29, 2005, Arch Re Bermuda, the Company's Bermuda-based reinsurer, entered into a quota share reinsurance treaty with Flatiron Re Ltd., a newly-formed Bermuda reinsurance company, pursuant to which Flatiron Re Ltd. is assuming a 45% quota share (the Treaty) of certain lines of property and marine business underwritten by Arch Re Bermuda for unaffiliated third parties for the 2006 and 2007 underwriting years (January 1, 2006 to December 31, 2007). The quota share is subject to decrease by Arch Re Bermuda under certain circumstances. In addition, in certain circumstances, Flatiron Re Ltd. may extend at its option the coverage provided by the Treaty to Arch Re Bermuda's 2008 underwriting year. Effective June 28, 2006, the parties amended the Treaty to increase the percentage ceded to Flatiron Re Ltd. from 45% to 70% of all covered business bound by Arch Re Bermuda from (and including) June 28, 2006 until (and including) August 15, 2006 provided such business does not incept beyond September 30, 2006. The ceding percentage for all business bound outside of this period will continue to be 45%, subject to adjustment as provided under the Treaty. As a result of the terms of the Treaty, the Company has determined that Flatiron Re Ltd. is a variable interest entity. However, Arch Re Bermuda is not the primary beneficiary of Flatiron Re Ltd. and, as such, the Company is not required to consolidate the assets, liabilities and results of operations of Flatiron Re Ltd. per FIN 46R.

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

Arch Re Bermuda pays to Flatiron Re Ltd. a reinsurance premium in the amount of the ceded percentage of the original gross written premium on the business reinsured with Flatiron Re Ltd. less a ceding commission, which includes a reimbursement of direct acquisition expenses as well as a commission to Arch Re Bermuda for generating the business. The Treaty also provides for a profit commission to Arch Re Bermuda based on the

underwriting results for the 2006 and 2007 underwriting years on a cumulative basis. Arch Re Bermuda records such profit commission based on underwriting experience recorded each quarter. As a result, the profit commission arrangement with Flatiron Re Ltd. may increase the volatility of our reported results of operations on both a quarterly and annual basis. For the 2006 second quarter and six months ended June 30, 2006, \$77.7 million and \$160.1 million, respectively, of premiums written and \$25.3 million and \$43.6 million, respectively, of premiums earned were ceded to Flatiron Re Ltd. by Arch Re Bermuda.

#### ***Guarantee and Other***

In the 2005 second quarter, the Company agreed to provide a guarantee, through the issuance of a standby letter of credit in the amount of \$6.0 million (the *Guarantee*) for the benefit of a commercial bank, to assist the principals of an agency to obtain a loan to purchase the agency from its prior owner. The agency loan is payable over a seven year term, and the *Guarantee* will be outstanding until such time as the loan is repaid in full. The bank has received payments on the agency loan that reduced the *Guarantee* to \$4.95 million at June 30, 2006. The fair value of the *Guarantee* included as a liability in the Company's balance sheet was \$0.3 million at June 30, 2006 and December 31, 2005.

In addition, the Company agreed to extend a \$10.0 million letter of credit through July 1, 2006 (*Extension*) for the benefit of a Lloyd's of London syndicate (*Syndicate*) which was originally issued in connection with a reinsurance treaty covering the 2002 year of account. The Company received \$0.5 million of fees in December 2004 and \$0.2 million in December 2005 in compensation for the *Extension*. To the extent that Lloyd's of London draws down on the letter of credit on behalf of the *Syndicate* for any reason not related to the Company's obligations under the 2002 year of account, the *Syndicate* will reimburse the Company for the amount drawn down plus interest at 6.0% per annum. The letter of credit was canceled in July 2006.

#### **14. Legal Proceedings**

The Company, in common with the insurance industry in general, is subject to litigation and arbitration in the normal course of its business. As of June 30, 2006, the Company was not a party to any material litigation or arbitration other than as a part of the ordinary course of business, none of which is expected by management to have a significant adverse effect on the Company's results of operations and financial condition and liquidity.

In 2003, the former owners of American Independent Insurance Holding Company (*American Independent*) commenced an action against ACGL, American Independent and certain of American Independent's directors and officers and others seeking unspecified damages relating to the reorganization agreement pursuant to which the Company acquired American Independent in 2001. The reorganization agreement provided that, as part of the consideration for the stock of American Independent, the former owners would have the right to receive a limited, contingent payment from the proceeds, if any, from certain pre-existing lawsuits that American Independent had brought as plaintiff prior to its acquisition by the Company. The former owners alleged, among other things, that the defendants entered into the agreement without intending to honor their commitments under the agreement and are liable for securities and common law fraud and breach of contract. In December 2004, the Company sold American Independent, PSIC and affiliated entities, which conducted its nonstandard automobile insurance operations, to a third party. Under the terms of the sale agreement, ACGL and certain of its affiliates retained the liabilities (if any) relating to the foregoing matters. ACGL and the other defendants filed a motion to dismiss all claims. That motion was granted on March 23, 2005, and the plaintiffs were allowed until April 15, 2005 to amend their complaint. Although they did attempt to amend the complaint, they did not timely and properly do so, and, on April 26, 2005, judgment was entered dismissing the action with prejudice. The plaintiffs thereafter moved to vacate the judgment and to allow retroactively the filing of their second amended complaint; that motion was granted. The plaintiffs filed a new pleading in October 2005. ACGL and the other defendants again moved to dismiss all claims, and those motions are now pending before the court. At the request of the judge, oral arguments were made on June 26, 2006.

Although no assurances can be made as to the resolution of such motions or of the plaintiffs' claims, management does not believe that any of the claims are meritorious.

#### **15. Recent Accounting Pronouncements**

On July 13, 2006, the FASB issued FASB Interpretation No. 48 ( FIN No. 48 ), Accounting for Uncertainty in Income Taxes, an interpretation of FASB Statement No. 109, Accounting for Income Taxes. FIN No. 48 prescribes a recognition threshold and measurement attribute for the financial statement recognition and measurement of a tax position taken or expected to be taken in a tax return. FIN No. 48 also provides guidance on derecognition, classification, interest and penalties, accounting in interim periods, disclosure and transition and is effective for fiscal years beginning after December 15, 2006. The Company is currently evaluating this pronouncement.

#### **16. Subsequent Event Transaction with a Related Party**

In July 2006, the Company committed to invest up to \$25 million in Aeolus LP ( Aeolus ), which initially will operate as an unrated reinsurance platform that will provide property catastrophe protection to insurers and reinsurers on both an ultimate net loss and industry loss warranty basis. Of such amount, \$6.25 million was funded on July 28, 2006. In return for its investment, the Company received an approximately 5% preferred interest in Aeolus and a pro rata share of certain founders' interests. A fund affiliated with Warburg Pincus has committed to fund up to \$475 million in Aeolus. Funds affiliated with Warburg Pincus owned 31.2% of the Company's outstanding voting shares as of December 31, 2005. The Company made the commitment on the same economic terms as Warburg Pincus. In addition, one of the founders of Aeolus is Peter Appel, former President and CEO and a former director of the Company. Marc Grandisson, the Chairman and CEO of the Company's Worldwide Reinsurance Group, has been appointed to serve on the initial Board of Directors of Aeolus.

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

The following discussion and analysis contains forward-looking statements which involve inherent risks and uncertainties. All statements other than statements of historical fact are forward-looking statements. These statements are based on our current assessment of risks and uncertainties. Actual results may differ materially from those expressed or implied in these statements. Important factors that could cause actual events or results to differ materially from those indicated in such statements are discussed in this report, including the section entitled "Cautionary Note Regarding Forward Looking Statements," and in our periodic reports filed with the Securities and Exchange Commission (SEC). For additional information regarding our business and operations, please also refer to our Annual Report on Form 10-K/A for the year ended December 31, 2005, including our audited consolidated financial statements and related notes and the sections entitled "Risk Factors" and "Management's Discussion and Analysis of Financial Condition and Results of Operation - Certain Matters Which May Materially Affect Our Results of Operations and/or Financial Condition."

**General**

*Overview*

Arch Capital Group Ltd. (ACGL and, together with its subsidiaries, we or us) is a Bermuda public limited liability company with approximately \$3.32 billion in capital at June 30, 2006 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.

The worldwide insurance and reinsurance industry is highly competitive and has traditionally been subject to an underwriting cycle in which a hard market (high premium rates, restrictive underwriting standards, as well as terms and conditions, and underwriting gains) is eventually followed by a soft market (low premium rates, relaxed underwriting standards, as well as broader terms and conditions, and underwriting losses). Insurance market conditions may affect, among other things, the demand for our products, our ability to increase premium rates, the terms and conditions of the insurance policies we write, changes in the products offered by us or changes in our business strategy.

The financial results of the insurance and reinsurance industry are influenced by factors such as the frequency and/or severity of claims and losses, including natural disasters or other catastrophic events, variations in interest rates and financial markets, changes in the legal, regulatory and judicial environments, inflationary pressures and general economic conditions. These factors influence, among other things, the demand for insurance or reinsurance, the supply of which is generally related to the total capital of competitors in the market.

In general, market conditions improved during 2002 and 2003 in the insurance and reinsurance marketplace. This reflected improvement in pricing, terms and conditions following significant industry losses arising from the events of September 11th, as well as the recognition that intense competition in the late 1990s led to inadequate pricing and overly broad terms, conditions and coverages. Such industry developments resulted in poor financial results and erosion of the industry's capital base. Consequently, many established insurers and reinsurers reduced their participation in, or exited from, certain markets and, as a result, premium rates escalated in many lines of business. These developments provided relatively new insurers and reinsurers, like us, with an opportunity to provide needed underwriting capacity. Beginning in late 2003 and continuing through 2006, additional capacity emerged in many classes of business and, consequently, premium rate increases have decelerated significantly and, in many classes of business, premium rates have decreased. However, we believe that we are still able to write insurance and reinsurance business at what we believe to be attractive rates.

In addition, the weather-related catastrophic events that occurred in the second half of 2005 have resulted in substantial improvements in market conditions in property and certain marine business. We are seeking to increase our writings in these lines of business and, as a result, these lines, which are volatile, may represent a larger proportion of our overall book of business in future periods, which may increase the volatility in our results of operations. In order to support this expansion, we sold \$325 million of non-cumulative preferred shares in 2006 and signed a quota-share reinsurance treaty with Flatiron Re Ltd., a dedicated reinsurance vehicle, which will allow us to increase our participation in property and marine lines without significantly increasing our probable maximum loss. In response to current market conditions, our gross and net writings in the property and marine lines of business in the 2006 periods represented a larger proportion of our overall book of business than in the 2005 periods.

#### **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 Annual Report on Form 10-K/A for the year ended December 31, 2005. That information is hereby supplemented as follows:

##### ***Share-Based Compensation***

On January 1, 2006, we adopted the fair value method of accounting for share-based awards using the modified prospective method of transition as described in Financial Accounting Standards Board ( FASB ) Statement No. 123 (revised 2004), Share-Based Payment ( SFAS No. 123(R) ). Under SFAS No.123(R), the estimated grant date fair value adjusted for assumed forfeitures of share-based compensation related to stock option awards is recognized as compensation expense over the requisite service period of the grant. Under the fair value method of accounting pursuant to SFAS No. 123(R), the fair value of restricted share and unit awards is measured by the grant date price of our shares. No value is attributed to awards that employees forfeit because they fail to satisfy vesting conditions. As such, the number of shares granted is reduced by assumed forfeitures and adjusted based on actual forfeitures until vesting. Such expense is amortized over the requisite service period of the related awards. The share-based compensation expense associated with awards that have graded vesting features and vest based on service conditions only (i) granted after the effective date of adoption is calculated on a straight-line basis over the requisite service periods of the related awards and (ii) granted prior to the effective date of adoption and that remain unvested as of the date of adoption is calculated on a graded-vesting basis as prescribed under FASB Interpretation No. 28, Accounting for Stock Appreciation Rights and Other Variable Stock Option or Award Plans an interpretation of APB Opinions No. 15 and 25, over the remaining requisite service periods of the related awards.

Under the modified prospective method of transition, compensation expense is recognized beginning with the effective date of adoption for all share-based payments (i) granted after the effective date of adoption and (ii) granted prior to the effective date of adoption and that remain unvested on the date of adoption. Under the modified prospective method of transition, we are not required to restate our prior period financial statements to reflect expensing of share-based compensation under SFAS No.123(R). Therefore, results for the 2006 periods presented are not comparable to results for the 2005 periods.

Under SFAS No. 123(R), we use the Black-Scholes option pricing model to estimate the fair value of the share-based option awards as of the grant date. The Black-Scholes model, by its design, is highly complex, and requires judgment in determining key data inputs including estimating the risk free interest rate, expected life of the option and expected volatility rate. In addition, judgment is also required in estimating the amount of share-based awards that are expected to be forfeited. The primary data inputs with the greatest degree of judgment are the estimated lives of the share-based awards and the estimated volatility of our stock price. The Black-Scholes model is highly sensitive to changes in these two data inputs. In our process for estimating the fair value of stock

options granted, we believe that we have made a good faith fair value estimate in accordance with the provisions of SFAS No. 123(R) as well as guidance from the SEC as contained in Staff Accounting Bulletin No. 107 in a way that is designed to take into account the assumptions that underlie the instrument's value that marketplace participants would reasonably make. If actual results differ significantly from these estimates, share-based compensation expense and our results of operations could be materially impacted.

See Results of Operations Share-Based Compensation below and note 2, Share-Based Compensation, of the notes accompanying our consolidated financial statements for more information about the adoption of SFAS No. 123(R).

#### ***Investment-Related Derivatives***

Under SFAS No. 133, Accounting for Derivative Instruments and Hedging Activities (SFAS No. 133), as amended on January 1, 2001, all derivative financial instruments, including embedded derivative instruments, are required to be recognized as either assets or liabilities in the consolidated balance sheets and measured at fair value. The accounting for gains and losses associated with changes in the fair value of a derivative and the effect on the consolidated financial statements depends on whether it has been designated and qualifies as part of a hedging relationship and whether the hedge is highly effective in achieving offsetting changes in the fair value of the asset or liability hedged.

Our investment strategy allows for the use of derivative instruments. We utilize various derivative instruments such as futures contracts as part of the management of our stock index fund investments and to replicate equity investment positions. Derivative instruments may be used to enhance investment performance, replicate investment positions or manage market exposures and duration risk that would be allowed under our investment guidelines if implemented in other ways. Pursuant to SFAS No. 133, these instruments, which have no hedging designation, are recognized as assets and liabilities in our balance sheets at fair market value and changes in fair value are included in net realized gains and losses in our results of operations. See note 7, Investment Information Investment-Related Derivatives, of the notes accompanying our consolidated financial statements for more information about our use of derivative instruments.

#### ***Recent Accounting Pronouncements***

On July 13, 2006, the FASB issued FASB Interpretation No. 48 (FIN No. 48), Accounting for Uncertainty in Income Taxes, an interpretation of FASB Statement No. 109, Accounting for Income Taxes. FIN No. 48 prescribes a recognition threshold and measurement attribute for the financial statement recognition and measurement of a tax position taken or expected to be taken in a tax return. FIN No. 48 also provides guidance on derecognition, classification, interest and penalties, accounting in interim periods, disclosure and transition and is effective for fiscal years beginning after December 15, 2006. We are currently evaluating this pronouncement.

#### **Results of Operations Three Months Ended June 30, 2006 and 2005**

The following table sets forth net income available to common shareholders and earnings per common share data:

(U.S. dollars in thousands, except share data)	Three Months Ended	
	June 30, 2006	2005
Net income available to common shareholders	\$ 137,848	\$ 125,992
Diluted net income per common share	\$ 1.81	\$ 1.69
Diluted weighted average common shares and common share equivalents outstanding	76,155,438	74,412,553

Net income available to common shareholders was \$137.8 million for the 2006 second quarter, compared to \$126.0 million for the 2005 second quarter. The increase in net income was primarily due to growth in investment income and an increase in underwriting income, as discussed in

Segment Information below. Our net income available to common shareholders represented a 21.0% annualized return on average common equity for both the 2006 and 2005 second quarters. For purposes of computing return on average common equity, average common equity has been calculated as the average of common shareholders' equity outstanding at the beginning and ending of each period. Basic earnings per share data has not been presented or discussed herein as such calculation for the 2005 periods presented does not reflect the significant number of series A convertible preference shares which were outstanding. During the 2005 fourth quarter, all remaining series A convertible preference shares were converted into an equal number of common shares. As such, the comparison of basic earnings per share for the 2006 and 2005 periods presented is not meaningful.

Diluted weighted average common shares and common share equivalents outstanding, used in the calculation of net income per common share, was 1.7 million shares, or 2.3%, higher in the 2006 second quarter than in the 2005 second quarter. The higher level was primarily due to increases in the assumed dilutive effects of stock options and nonvested restricted stock calculated using the treasury stock method. Under the treasury stock method, the assumed dilutive impact of options and nonvested stock on diluted weighted average shares outstanding increases as the market price of our common shares increases.

### Segment Information

We classify our businesses into two underwriting segments—insurance and reinsurance—and a corporate and other segment (non-underwriting). SFAS No. 131, Disclosures About Segments of an Enterprise and Related Information, requires certain disclosures about operating segments in a manner that is consistent with how management evaluates the performance of the segment. For a description of our underwriting segments, refer to note 4, Segment Information, of the notes accompanying our consolidated financial statements. Management measures segment performance based on underwriting income or loss.

#### Insurance Segment

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

(U.S. dollars in thousands)	Three Months Ended		
	June 30, 2006	2005	
Gross premiums written	\$ 647,817	\$ 577,420	
Net premiums written	409,302	373,672	
Net premiums earned	\$ 385,877	\$ 354,086	
Fee income	1,253	1,003	
Losses and loss adjustment expenses	(251,172 )	(229,971 )	
Acquisition expenses, net	(41,275 )	(35,095 )	
Other operating expenses	(63,689 )	(57,543 )	
Underwriting income	\$ 30,994	\$ 32,480	
<b>Underwriting Ratios</b>			
Loss ratio	65.1	% 64.9	%
Acquisition expense ratio (1)	10.5	% 9.7	%
Other operating expense ratio	16.5	% 16.3	%
Combined ratio	92.1	% 90.9	%

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





*Underwriting Income.* The insurance segment's underwriting income was \$31.0 million for the 2006 second quarter, compared to \$32.5 million for the 2005 second quarter. The combined ratio for the insurance segment was 92.1% for the 2006 second quarter, compared to 90.9% for the 2005 second quarter. The components of the insurance segment's underwriting income are discussed below.

*Premiums Written.* Gross premiums written by the insurance segment were \$647.8 million for the 2006 second quarter, compared to \$577.4 million for the 2005 second quarter, and ceded premiums written were 36.8% of gross premiums written for the 2006 second quarter, compared to 35.3% for the 2005 second quarter. The increase in the percentage of ceded premiums written primarily reflects a higher level of reinsurance costs related to property-catastrophe protection in the 2006 second quarter than in the 2005 second quarter. Net premiums written by the insurance segment were \$409.3 million for the 2006 second quarter, compared to \$373.7 million for the 2005 second quarter. Roughly half of the growth in net premiums written was in construction and surety business, primarily due to growth in large deductible construction accounts and surety business. The balance of the growth was generated from increases in professional liability and executive assurance lines, primarily as a result of growth in policies written, and property business, as a result of rate increases which were tempered by the higher reinsurance costs noted above. For information regarding net premiums written produced by major line of business and geographic location, refer to note 4, Segment Information, of the notes accompanying our consolidated financial statements.

*Net Premiums Earned.* Net premiums earned for the insurance segment were \$385.9 million for the 2006 second quarter, compared to \$354.1 million for the 2005 second quarter, and generally reflect changes in net premiums written over the previous five quarters, including the mix and type of business written.

*Losses and Loss Adjustment Expenses.* The loss ratio for the insurance segment was 65.1% for the 2006 second quarter, compared to 64.9% for the 2005 second quarter. The insurance segment's results for the 2006 second quarter included two significant losses totaling \$18.3 million, while the 2005 second quarter did not include significant large loss activity. The net impact of the change in large loss activity was a 4.7 point increase in the 2006 second quarter loss ratio. The 2006 second quarter included \$14.8 million of estimated net favorable development in prior year loss reserves, compared to \$8.0 million of estimated net adverse development in the 2005 second quarter. The net impact of the change in estimated net prior year development was a 5.9 point decrease in the 2006 second quarter loss ratio. The estimated net favorable development in the 2006 second quarter was primarily in medium and long-tail lines, mainly executive assurance and construction, resulting from a reevaluation of estimated ultimate losses due to better than expected claims activity, partially offset by \$6.5 million of adverse development on short-tail business which included \$0.9 million related to the 2004 and 2005 hurricanes.

In addition to the use of individual per risk and inuring reinsurance contracts to limit exposure, the insurance segment had in force during 2005 a catastrophe reinsurance program which provides coverage for certain property catastrophe-related losses occurring during the contract period equal to a maximum of 95% of the first \$200 million in excess of a \$50 million retention per occurrence of such losses. Estimated losses related to Hurricane Katrina and Hurricane Wilma have exceeded the per occurrence retention. Based on current estimates, the insurance segment expects to recover approximately \$124.7 million through such coverage for Hurricane Katrina and \$11.8 million for Hurricane Wilma with approximately \$57.3 million of remaining available coverage for Hurricane Katrina and \$187.6 million of remaining available coverage for Hurricane Wilma should the actual amount of losses ultimately attributable to such events exceed current estimates. Amounts shown for Hurricane Katrina are net of reinstatement premiums.

Estimates for the insurance segment related to Hurricanes Katrina, Rita and Wilma and other catastrophic events that occurred in the second half of 2005 are based on currently available information derived from modeling techniques, industry assessments of exposure, preliminary claims information obtained from its clients and brokers to date and a review of its in-force contracts. Actual losses from these events, as well as any additional catastrophic events which may occur, may vary materially from the insurance segment's estimates

due to the inherent uncertainties in making such determinations resulting from several factors, including the preliminary nature of the available information, the potential inaccuracies and inadequacies in the data provided by clients and brokers, the modeling techniques and the application of such techniques, the contingent nature of business interruption exposures, the effects of any resultant demand surge on claims activity and attendant coverage issues. In addition, actual losses may increase if reinsurers fail to meet their obligations to the insurance segment or the reinsurance protections purchased by the insurance segment are exhausted or are otherwise unavailable.

Beginning in the 2006 first quarter, our insurance operations have in effect a reinsurance program which provides coverage for certain property catastrophe-related losses occurring during 2006 equal to a maximum of 92% of the first \$325 million in excess of a \$75 million retention per occurrence of such losses. The cost of the coverage was substantially higher than in 2005.

*Underwriting Expenses.* The underwriting expense ratio for the insurance segment was 27.0% in the 2006 second quarter, compared to 26.0% in the 2005 second quarter. The acquisition expense ratio was 10.5% for the 2006 second quarter, compared to 9.7% for the 2005 second quarter. The acquisition expense ratio is influenced by, among other things, (1) the amount of ceding commissions received from unaffiliated reinsurers and (2) the amount of business written on a surplus lines (non-admitted) basis and (3) the amount of reinstatement premiums recorded in the period. The increase in the acquisition expense ratio was primarily due to changes in the mix of business. The insurance segment's other operating expense ratio was 16.5% for the 2006 second quarter, compared to 16.3% for the 2005 second quarter.

#### *Reinsurance Segment*

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

(U.S. dollars in thousands)	Three Months Ended		
	June 30, 2006	2005	
Gross premiums written	\$ 499,241	\$ 376,803	
Net premiums written	385,256	350,056	
Net premiums earned	\$ 411,573	\$ 385,806	
Fee income	2,215	22	
Losses and loss adjustment expenses	(211,083 )	(213,947 )	
Acquisition expenses, net	(107,306 )	(113,443 )	
Other operating expenses	(14,179 )	(11,905 )	
Underwriting income	\$ 81,220	\$ 46,533	
<b>Underwriting Ratios</b>			
Loss ratio	51.3	% 55.5	%
Acquisition expense ratio	26.1	% 29.4	%
Other operating expense ratio	3.4	% 3.1	%
Combined ratio	80.8	% 88.0	%

*Underwriting Income.* The reinsurance segment's underwriting income was \$81.2 million for the 2006 second quarter, compared to \$46.5 million for the 2005 second quarter. The combined ratio for the reinsurance segment was 80.8% for the 2006 second quarter, compared to 88.0% for the 2005 second quarter. The components of the reinsurance segment's underwriting income are discussed below.

*Premiums Written.* Gross premiums written by the reinsurance segment were \$499.2 million in the 2006 second quarter, compared to \$376.8 million for the 2005 second quarter. A substantial portion of the growth came in property and marine lines, of which \$77.7 million of premiums were ceded by Arch Reinsurance Ltd.

( Arch Re Bermuda ), the reinsurance segment's Bermuda operations, to Flatiron Re Ltd. under a quota-share reinsurance treaty, as previously disclosed. Under such treaty, which was effective January 1, 2006, Flatiron Re Ltd. is assuming a percentage of certain lines of property and marine business underwritten by Arch Re Bermuda for unaffiliated third parties. In addition, during the 2006 second quarter, the reinsurance segment recorded \$21.5 million of additional premiums related to certain treaties written in 2002 to 2004, based on new information received from ceding companies, compared to \$23.8 million in the 2005 second quarter relating to treaties written in 2002 and 2003. Of the 2005 second quarter amount, \$11.3 million related to an adjustment to gross and net premiums written, premiums earned and acquisition expenses which had no effect on underwriting income.

Ceded premiums written by the reinsurance segment were 22.8% of gross premiums written for the 2006 second quarter, compared to 7.1% for the 2005 second quarter. The higher ceded percentage in the 2006 second quarter primarily resulted from the \$77.7 million of premiums written ceded (\$25.3 million on an earned basis) to Flatiron Re Ltd. noted above.

Net premiums written by the reinsurance segment were \$385.3 million for the 2006 second quarter, compared to \$350.1 million for the 2005 second quarter. Continued growth in international property and marine lines, along with a higher level of U.S. casualty business, was offset by a reduction in international casualty and other business. The growth in property and marine lines resulted from higher rates and an increase in exposure and resulted from current market opportunities as catastrophe-exposed property and marine lines have continued to provide attractive opportunities in the wake of the 2005 storms. The reduction in international casualty business was primarily in response to market conditions for European business. For information regarding net premiums written produced by major line and type of business and geographic location, refer to note 4, Segment Information, of the notes accompanying our consolidated financial statements.

*Net Premiums Earned.* Net premiums earned for our reinsurance segment were \$411.6 million for the 2006 second quarter, compared to \$385.8 million for the 2005 second quarter, and generally reflect changes in net premiums written over the previous five quarters, including the mix and type of business written.

*Fee Income.* The reinsurance segment recorded \$2.2 million of fee income for the 2006 second quarter. Such amount related to certain assumed reinsurance contracts which were deemed, under GAAP, not to transfer insurance risk, and are accounted for using the deposit method of accounting.

*Losses and Loss Adjustment Expenses.* Underwriting income for the reinsurance segment in the 2006 second quarter included estimated net favorable development in prior year loss reserves, net of related adjustments, of \$3.3 million. Such amount consisted of \$12.8 million of favorable development, primarily in short-tail lines, partially offset by \$9.5 million of adverse development related to the 2004 and 2005 hurricanes and the European floods. For the 2005 second quarter, underwriting income benefited from estimated net favorable development in prior year loss reserves, net of related adjustments, of \$13.5 million.

The loss ratio for the reinsurance segment was 51.3% for the 2006 second quarter, compared to 55.5% for the 2005 second quarter. The reinsurance segment's results reflected a low level of catastrophic activity in the period which, combined with a higher level of net premiums earned for property business in the period, contributed to the significant reduction in the 2006 second quarter loss ratio. Partially offsetting this, as noted above, the 2006 second quarter included estimated net favorable development in prior year loss reserves of \$2.4 million, compared to estimated net favorable development in the 2005 second quarter of \$15.1 million. The net impact of the change in estimated net prior year development was a 3.1 point increase in the 2006 second quarter loss ratio.

The reinsurance segment previously purchased a catastrophe reinsurance program which provides up to \$55 million of coverage in excess of certain deductibles for any one occurrence and \$110 million in the aggregate annually, for certain catastrophe-related losses worldwide occurring during the period from May 2005 through

April 2006. Based on current estimates, the reinsurance segment expects to recover approximately \$92.3 million, net of reinstatement premiums, related to the 2005 catastrophic events. The recovery represents full usage of the available coverage under the reinsurance program, and the coverage was not renewed upon expiration. The reinsurance segment's estimates related to Hurricanes Katrina, Rita and Wilma and other catastrophic events that occurred in the second half of 2005 are based on currently available information derived from modeling techniques, industry assessments of exposure, preliminary claims information obtained from its clients and brokers to date and a review of its in-force contracts. Actual losses from these events, as well as any additional catastrophic events which may occur, may vary materially from the reinsurance segment's estimates due to the inherent uncertainties in making such determinations resulting from several factors, including the preliminary nature of the available information, the potential inaccuracies and inadequacies in the data provided by clients and brokers, the modeling techniques and the application of such techniques, the contingent nature of business interruption exposures, the effects of any resultant demand surge on claims activity and attendant coverage issues. In addition, actual losses may increase if reinsurers fail to meet their obligations to the reinsurance segment or the reinsurance protections purchased by the reinsurance segment are otherwise unavailable.

*Underwriting Expenses.* The underwriting expense ratio for the reinsurance segment was 29.5% in the 2006 second quarter, compared to 32.5% in the 2005 second quarter. The acquisition expense ratio for the 2006 second quarter was 26.1%, compared to 29.4% for the 2005 second quarter. The reinsurance segment's 2006 results included commission income (in excess of the reimbursement of direct acquisition expenses) on the quota-share reinsurance treaty with Flatiron Re Ltd., which reduced the 2006 second quarter acquisition expense ratio by 0.9 points. The 2006 second quarter also included a \$0.9 million reduction in acquisition expenses related to estimated net development in prior year loss reserves, compared to an increase of \$1.6 million in the 2005 second quarter. Such amounts primarily resulted from contracts that contain commissions which are adjusted as the loss ratio changes. The net impact of the change in estimated net prior year development resulted in a 0.6 point decrease in the 2006 second quarter acquisition expense ratio. In addition, the 2005 second quarter acquisition expense ratio included 2.9 points for the \$11.3 million adjustment on certain treaties written in 2002 and 2003, as discussed above. The reinsurance segment's other operating expense ratio was 3.4% for the 2006 second quarter, compared to 3.1% for the 2005 second quarter. The higher ratio in the 2006 second quarter was driven, in part, by an increase in accrued expenses for incentive compensation related to underwriting performance in prior periods.

#### ***Net Investment Income***

Net investment income was \$90.5 million for the 2006 second quarter, compared to \$53.7 million for the 2005 second quarter. The increase in net investment income in the 2006 second quarter resulted from a higher level of average invested assets in the 2006 period primarily due to cash flows from operations. In addition, an increase in the pre-tax investment income yield to 4.5% for the 2006 second quarter, compared to 3.4% for the 2005 second quarter, contributed to the growth in net investment income. These yields were calculated based on amortized cost. Yields on future investment income may vary based on financial market conditions, investment allocation decisions and other factors.

**Net Realized Gains or Losses**

Following is a summary of net realized gains (losses):

(U.S. dollars in thousands)	Three Months Ended	
	June 30, 2006	2005
Fixed maturities	\$ (33,492 )	\$ 2,753
Other investments	414	(1,305 )
Other	876	657
Total	\$ (32,202 )	\$ 2,105

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. Total return on our portfolio under management, as reported to us by our investment advisors, for the 2006 second quarter was 0.77%, compared to 2.45% for the 2005 second quarter. The lower total return in the 2006 second quarter reflected the higher level of interest rates in the period.

For the 2006 second quarter, net realized losses on our fixed maturities of \$33.5 million included a provision of \$11.1 million for declines in the market value of investments held in our available for sale portfolio which were considered to be other-than-temporary, based on a review performed during the 2006 second quarter. The declines in market value on such securities were primarily due to the current interest rate environment. For the 2005 second quarter, we did not consider any declines in the market value of investments to be other-than-temporary. The balance of \$22.4 million in net realized losses on our fixed maturities in the 2006 second quarter resulted from the sale of securities, compared to net realized gains from the sale of fixed maturities of \$2.8 million in the 2005 second quarter. In the 2006 and 2005 second quarters, net realized gains or losses from the sale of fixed maturities resulted from our decisions to reduce credit exposure, changes in duration targets, relative value determinations and sales related to rebalancing the portfolio.

Our investment portfolio is classified as available for sale. During the 2006 and 2005 second quarters, we realized gross losses from the sale of fixed maturities of \$33.8 million and \$3.8 million, respectively. With respect to those securities that were sold at a loss, the following is an analysis of the gross realized losses based on the period of time those securities had been in an unrealized loss position:

(U.S. dollars in thousands)	Three Months Ended	
	June 30, 2006	2005
Less than 6 months	\$ 22,528	\$ 1,635
At least 6 months but less than 12 months	11,036	1,124
Over 12 months	197	1,011
Total	\$ 33,761	\$ 3,770

***Other Expenses***

Other expenses, which are included in our other operating expenses and part of our corporate and other segment (non-underwriting), were \$6.5 million for the 2006 second quarter, compared to \$5.5 million for the 2005 second quarter. Such amounts primarily represent certain holding company costs necessary to support our worldwide insurance and reinsurance operations and costs associated with operating as a publicly traded company.

***Share-Based Compensation***

Effective January 1, 2006, we adopted the fair value method of accounting for share-based compensation arrangements in accordance with SFAS No.123(R), using the modified prospective method of transition. Share-based compensation arrangements covered by SFAS No.123(R) currently include stock options, and restricted shares and units granted under our Long Term Incentive and Share Award Plans. Prior to January 1, 2006, we accounted for share-based employee compensation plans using the intrinsic value method of accounting in accordance with APB 25. Under the provisions of APB 25, no compensation expense was recognized when stock options were granted with exercise prices equal to or greater than market value on the date of grant. However, we did recognize compensation expense related to restricted shares and units awarded based on the fair market value of our common shares at the measurement date. Under the modified prospective method of transition, we are not required to restate our prior period financial statements to reflect expensing of share-based compensation related to stock options under SFAS No.123(R). Therefore, results for the 2006 second quarter are not comparable to the 2005 second quarter.

As required by the provisions of SFAS 123(R), we recorded pre-tax share-based compensation expense related to stock options of \$2.1 million in the 2006 second quarter. Under the modified prospective method of transition, no expense related to stock options was recorded in the 2005 second quarter. For the remaining six months of 2006, the Company expects to record pre-tax share-based compensation expense related to stock options of approximately \$3.6 million. These charges have no impact on our cash flows or shareholders' equity. We used the Black-Scholes option pricing model to determine the estimated fair value of our share-based compensation arrangements related to stock options.

As of June 30, 2006, there was approximately \$28.8 million of total unrecognized compensation expense related to unvested share-based compensation arrangements (consisting of restricted shares and units and stock options) granted under our Long Term Incentive and Share Award Plans. See note 2, *Share-Based Compensation*, of the notes accompanying our consolidated financial statements and *Critical Accounting Policies, Estimates and Recent Accounting Policies - Share-Based Compensation* for more information about the adoption of SFAS No. 123(R).

***Net Foreign Exchange Gains or Losses***

Net foreign exchange losses for the 2006 second quarter of \$1.1 million consisted of net unrealized losses of \$0.1 million and net realized losses of \$1.0 million, compared to net foreign exchange gains for the 2005 second quarter of \$10.2 million, which consisted of net unrealized gains of \$10.7 million and net realized losses of \$0.5 million. Net unrealized foreign exchange gains or losses result from the effects of revaluing our net insurance liabilities required to be settled in foreign currencies at each balance sheet date. We hold 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, as part of the *Change in unrealized appreciation (decline) in value of investments, net of deferred income tax* in accumulated other comprehensive income, and not in the statement of income. For the 2006 and 2005 second quarters, the net unrealized foreign exchange gains or losses recorded were largely offset by changes in the value of our investments held in foreign currencies.

**Income Taxes**

For the 2006 and 2005 second quarters, the effective tax rates on income before income taxes were 9.1% and 5.8%, respectively. The higher effective tax rate in the 2006 second quarter resulted from a change in the relative mix of income reported by jurisdiction. Our effective tax rates may fluctuate from period to period based on the relative mix of income reported by jurisdiction primarily due to the varying tax rates in each jurisdiction. Our quarterly tax provision is adjusted to reflect changes in our expected annual effective tax rates, if any.

**Results of Operations Six Months Ended June 30, 2006 and 2005**

The following table sets forth net income available to common shareholders and earnings per common share data:

(U.S. dollars in thousands, except share data)	<b>Six Months Ended June 30,</b>	
	<b>2006</b>	<b>2005</b>
Net income available to common shareholders	\$ 267,471	\$ 241,884
Diluted net income per common share	\$ 3.52	\$ 3.26
Diluted weighted average common shares and common share equivalents outstanding	76,014,819	74,249,728

Net income available to common shareholders was \$267.5 million for the 2006 period, compared to \$241.9 million for the six months ended June 30, 2005. The increase in net income was primarily due to growth in investment income and an increase in underwriting income, as discussed in Segment Information below. Our net income available to common shareholders for the 2006 period represented a 20.7% annualized return on average common equity, compared to 20.4% for the 2005 period.

Diluted weighted average common shares and common share equivalents outstanding, used in the calculation of net income per common share, was 1.8 million shares, or 2.4%, higher in the 2006 period than in the 2005 period. The higher level was primarily due to increases in the assumed dilutive effects of stock options and nonvested restricted stock calculated using the treasury stock method.

**Segment Information***Insurance Segment*

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

(U.S. dollars in thousands)	Six Months Ended June 30,		
	2006	2005	
Gross premiums written	\$ 1,263,301	\$ 1,084,164	
Net premiums written	806,556	695,780	
Net premiums earned	\$ 766,131	\$ 675,122	
Fee income	2,657	2,492	
Losses and loss adjustment expenses	(499,174 )	(436,833 )	
Acquisition expenses, net	(79,160 )	(61,776 )	
Other operating expenses	(125,765 )	(114,830 )	
Underwriting income	\$ 64,689	\$ 64,175	
<b>Underwriting Ratios</b>			
Loss ratio	65.2	% 64.7	%
Acquisition expense ratio (1)	10.1	%	8.9 %
Other operating expense ratio	16.4	%	17.0 %
Combined ratio	91.7	%	90.6 %

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

*Underwriting Income.* The insurance segment's underwriting income was \$64.7 million for the 2006 period, compared to \$64.2 million for the 2005 period. The combined ratio for the insurance segment was 91.7% for the 2006 period, compared to 90.6% for the 2005 period. The components of the insurance segment's underwriting income are discussed below.

*Premiums Written.* Gross premiums written by the insurance segment were \$1.26 billion for the 2006 period, compared to \$1.08 billion for the 2005 period, and ceded premiums written were 36.2% of gross premiums written for the 2006 period, compared to 35.8% for the 2005 period. The increase in the percentage of ceded premiums written primarily reflects a higher level of reinsurance costs related to property-catastrophe protection for the 2006 period than in the 2005 period. Net premiums written by the insurance segment were \$806.6 million for the 2006 period, compared to \$695.8 million for the 2005 period. Roughly a third of the growth in net premiums written was in construction and surety business, primarily due to growth in large deductible construction accounts and surety business. The balance of the growth was generated from increases in professional liability and executive assurance lines, primarily as a result of growth in policies written, and property business, as a result of rate increases which were tempered by the higher reinsurance costs noted above. For information regarding net premiums written produced by major line of business and geographic location, refer to note 4, Segment Information, of the notes accompanying our consolidated financial statements.

*Net Premiums Earned.* Net premiums earned for the insurance segment were \$766.1 million for the 2006 period, compared to \$675.1 million for the 2005 period, and generally reflect changes in net premiums written over the previous five quarters, including the mix and type of business written.

*Losses and Loss Adjustment Expenses.* The loss ratio for the insurance segment was 65.2% for the 2006 period, compared to 64.7% for the 2005 period. The insurance segment's results for the 2006 period included two significant losses which occurred in the 2006 second quarter totaling \$18.3 million, while the 2005 period did not include significant large loss activity. The net impact of the change in large loss activity was a 2.4 point increase in the loss ratio for the 2006 period. Losses incurred for the 2006 period included \$6.9 million of



estimated net favorable development in prior year loss reserves, compared to \$7.4 million of estimated net adverse development in the 2005 period. The net impact of the change in estimated net prior year development was a 1.9 point decrease in the loss ratio for the 2006 period. The estimated net favorable development in the 2006 period primarily resulted in medium and long-tail lines, mainly executive assurance, healthcare and construction, resulting from a reevaluation of estimated ultimate losses due to better than expected claims activity, partially offset by \$33.6 million of adverse development on short-tail lines which included \$26.7 million related to the 2004 and 2005 hurricanes.

In addition to the use of individual per risk and inuring reinsurance contracts to limit exposure, the insurance segment had in force during 2005 a catastrophe reinsurance program which provides coverage for certain property catastrophe-related losses occurring during the contract period equal to a maximum of 95% of the first \$200 million in excess of a \$50 million retention per occurrence of such losses. Estimated losses related to Hurricane Katrina and Hurricane Wilma have exceeded the per occurrence retention. Based on current estimates, the insurance segment expects to recover approximately \$124.7 million through such coverage for Hurricane Katrina and \$11.8 million for Hurricane Wilma with approximately \$57.3 million of remaining available coverage for Hurricane Katrina and \$187.6 million of remaining available coverage for Hurricane Wilma should the actual amount of losses ultimately attributable to such events exceed current estimates. Amounts shown for Hurricane Katrina are net of reinstatement premiums.

Estimates for the insurance segment related to Hurricanes Katrina, Rita and Wilma and other catastrophic events that occurred in the second half of 2005 are based on currently available information derived from modeling techniques, industry assessments of exposure, preliminary claims information obtained from its clients and brokers to date and a review of its in-force contracts. Actual losses from these events, as well as any additional catastrophic events which may occur, may vary materially from the insurance segment's estimates due to the inherent uncertainties in making such determinations resulting from several factors, including the preliminary nature of the available information, the potential inaccuracies and inadequacies in the data provided by clients and brokers, the modeling techniques and the application of such techniques, the contingent nature of business interruption exposures, the effects of any resultant demand surge on claims activity and attendant coverage issues. In addition, actual losses may increase if reinsurers fail to meet their obligations to the insurance segment or the reinsurance protections purchased by the insurance segment are exhausted or are otherwise unavailable.

Beginning in the 2006 first quarter, our insurance operations have in effect a reinsurance program which provides coverage for certain property catastrophe-related losses occurring during 2006 equal to a maximum of 92% of the first \$325 million in excess of a \$75 million retention per occurrence of such losses. The cost of the coverage was substantially higher than in 2005.

*Underwriting Expenses.* The underwriting expense ratio for the insurance segment was 26.5% in the 2006 period, compared to 25.9% for the 2005 period. The acquisition expense ratio was 10.1% for the 2006 period, compared to 8.9% for the 2005 period. The increase in the acquisition expense ratio was primarily due to changes in the mix of business. The insurance segment's other operating expense ratio was 16.4% for the 2006 period, compared to 17.0% for the 2005 period. The lower ratio for the 2006 period resulted from growth in net premiums earned which was higher than the attendant growth in operating expenses.

*Reinsurance Segment*

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

(U.S. dollars in thousands)	Six Months Ended		
	June 30, 2006	2005	
Gross premiums written	\$ 1,063,909	\$ 865,598	
Net premiums written	861,721	827,749	
Net premiums earned	\$ 792,920	\$ 761,838	
Fee income	2,616	4,645	
Losses and loss adjustment expenses	(431,259 )	(432,621 )	
Acquisition expenses, net	(199,093 )	(212,895 )	
Other operating expenses	(27,431 )	(22,821 )	
Underwriting income	\$ 137,753	\$ 98,146	
<b>Underwriting Ratios</b>			
Loss ratio	54.4	% 56.8	%
Acquisition expense ratio	25.1	% 27.9	%
Other operating expense ratio	3.5	% 3.0	%
Combined ratio	83.0	% 87.7	%

*Underwriting Income.* The reinsurance segment's underwriting income was \$137.8 million for the 2006 period, compared to \$98.1 million for the 2005 period. The combined ratio for the reinsurance segment was 83.0% for the 2006 period, compared to 87.7% for the 2005 period. The components of the reinsurance segment's underwriting income are discussed below.

*Premiums Written.* Gross premiums written by the reinsurance segment were \$1.06 billion in the 2006 period, compared to \$865.6 million for the 2005 period. A substantial portion of the growth came in property and marine lines, of which \$160.1 million of premiums were ceded by Arch Re Bermuda to Flatiron Re Ltd. under a quota-share reinsurance treaty, as previously disclosed. In addition, during the 2006 period, the reinsurance segment recorded \$22.7 million of additional premiums related to certain treaties written in 2002 to 2004, based on new information received from ceding companies, compared to \$14.5 million in the 2005 period relating to treaties written in 2002 and 2003. Of the 2005 amount, \$11.3 million related to an adjustment to gross and net premiums written, premiums earned and acquisition expenses which had no effect on underwriting income.

Ceded premiums written by the reinsurance segment were 19.0% of gross premiums written for the 2006 period, compared to 4.4% for the 2005 period. The higher ceded percentage in the 2006 period primarily resulted from the \$160.1 million of premiums written ceded (\$43.6 million on an earned basis) to Flatiron Re Ltd. noted above.

Net premiums written by the reinsurance segment were \$861.7 million for the 2006 period, compared to \$827.7 million for the 2005 period. Continued growth in international property and marine lines, along with a higher level of U.S. casualty business, was offset by a reduction in international casualty and other business. The growth in property and marine lines resulted from higher rates and an increase in exposure and resulted from current market opportunities as catastrophe-exposed property and marine lines have continued to provide attractive opportunities in the wake of the 2005 storms. The reduction in international casualty business was primarily in response to market conditions for European business. For information regarding net premiums written produced by major line and type of business and geographic location, refer to note 4, Segment Information, of the notes accompanying our consolidated financial statements.

*Net Premiums Earned.* Net premiums earned for our reinsurance segment were \$792.9 million for the 2006 period, compared to \$761.8 million for the 2005 period, and generally reflect changes in net premiums written over the previous five quarters, including the mix and type of business written.

*Fee Income.* The reinsurance segment recorded \$2.6 million of fee income for the 2006 period, compared to \$4.6 million for the 2005 period. The 2006 amount related to certain assumed reinsurance contracts which were deemed, under GAAP, not to transfer insurance risk, and are accounted for using the deposit method of accounting. Of the 2005 amount, \$4.5 million related to an industry loss warranty contract. Under this contract, we received payment when industry-wide losses from certain natural perils exceeded a specified amount.

*Losses and Loss Adjustment Expenses.* Underwriting income for the reinsurance segment in the 2006 period benefited from estimated net favorable development in prior year loss reserves, net of related adjustments, of \$4.8 million, which consisted of a de minimis change in incurred losses and \$4.8 million of reductions in acquisition expenses. The 2006 period estimated net favorable development consisted of \$38.6 million of favorable development, primarily in short-tail lines, partially offset by \$33.8 million of adverse development related to the 2004 and 2005 hurricanes and the European floods. For the 2005 period, underwriting income benefited from estimated net favorable development in prior year loss reserves, net of related adjustments, of \$35.2 million, which consisted of \$39.7 million of reductions in losses incurred and \$4.5 million of increases to acquisition expenses.

The loss ratio for the reinsurance segment was 54.4% for the 2006 period, compared to 56.8% for the 2005 period. The reinsurance segment's results reflected a low level of catastrophic activity in the period which, combined with a higher level of net premiums earned for property business in the period, contributed to the significant reduction in the loss ratio for the 2006 period. Partially offsetting this, as noted above, the 2006 period included a de minimis change in losses incurred due to prior year loss reserves, compared to estimated net favorable development in the 2005 period of \$39.7 million. The net impact of the change in estimated net prior year development was a 5.0 point increase in the loss ratio for the 2006 period.

The reinsurance segment previously purchased a catastrophe reinsurance program which provides up to \$55 million of coverage in excess of certain deductibles for any one occurrence and \$110 million in the aggregate annually, for certain catastrophe-related losses worldwide occurring during the period from May 2005 through April 2006. Based on current estimates, the reinsurance segment expects to recover approximately \$92.3 million, net of reinstatement premiums, related to the 2005 catastrophic events. The recovery represents full usage of the available coverage under the reinsurance program and the coverage was not renewed upon expiration. The reinsurance segment's estimates related to Hurricanes Katrina, Rita and Wilma and other catastrophic events that occurred in the second half of 2005 are based on currently available information derived from modeling techniques, industry assessments of exposure, preliminary claims information obtained from its clients and brokers to date and a review of its in-force contracts. Actual losses from these events, as well as any additional catastrophic events which may occur, may vary materially from the reinsurance segment's estimates due to the inherent uncertainties in making such determinations resulting from several factors, including the preliminary nature of the available information, the potential inaccuracies and inadequacies in the data provided by clients and brokers, the modeling techniques and the application of such techniques, the contingent nature of business interruption exposures, the effects of any resultant demand surge on claims activity and attendant coverage issues. In addition, actual losses may increase if reinsurers fail to meet their obligations to the reinsurance segment or the reinsurance protections purchased by the reinsurance segment are otherwise unavailable.

*Underwriting Expenses.* The underwriting expense ratio for the reinsurance segment was 28.6% for the 2006 period, compared to 30.9% for the 2005 period. The acquisition expense ratio for the 2006 period was 25.1%, compared to 27.9% for the 2005 period. The reinsurance segment's 2006 results included commission income (in excess of the reimbursement of direct acquisition expenses) on the quota-share reinsurance treaty with Flatiron Re Ltd., which reduced the acquisition expense ratio by 0.9 points in the 2006 period. The 2006 period also included a \$4.8 million reduction in acquisition expenses related to estimated net development in

prior year loss reserves, compared to an increase of \$4.5 million in the 2005 period. Such amounts primarily resulted from contracts that contain commissions which are adjusted as the loss ratio changes. The net impact of the change in acquisition expenses related to the estimated net prior year development resulted in a 1.2 point decrease in the acquisition expense ratio for the 2006 period. In addition, the acquisition expense ratio for the 2005 period included 1.4 points for the \$11.3 million adjustment on certain treaties written in 2002 and 2003, as discussed above. The reinsurance segment's other operating expense ratio was 3.5% for the 2006 period, compared to 3.0% for the 2005 period. The higher ratio in the 2006 period was driven, in part, by an increase in accrued expenses for incentive compensation related to underwriting performance in prior periods.

#### ***Net Investment Income***

Net investment income was \$170.8 million for the 2006 period, compared to \$103.6 million for the 2005 period. The increase in net investment income in the 2006 period resulted from a higher level of average invested assets in the 2006 period primarily due to cash flows from operations. In addition, an increase in the pre-tax investment income yield to 4.4% for the 2006 period, compared to 3.4% for the 2005 period, contributed to the growth in net investment income. These yields were calculated based on amortized cost.

#### ***Net Realized Gains or Losses***

Following is a summary of net realized gains (losses):

(U.S. dollars in thousands)	Six Months Ended	
	June 30, 2006	2005
Fixed maturities	\$ (37,645 )	\$ 2,473
Other investments	3,142	(1,451 )
Other	(1,082 )	1,544
Total	\$ (35,585 )	\$ 2,566

Total return on our portfolio under management, as reported to us by our investment advisors, for the 2006 period was 0.79%, compared to 0.99% for the 2005 period. The lower total return in the 2006 period reflected the higher level of interest rates in the period. For the 2006 period, net realized losses on our fixed maturities of \$37.6 million included a provision of \$16.5 million for declines in the market value of investments held in our available for sale portfolio which were considered to be other-than-temporary, based on a review performed during the 2006 period. The declines in market value on such securities were primarily due to the current interest rate environment. For the six months ended June 30, 2005, we did not consider any declines in the market value of investments to be other-than-temporary. The balance of \$21.1 million in net realized losses on our fixed maturities in the 2006 period resulted from the sale of securities, compared to net realized gains from the sale of fixed maturities of \$2.5 million for the 2005 period. For the 2006 and 2005 periods, net realized gains or losses from the sale of fixed maturities resulted from our decisions to reduce credit exposure, changes in duration targets, relative value determinations and sales related to rebalancing the portfolio.

During the 2006 and 2005 periods, we realized gross losses from the sale of fixed maturities of \$50.6 million and \$8.5 million, respectively. With respect to those securities that were sold at a loss, the following is an analysis of the gross realized losses based on the period of time those securities had been in an unrealized loss position:

(U.S. dollars in thousands)	Six Months Ended	
	June 30, 2006	2005
Less than 6 months	\$ 37,337	\$ 4,755
At least 6 months but less than 12 months	11,744	2,063
Over 12 months	1,518	1,711
Total	\$ 50,599	\$ 8,529
<b><i>Other Expenses</i></b>		

Other expenses, which are included in our other operating expenses and part of our corporate and other segment (non-underwriting), were \$14.1 million for the 2006 period, compared to \$11.5 million for the 2005 period.

#### ***Share-Based Compensation***

As required by the provisions of SFAS 123(R), we recorded pre-tax share-based compensation expense related to stock options of \$3.4 million in the 2006 period. Under the modified prospective method of transition, no expense related to stock options was recorded in the 2005 period. Therefore, results for the 2006 period are not comparable to the 2005 period. See note 2, *Share-Based Compensation*, of the notes accompanying our consolidated financial statements and *Critical Accounting Policies, Estimates and Recent Accounting Policies* *Share-Based Compensation* for more information about the adoption of SFAS No. 123(R).

#### ***Net Foreign Exchange Gains or Losses***

Net foreign exchange losses for the six months ended June 30, 2006 of \$11.4 million consisted of net unrealized losses of \$8.0 million and net realized losses of \$3.4 million, compared to net foreign exchange gains of \$13.4 million for the 2005 period, which consisted of net unrealized gains of \$13.4 million and de minimis net realized gains. For the 2006 and 2005 periods, the net unrealized foreign exchange gains or losses recorded were largely offset by changes in the value of our investments held in foreign currencies.

#### ***Income Taxes***

The effective tax rate on income before income taxes was 8.6% for the 2006 period, compared to 6.7% for the 2005 period. The higher effective tax rate in the 2006 period resulted from a change in the relative mix of income reported by jurisdiction. Our effective tax rates may fluctuate from period to period based on the relative mix of income reported by jurisdiction primarily due to the varying tax rates in each jurisdiction. Our quarterly tax provision is adjusted to reflect changes in our expected annual effective tax rates, if any.

#### ***Liquidity and Capital Resources***

ACGL is a holding company whose assets primarily consist of the shares in its subsidiaries. Generally, ACGL depends on its available cash resources, liquid investments and dividends or other distributions from its subsidiaries to make payments, including the payment of debt service obligations and operating expenses it may incur and any dividends or liquidation amounts with respect to the non-cumulative preferred shares and common shares.

On a consolidated basis, our aggregate cash and invested assets totaled \$8.16 billion at June 30, 2006, compared to \$7.12 billion at December 31, 2005. At June 30, 2006 and December 31, 2005, our fixed income portfolio, which includes fixed maturity securities and short-term investments, had an average Standard & Poor's quality rating of AA+ and an average effective duration of 2.9 years and 3.3 years, respectively. ACGL's readily available cash, short-term investments and marketable securities, excluding amounts held by our regulated insurance and reinsurance subsidiaries, totaled \$19.2 million at June 30, 2006, compared to \$21.0 million at December 31, 2005.

The ability of our regulated insurance and reinsurance subsidiaries to pay dividends or make distributions or other payments to us is dependent on their ability to meet applicable regulatory standards. Under Bermuda law, Arch Re Bermuda is required to maintain a minimum solvency margin (*i.e.*, the amount by which the value of its general business assets must exceed its general business liabilities) equal to the greatest of (1) \$100 million, (2) 50% of net premiums written (being gross premiums written by us less any premiums ceded by us, but we may not deduct more than 25% of gross premiums when computing net premiums written) and (3) 15% of loss and other insurance reserves. Arch Re Bermuda is prohibited from declaring or paying any dividends during any financial year if it is not in compliance with its minimum solvency margin. In addition, Arch Re Bermuda is prohibited from declaring or paying in any financial year dividends of more than 25% of its total statutory capital and surplus (as shown on its previous financial year's statutory balance sheet) unless it files, at least seven days before payment of such dividends, with the Bermuda Monetary Authority an affidavit stating that it will continue to meet the required margins. In addition, Arch Re Bermuda is prohibited, without prior approval of the Bermuda Monetary Authority, from reducing by 15% or more its total statutory capital, as set out in its previous year's statutory financial statements. At December 31, 2005, as determined under Bermuda law, Arch Re Bermuda had statutory capital of \$1.66 billion and statutory capital and surplus of \$2.19 billion. Such amounts include ownership interests in U.S. insurance and reinsurance subsidiaries. Accordingly, Arch Re Bermuda can pay approximately \$249 million in dividends or distributions to ACGL during 2006 without prior approval under Bermuda law, as discussed above. Our U.S. insurance and reinsurance subsidiaries can pay \$72.3 million in dividends or distributions to Arch Capital Group (U.S.) Inc. ( Arch-U.S. ), our U.S. holding company, which is owned by Arch Re Bermuda, during 2006 without prior regulatory approval. Such dividends or distributions may be subject to applicable withholding or other taxes. Arch Insurance Company (Europe) Limited can pay a de minimis amount of dividends to ACGL during 2006 without prior notice and approval by the FSA. In addition, the ability of our insurance and reinsurance subsidiaries to pay dividends is also constrained by our dependence on the financial strength ratings of our insurance and reinsurance subsidiaries from independent rating agencies. The ratings from these agencies depend to a large extent on the capitalization levels of our insurance and reinsurance subsidiaries. We believe that ACGL has sufficient cash resources and available dividend capacity to service its indebtedness and other current outstanding obligations.

Our insurance and reinsurance subsidiaries are required to maintain assets on deposit, which primarily consist of fixed maturities, with various regulatory authorities to support their operations. The assets on deposit are available to settle insurance and reinsurance liabilities to third parties. Our insurance and reinsurance subsidiaries also have investments in segregated portfolios primarily to provide collateral or guarantees for letters of credit to third parties. At June 30, 2006 and December 31, 2005, such amounts approximated \$980.0 million and \$1.0 billion, respectively. In addition, Arch Re Bermuda maintains assets in trust accounts as collateral for insurance and reinsurance transactions with affiliated companies. At June 30, 2006 and December 31, 2005, such amounts approximated \$3.05 billion and \$2.77 billion, respectively.

ACGL, through its subsidiaries, provides financial support to certain of its insurance subsidiaries and affiliates, through certain reinsurance arrangements essential to the ratings of such subsidiaries. Except as described in the preceding sentence, or where express reinsurance, guarantee or other financial support contractual arrangements are in place, each of ACGL's subsidiaries or affiliates is solely responsible for its own liabilities and commitments (and no other ACGL subsidiary or affiliate is so responsible). Any reinsurance arrangements, guarantees or other financial support contractual arrangements that are in place are solely for the

benefit of the ACGL subsidiary or affiliate involved and third parties (creditors or insureds of such entity) are not express beneficiaries of such arrangements.

Arch Specialty Insurance Company ( Arch Specialty ) entered into a Stipulation and Order ( Stipulation ) with the Wisconsin Office of the Commissioner of Insurance ( OCI ) in connection with ACGL's acquisition of Arch Specialty in 2002. While the ratio of Arch Specialty's total adjusted capital to authorized control level risk-based capital exceeded 200% at December 31, 2005, and thus was above the risk-based capital threshold that would require company action (the lowest level of corrective action), it was below the 275% ratio that the Stipulation requires Arch Specialty to maintain. Arch Specialty was in compliance with the ratio required under the Stipulation at December 31, 2005 following its receipt during the 2006 first quarter of a capital contribution in the amount of \$57.0 million provided by subsidiaries of ACGL, and remains in compliance with such ratio at June 30, 2006. Western Diversified Casualty Insurance Company, which, like Arch Specialty, is domiciled in Wisconsin, also entered into a Stipulation with the OCI in 2003 whereby it must maintain a ratio of total adjusted capital to authorized control level risk-based capital of not less than 275%, and was in compliance with this ratio at June 30, 2006.

Our insurance and reinsurance operations provide liquidity in that premiums are received in advance, sometimes substantially in advance, of the time losses are paid. The period of time from the occurrence of a claim through the settlement of the liability may extend many years into the future. Sources of liquidity include cash flows from operations, financing arrangements or routine sales of investments.

We monitor the financial condition of our reinsurers and attempt to place coverages only with substantial, financially sound carriers. At June 30, 2006 and December 31, 2005, approximately 94.0% and 92.6%, respectively, of our reinsurance recoverables on paid and unpaid losses (not including prepaid reinsurance premiums) of \$1.68 billion and \$1.47 billion, respectively, were due from carriers which had an A.M. Best rating of A- or better. At June 30, 2006 and December 31, 2005, the largest reinsurance recoverables from any one carrier were less than 1.0% and 5.6%, respectively, of our total shareholders' equity.

As part of our investment strategy, we seek to establish a level of cash and highly liquid short-term and intermediate-term securities which, combined with expected cash flow, is believed by us to be adequate to meet our foreseeable payment obligations. However, due to the nature of our operations, cash flows are affected by claim payments that may comprise large payments on a limited number of claims and which can fluctuate from year to year. We believe that our liquid investments and cash flow will provide us with sufficient liquidity in order to meet our claim payment obligations. However, the timing and amounts of actual claim payments related to recorded loss reserves vary based on many factors, including large individual losses, changes in the legal environment, as well as general market conditions. The ultimate amount of the claim payments could differ materially from our estimated amounts. Certain lines of business written by us, such as excess casualty, have loss experience characterized as low frequency and high severity. The foregoing may result in significant variability in loss payment patterns. The impact of this variability can be exacerbated by the fact that the timing of the receipt of reinsurance recoverables owed to us may be slower than anticipated by us. Therefore, the irregular timing of claim payments can create significant variations in cash flows from operations between periods and may require us to utilize other sources of liquidity to make these payments, which may include the sale of investments or utilization of existing or new credit facilities or capital market transactions. If the source of liquidity is the sale of investments, we may be forced to sell such investments at a loss, which may be material.

Consolidated cash flow provided by operating activities was \$823.2 million for the six months ended June 30, 2006, compared to \$685.6 million for the 2005 period. The increase in operating cash flows in the 2006 period was due, in part, to growth in premiums written and net investment income, partially offset by a higher level of paid losses as our loss reserves have continued to mature and due to payments related to the 2004 and 2005 catastrophic events that contributed \$104.4 million to paid losses for the six months ended June 30, 2006. Cash flow from operating activities are provided by premiums collected, fee income, investment income and

collected reinsurance recoverables, offset by losses and loss adjustment expense payments, reinsurance premiums paid, operating costs and current taxes paid.

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

We monitor our capital adequacy on a regular basis and will seek to adjust our capital base (up or down) according to the needs of our business. The future capital requirements of our business will depend on many factors, including our ability to write new business successfully and to establish premium rates and reserves at levels sufficient to cover losses. Our ability to underwrite is largely dependent upon the quality of our claims paying and financial strength ratings as evaluated by independent rating agencies. In particular, we require (1) sufficient capital to maintain our financial strength ratings, as issued by several ratings agencies, at a level considered necessary by management to enable our key underwriting subsidiaries to compete; (2) sufficient capital to enable our underwriting subsidiaries to meet the capital adequacy tests performed by statutory agencies in the U.S. and other key markets; and (3) letters of credit and other forms of collateral that are necessary for our non-U.S. underwriting companies because they are non-admitted under U.S. state insurance regulations.

As part of our capital management program, we may seek to raise additional capital or may seek to return capital to our shareholders through share repurchases, cash dividends or other methods (or a combination of such methods). Any such determination will be at the discretion of our board of directors and will be dependent upon our profits, financial requirements and other factors, including legal restrictions, rating agency requirements and such other factors as our board of directors deems relevant.

To the extent that our existing capital is insufficient to fund our future operating requirements or maintain such ratings, we may need to raise additional funds through financings or limit our growth. If we are not able to obtain adequate capital, our business, results of operations and financial condition could be adversely affected, which could include, among other things, the following possible outcomes: (1) potential downgrades in the financial strength ratings assigned by ratings agencies to our operating subsidiaries, which could place those operating subsidiaries at a competitive disadvantage compared to higher-rated competitors; (2) reductions in the amount of business that our operating subsidiaries are able to write in order to meet capital adequacy-based tests enforced by statutory agencies; and (3) any resultant ratings downgrades could, among other things, affect our ability to write business and increase the cost of bank credit and letters of credit.

In addition to common share capital, we depend on external sources of finance to support our underwriting activities, which can be in the form (or any combination) of debt securities, preference shares, common equity and bank credit facilities providing loans and/or letters of credit. Any equity or debt financing, if available at all, may be on terms that are unfavorable to us. In the case of equity financings, dilution to our shareholders could result, and, in any case, such securities may have rights, preferences and privileges that are senior to those of our outstanding securities.

In June 2006, ACGI and Arch-U.S. filed a universal shelf registration statement with the SEC. This registration statement allows for the possible future offer and sale by us of various types of securities, including unsecured debt securities, preference shares, common shares, warrants, share purchase contracts and units and depositary shares. The shelf registration statement enables us to efficiently access the public debt and/or equity capital markets in order to meet our future capital needs. The shelf registration statement also allows selling shareholders to resell common shares that they own in one or more offerings from time to time. We will not receive any proceeds from any shares offered by the selling shareholders. This report is not an offer to sell or the solicitation of an offer to buy nor shall there be any sale of these securities in any state in which such offer,



solicitation or sale would be unlawful prior to registration or qualification under the securities laws of any such state.

In November 2005, we entered into a five-year agreement for a \$300 million unsecured revolving loan and letter of credit facility and a \$500 million secured letter of credit facility, which was amended in April 2006 to provide Arch Insurance Company (Europe) Limited access to the secured portion of the credit facility. The \$300 million unsecured loan and letter of credit facility is also available for the issuance of unsecured letters of credit up to \$100 million for our U.S.-based reinsurance operation. In light of the expansion of our reinsurance business in property lines, we are considering increasing the capacity of our secured letter of credit facility.

During 2006, ACGL completed two public offerings of non-cumulative preferred shares ( Preferred Shares ). On February 1, 2006, \$200.0 million principal amount of 8.0% series A non-cumulative preferred shares ( Series A Preferred Shares ) were issued with net proceeds of \$193.5 million and, on May 24, 2006, \$125.0 million principal amount of 7.875% series B non-cumulative preferred shares ( Series B Preferred Shares ) were issued with net proceeds of \$120.9 million. The net proceeds of the offerings were used to support the underwriting activities of ACGL's insurance and reinsurance subsidiaries. ACGL has the right to redeem all or a portion of each series of Preferred Shares at a redemption price of \$25.00 per share on or after (1) February 1, 2011 for the Series A Preferred Shares and (2) May 15, 2011 for the Series B Preferred Shares. Dividends on the Preferred Shares are non-cumulative. Consequently, in the event dividends are not declared on the Preferred Shares for any dividend period, holders of Preferred Shares will not be entitled to receive a dividend for such period, and such undeclared dividend will not accrue and will not be payable. Holders of Preferred Shares will be entitled to receive dividend payments only when, as and if declared by ACGL's board of directors or a duly authorized committee of the board of directors. Any such dividends will be payable from the date of original issue on a non-cumulative basis, quarterly in arrears. To the extent declared, these dividends will accumulate, with respect to each dividend period, in an amount per share equal to 8.0% of the \$25.00 liquidation preference per annum for the Series A Preferred Shares and 7.875% of the \$25.00 liquidation preference per annum for the Series B Preferred Shares. At June 30, 2006, we had declared an aggregate of \$3.1 million of dividends to be paid to holders of the Preferred Shares.

At June 30, 2006, ACGL's capital of \$3.32 billion consisted of \$300.0 million of senior notes, representing 9.0% of the total, \$325.0 million of preferred shares, representing 9.8% of the total, and common shareholders' equity of \$2.69 billion, representing the balance. At December 31, 2005, ACGL's capital of \$2.78 billion consisted of senior notes of \$300 million, representing 10.8% of the total, and common shareholders' equity of \$2.48 billion, representing the balance. The increase in capital during 2006 of \$535.3 million was primarily attributable to the issuance of preferred shares and net income for the six months ended June 30, 2006, partially offset by an after-tax decline in the market value of our investment portfolio of \$64.3 million which was primarily due to an increase in the level of interest rates.

#### **Off-Balance Sheet Arrangements**

We are not party to any transaction, agreement or other contractual arrangement to which an entity unconsolidated with us is a party that management believes is reasonably likely to have a current or future effect on our financial condition, revenues or expenses, results of operations, liquidity, capital expenditures or capital resources that is material to investors. We concluded that, under FASB Interpretation No. 46R, Consolidation of Variable Interest Entities, which was issued and became effective for us during the 2004 first quarter, we are required to consolidate the assets, liabilities and results of operations (if any) of a certain managing general agency in which one of our subsidiaries has an investment. Such agency ceased producing business in 1999 and is currently running-off its operations. Based on current information, there are no assets or liabilities of such agency required to be reflected on the face of our consolidated financial statements that are not, or have not been previously, otherwise reflected therein.

On December 29, 2005, Arch Re Bermuda entered into a quota share reinsurance treaty with Flatiron Re Ltd., a newly-formed Bermuda reinsurance company, pursuant to which Flatiron Re Ltd. is assuming a 45% quota share (the Treaty) of certain lines of property and marine business underwritten by Arch Re Bermuda for unaffiliated third parties for the 2006 and 2007 underwriting years (January 1, 2006 to December 31, 2007). The quota share is subject to decrease by Arch Re Bermuda under certain circumstances. In addition, in certain circumstances, Flatiron Re Ltd. may extend at its option the coverage provided by the Treaty to Arch Re Bermuda's 2008 underwriting year. Effective June 28, 2006, the parties amended the Treaty to increase the percentage ceded to Flatiron Re Ltd. from 45% to 70% of all covered business bound by Arch Re Bermuda from (and including) June 28, 2006 until (and including) August 15, 2006 provided such business does not incept beyond September 30, 2006. The ceding percentage for all business bound outside of this period will continue to be 45%, subject to adjustment as provided under the Treaty. As a result of the terms of the Treaty, we determined that Flatiron Re Ltd. is a variable interest entity. However, Arch Re Bermuda is not the primary beneficiary of Flatiron Re Ltd. and, as such, we are not required to consolidate the assets, liabilities and results of operations of Flatiron Re Ltd. per FIN 46R. See note 13, Commitments and Contingencies, of the notes accompanying our consolidated financial statements for further details on the Treaty with Flatiron Re Ltd.

### Investments

The finance and investment committee of our board of directors establishes our investment policies and creates 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.

Our cash and invested assets were as follows at June 30, 2006 and December 31, 2005:

(U.S. dollars in thousands)	June 30, 2006	December 31, 2005
Fixed maturities available for sale, at fair value	\$ 5,948,595	\$ 5,280,987
Fixed maturities pledged under securities lending agreements, at fair value (1)	740,966	862,766
Total fixed maturities	6,689,561	6,143,753
Short-term investments available for sale, at fair value	973,671	681,887
Short-term investments pledged under securities lending agreements, at fair value (1)	935	1,100
Other investments, at fair value	132,046	70,233
Cash	366,373	222,477
Total cash and invested assets (1)	\$ 8,162,586	\$ 7,119,450

(1) In securities lending transactions, we receive collateral in excess of the market value of the fixed maturities and short-term investments pledged under securities lending agreements. For purposes of this table, we have excluded \$762.2 million and \$893.4 million, respectively, of collateral received which is reflected as short-term investment of funds received under securities lending agreements, at fair value and included \$741.9 million and \$863.9 million, respectively, of fixed maturities and short-term investments pledged under securities lending agreements, at fair value at June 30, 2006 and December 31, 2005.

Our investment strategy allows for the use of derivative instruments. We utilize various derivative instruments such as futures contracts as part of the management of our stock index fund investments and to replicate equity investment positions. Derivative instruments may be used to enhance investment performance, to replicate investment positions or to manage market exposures and duration risk that would be allowed under our investment guidelines if implemented in other ways. See note 7, Investment Information Investment-Related Derivatives, of the notes accompanying our consolidated financial Statements and Critical Accounting Policies, Estimates and Recent Accounting Policies Investment-Related Derivatives for additional disclosures concerning derivatives.

At June 30, 2006 and December 31, 2005, our fixed income portfolio, which includes fixed maturity securities and short-term investments, had an average effective duration of 2.9 years and 3.3 years, respectively, an average Standard & Poor's quality rating of AA+ and an imbedded book yield, before investment expenses, of 4.8% and 4.2%, respectively.

### Reserves for Losses and Loss Adjustment Expenses

We establish reserves for losses and loss adjustment expenses ( Loss Reserves ) which represent estimates involving actuarial and statistical projections, at a given point in time, of our expectations of the ultimate settlement and administration costs of losses incurred. Estimating Loss Reserves is inherently difficult, which is exacerbated by the fact that we are a relatively new company with relatively limited historical experience upon which to base such estimates. We utilize actuarial models as well as available historical insurance industry loss ratio experience and loss development patterns to assist in the establishment of Loss Reserves. Actual losses and loss adjustment expenses paid will deviate, perhaps substantially, from the reserve estimates reflected in our financial statements.

At June 30, 2006 and December 31, 2005, our Loss Reserves, net of unpaid losses and loss adjustment expenses recoverable, by type and by operating segment were as follows:

(U.S. dollars in thousands)	June 30, 2006	December 31, 2005
<b>Insurance:</b>		
Case reserves	\$ 531,221	\$ 421,131
IBNR reserves	1,624,407	1,413,243
Total net reserves	\$ 2,155,628	\$ 1,834,374
<b>Reinsurance:</b>		
Case reserves	\$ 596,910	\$ 488,593
Additional case reserves	75,264	116,788
IBNR reserves	1,709,252	1,623,303
Total net reserves	\$ 2,381,426	\$ 2,228,684
<b>Total:</b>		
Case reserves	\$ 1,128,131	\$ 909,724
Additional case reserves	75,264	116,788
IBNR reserves	3,333,659	3,036,546
Total net reserves	\$ 4,537,054	\$ 4,063,058

At June 30, 2006 and December 31, 2005, the insurance segment's Loss Reserves by major line of business, net of unpaid losses and loss adjustment expenses recoverable, were as follows:

(U.S. dollars in thousands)	June 30, 2006	December 31, 2005
Casualty	\$ 504,524	\$ 420,113
Programs	332,323	323,527
Construction and surety	327,620	267,569
Executive assurance	296,885	222,949
Property, marine and aviation	291,786	259,686
Professional liability	284,314	226,815
Healthcare	108,634	104,464
Other	9,542	9,251
Total net reserves	\$ 2,155,628	\$ 1,834,374

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At June 30, 2006 and December 31, 2005, the reinsurance segment's Loss Reserves by major line of business, net of unpaid losses and loss adjustment expenses recoverable, were as follows:

(U.S. dollars in thousands)	June 30, 2006	December 31, 2005
Casualty	\$ 1,410,685	\$ 1,304,859
Property excluding property catastrophe	301,918	265,355
Other specialty	257,120	267,850
Marine and aviation	178,457	175,364
Property catastrophe	128,588	107,307
Other	104,658	107,949
<b>Total net reserves</b>	<b>\$ 2,381,426</b>	<b>\$ 2,228,684</b>

### Calculation of Book Value Per Common Share

The following presents the calculation of book value per common share for June 30, 2006 and December 31, 2005. The shares and per share numbers set forth below exclude the effects of 5,976,146 and 5,637,108 stock options and 95,419 and 93,545 restricted stock units outstanding at June 30, 2006 and December 31, 2005, respectively.

(U.S. dollars in thousands, except share data)	(Unaudited) June 30, 2006	December 31, 2005
Total shareholders' equity	\$ 3,015,780	\$ 2,480,527
Less preferred shareholders' equity	(325,000)	( )
Common shareholders' equity	\$ 2,690,780	\$ 2,480,527
Common shares outstanding	73,937,973	73,334,870
Book value per common share	\$ 36.39	\$ 33.82

### Market Sensitive Instruments and Risk Management

In accordance with the SEC's Financial Reporting Release No. 48, we performed a sensitivity analysis to determine the effects that market risk exposures could have on the future earnings, fair values or cash flows of our financial instruments as of June 30, 2006. (See section captioned "Management's Discussion and Analysis of Financial Condition and Results of Operations - Market Sensitive Instruments and Risk Management" included in our 2005 Annual Report on Form 10-K/A.) Market risk represents the risk of changes in the fair value of a financial instrument and is comprised of several components, including liquidity, basis and price risks. At June 30, 2006, material changes in market risk exposures that affect the quantitative and qualitative disclosures presented as of December 31, 2005 are as follows:

#### Interest Rate and General Portfolio Risk

*Fixed Maturities and Short-Term Investments.* We invest in interest rate sensitive securities, primarily debt securities. We consider the effect of interest rate movements on the market value of our fixed maturities, fixed maturities pledged under securities lending agreements and short-term investments and the corresponding change in unrealized appreciation. As interest rates rise, the market value of our interest rate sensitive securities falls, and the converse is also true. The following table summarizes the effect that an immediate, parallel shift in the interest rate yield curve would have had on the portfolio at June 30, 2006 and December 31, 2005. Based on historical observations, there is a low probability that all interest rate yield curves would shift in the same direction at the same time and, accordingly, the actual effect of interest rate movements may differ materially

from the amounts set forth below. For further discussion on investment activity, please refer to Results of Operations.

(U.S. dollars in millions)	Interest Rate Shift in Basis Points				
	-100	-50	0	50	100
<b>June 30, 2006:</b>	\$ 7,891.4	\$ 7,775.9	\$ 7,664.2	\$ 7,554.2	\$ 7,448.2
Total market value	2.96	% 1.46	%	(1.44)	)% (2.82)
Market value change from base	\$ 227.2	\$ 111.7		\$ (110.0)	) \$ (216.0)
Change in unrealized value					
<b>December 31, 2005:</b>					
Total market value	\$ 7,060.9	\$ 6,942.1	\$ 6,826.7	\$ 6,715.0	\$ 6,606.9
Market value change from base	3.43	% 1.69	%	(1.64)	)% (3.22)
Change in unrealized value	\$ 234.2	\$ 115.4		\$ (111.7)	) \$ (219.8)

Another method that attempts to measure portfolio risk is Value-at-Risk ( VaR ). VaR attempts to take into account a broad cross-section of risks facing a portfolio by utilizing relevant securities volatility data skewed towards the most recent months and quarters. VaR measures the amount of a portfolio at risk for outcomes 1.65 standard deviations from the mean based on normal market conditions over a one year time horizon and is expressed as a percentage of the portfolio's initial value. In other words, 95% of the time, should the risks taken into account in the VaR model perform per their historical tendencies, the portfolio's loss in any one year period is expected to be less than or equal to the calculated VaR, stated as a percentage of the measured portfolio's initial value. As of June 30, 2006, our portfolio's VaR was estimated to be 3.08%, compared to an estimated 3.29% at December 31, 2005.

#### Foreign Currency Exchange Risk

Foreign currency rate risk is the potential change in value, income and cash flow arising from adverse changes in foreign currency exchange rates. A 10% depreciation of the U.S. Dollar against other currencies under our outstanding contracts at June 30, 2006 and December 31, 2005, net of unrealized appreciation on our securities denominated in currencies other than the U.S. Dollar, would have resulted in unrealized losses of approximately \$22.5 million and \$7.7 million, respectively, and would have decreased book value per common share by approximately \$0.30 and \$0.11, respectively. Based on historical observations, there is a low probability that all foreign currency exchange rates would shift against the U.S. Dollar in the same direction and at the same time and, accordingly, the actual effect of foreign currency rate movements may differ materially from the amounts set forth above. For further discussion on foreign exchange activity, please refer to Results of Operations.

#### Cautionary Note Regarding Forward-Looking Statements

The Private Securities Litigation Reform Act of 1995 provides a safe harbor for forward-looking statements. This report or any other written or oral statements made by or on behalf of us may include forward-looking statements, which reflect our current views with respect to future events and financial performance. All statements other than statements of historical fact included in or incorporated by reference in this report are forward-looking statements. Forward-looking statements can generally be identified by the use of forward-looking terminology such as may, will, expect, intend, estimate, anticipate, believe or continue or their negative or variations or similar terminology.

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

- our ability to successfully implement our business strategy during soft as well as hard markets;
- acceptance of our business strategy, security and financial condition by rating agencies and regulators, as well as by brokers and our insureds and reinsureds;
- our ability to maintain or improve our ratings, which may be affected by our ability to raise additional equity or debt financings, by ratings agencies existing or new policies and practices, as well as other factors described herein;
- general economic and market conditions (including inflation, interest rates and foreign currency exchange rates) and conditions specific to the reinsurance and insurance markets in which we operate;
- competition, including increased competition, on the basis of pricing, capacity, coverage terms or other factors;
- our ability to successfully integrate, establish and maintain operating procedures (including the implementation of improved computerized systems and programs to replace and support manual systems) to effectively support our underwriting initiatives and to develop accurate actuarial data, especially in light of the rapid growth of our business;
- the loss of key personnel;
- the integration of businesses we have acquired or may acquire into our existing operations;
- accuracy of those estimates and judgments utilized in the preparation of our financial statements, including those related to revenue recognition, insurance and other reserves, reinsurance recoverables, investment valuations, intangible assets, bad debts, income taxes, contingencies and litigation, and any determination to use the deposit method of accounting, which for a relatively new insurance and reinsurance company, like our company, are even more difficult to make than those made in a mature company since limited historical information has been reported to us through June 30, 2006;
- greater than expected loss ratios on business written by us and adverse development on claim and/or claim expense liabilities related to business written by our insurance and reinsurance subsidiaries;
- severity and/or frequency of losses;
- claims for natural or man-made catastrophic events in our insurance or reinsurance business could cause large losses and substantial volatility in our results of operations;
- acts of terrorism, political unrest and other hostilities or other unforecasted and unpredictable events;
- losses relating to aviation business and business produced by a certain managing underwriting agency for which we may be liable to the purchaser of our prior reinsurance business or to others in connection with the May 5, 2000 asset sale described in our periodic reports filed with the SEC;
- availability to us of reinsurance to manage our gross and net exposures and the cost of such reinsurance;
- the failure of reinsurers, managing general agents, third party administrators or others to meet their obligations to us;
- the timing of loss payments being faster or the receipt of reinsurance recoverables being slower than anticipated by us;

- material differences between actual and expected assessments for guaranty funds and mandatory pooling arrangements;
- changes in accounting principles or policies or in our application of such accounting principles or policies; and
- statutory or regulatory developments, including as to tax policy and matters and insurance and other regulatory matters such as the adoption of proposed legislation that would affect Bermuda-headquartered companies and/or Bermuda-based insurers or reinsurers and/or changes in regulations or tax laws applicable to us, our subsidiaries, brokers or customers.

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In addition, other general factors could affect our results, including developments in the world's financial and capital markets and our access to such markets.

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

#### **Other Financial Information**

The interim financial information included in this Quarterly Report on Form 10-Q as of and for the three and six months ended June 30, 2006 has not been audited by PricewaterhouseCoopers LLP. In reviewing such information, PricewaterhouseCoopers LLP has applied limited procedures in accordance with professional standards for reviews of interim financial information. However, their separate report included in this Quarterly Report on Form 10-Q for the 2006 second quarter states that they did not audit and they do not express an opinion on that interim financial information. Accordingly, you should restrict your reliance on their reports on such information. PricewaterhouseCoopers LLP is not subject to the liability provisions of Section 11 of the Securities Act of 1933 for their reports on the interim financial information because such reports do not constitute reports or parts of the registration statements prepared or certified by PricewaterhouseCoopers LLP within the meaning of Sections 7 and 11 of the Securities Act of 1933.

#### **ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK**

Reference is made to the information appearing above under the subheading "Market Sensitive Instruments and Risk Management" under the caption "Management's Discussion and Analysis of Financial Condition and Results of Operations," which information is hereby incorporated by reference.

#### **ITEM 4. CONTROLS AND PROCEDURES**

##### **Evaluation of Disclosure Controls and Procedures**

In connection with the filing of this Form 10-Q, our management, including the Chief Executive Officer and Chief Financial Officer, conducted an evaluation of the effectiveness of disclosure controls and procedures pursuant to applicable Exchange Act Rules as of the end of the period covered by this report. Based on that evaluation, the Chief Executive Officer and Chief Financial Officer concluded that the disclosure controls and procedures are effective.

We continue to enhance our operating procedures and internal controls (including the timely and successful implementation of our information technology initiatives, which include the implementation of improved computerized systems and programs to replace and support manual systems, and including controls over financial reporting) to effectively support our business and our regulatory and reporting requirements. Our management does not expect that our disclosure controls or our internal controls will prevent all errors and all fraud. A control system, no matter how well conceived and operated, can provide only reasonable, not absolute, assurance that the objectives of the control system are met. Further, the design of a control system must reflect the fact that there are resource constraints, and the benefits of controls must be considered relative to their costs. As a result of the inherent limitations in all control systems, no evaluation of controls can provide absolute assurance that all control issues and instances of fraud, if any, within the company have been detected. These inherent limitations include the realities that judgments in decision-making can be faulty, and that breakdowns can occur because of simple error or mistake. Additionally, controls can be circumvented by the individual acts of some persons or by collusion of two or more people. The design of any system of controls also is based in part upon certain assumptions about the



likelihood of future events, and there can be no assurance that any design will succeed in achieving its stated goals under all potential future conditions; over time, controls may become inadequate because of changes in conditions, or the degree of compliance with the policies or procedures may deteriorate. As a result of the inherent limitations in a cost-effective control system, misstatement due to error or fraud may occur and not be detected. Accordingly, our disclosure controls and procedures are designed to provide reasonable, not absolute, assurance that the disclosure controls and procedures are met.

**Changes in Internal Controls Over Financial Reporting**

There have been no changes in internal control over financial reporting that occurred during the fiscal quarter ended June 30, 2006 that have materially affected, or are reasonably likely to materially affect, internal control over financial reporting.

**PART II. OTHER INFORMATION**

*Item 1. Legal Proceedings*

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We, in common with the insurance industry in general, are subject to litigation and arbitration in the normal course of our business. As of June 30, 2006, we were not a party to any material litigation or arbitration other than as a part of the ordinary course of business, none of which is expected by management to have a significant adverse effect on our results of operations and financial condition and liquidity.

In 2003, the former owners of American Independent Insurance Holding Company ( American Independent ) commenced an action against ACGL, American Independent and certain of American Independent s directors and officers and others seeking unspecified damages relating to the reorganization agreement pursuant to which we acquired American Independent in 2001. The reorganization agreement provided that, as part of the consideration for the stock of American Independent, the former owners would have the right to receive a limited, contingent payment from the proceeds, if any, from certain pre-existing lawsuits that American Independent had brought as plaintiff prior to its acquisition by us. The former owners alleged, among other things, that the defendants entered into the agreement without intending to honor their commitments under the agreement and are liable for securities and common law fraud and breach of contract. In December 2004, we sold American Independent, PSIC and affiliated entities, which conducted our nonstandard automobile insurance operations, to a third party. Under the terms of the sale agreement, ACGL and certain of its affiliates retained the liabilities (if any) relating to the foregoing matters. ACGL and the other defendants filed a motion to dismiss all claims. That motion was granted on March 23, 2005, and the plaintiffs were allowed until April 15, 2005 to amend their complaint. Although they did attempt to amend the complaint, they did not timely and properly do so, and, on April 26, 2005, judgment was entered dismissing the action with prejudice. The plaintiffs thereafter moved to vacate the judgment and to allow retroactively the filing of their second amended complaint; that motion was granted. The plaintiffs filed a new pleading in October 2005. ACGL and the other defendants again moved to dismiss all claims, and those motions are now pending before the court. At the request of the judge, oral arguments were made on June 26, 2006. Although no assurances can be made as to the resolution of such motions or of the plaintiffs claims, management does not believe that any of the claims are meritorious.

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

The following table summarizes ACGL's purchases of its common shares for the 2006 second quarter:

Period	Issuer Purchases of Equity Securities		Total Number of Shares Purchased as Part of Publicly Announced Plans or Programs	Maximum Number of Shares that May Yet be Purchased Under the Plan or Programs
	Total Number of Shares Purchased (1)	Average Price Paid per Share		
4/1/2006-4/30/2006				
5/1/2006-5/31/2006	186	\$ 58.19		
6/1/2006-6/30/2006				
Total	186	\$ 58.19		

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

**Item 4. Submission of Matters to a Vote of Security Holders**

- (a) The annual meeting of shareholders (the Annual Meeting) of ACGL was held on May 3, 2006.
- (b) Proxies for the Annual Meeting were solicited pursuant to Regulation 14 under the Securities Exchange Act of 1934. There was no solicitation in opposition to management's nominees as listed in ACGL's proxy statement, dated March 31, 2006 (the Proxy Statement).
- (c) The shareholders of ACGL (1) elected Class II Directors to hold office until the 2009 annual meeting of shareholders or until their successors are elected or qualified, (2) elected certain individuals as Designated Company Directors of certain of ACGL's non-U.S. subsidiaries and (3) ratified the selection of PricewaterhouseCoopers LLP as independent registered public accounting firm for the fiscal year ending December 31, 2006. Set forth below are the voting results for these proposals:

**Election of Class I Directors of ACGL**

	FOR	WITHHOLD
Constantine Iordanou Total:	70,347,572	193,386
James J. Meenaghan Total:	70,450,672	90,286
John M. Pasquesi Total:	68,873,955	1,667,003

**Election of Designated Directors of Non-U.S. Subsidiaries**

	<b>FOR</b>	<b>WITHHOLD</b>
James J. Ansaldi Total:	70,423,292	117,666
Graham B. Collis Total:	69,262,700	1,278,258
Marc Grandisson Total:	70,423,292	117,666
W. Preston Hutchings Total:	70,423,292	117,666
Constantine Iordanou Total:	70,520,927	20,031
Ralph E. Jones III Total:	70,422,542	118,416
Thomas G. Kaiser Total:	70,423,292	117,666
Mark D. Lyons Total:	70,423,292	117,666
Nicolas J. Metcalf Total:	70,423,292	117,666
Martin J. Nilsen Total:	70,423,292	117,666
Nicolas Papadopoulo Total:	70,423,292	117,666
Michael Quinn Total:	70,423,292	117,666
Maamoun Rajeh Total:	70,423,292	117,666
Paul S. Robotham Total:	69,169,755	1,371,203
Robert Van Gieson Total:	70,423,292	117,666
John D. Vollaro Total:	69,169,455	1,371,503

**Ratification of Selection of PricewaterhouseCoopers LLP as Independent Registered Public Accounting Firm**

	<b>FOR</b>	<b>AGAINST</b>	<b>ABSTAIN</b>
<b>Total:</b>	70,496,828	41,084	3,046

**Item 5. Other Information**

In accordance with Section 10a(i)(2) of the Securities Exchange Act of 1934, as amended, we are responsible for disclosing non-audit services to be provided by our independent auditor, PricewaterhouseCoopers LLP, which are approved by the Audit Committee of our board of directors.

During the 2006 second quarter, the Audit Committee approved engagements of PricewaterhouseCoopers LLP for the following permitted non-audit services: tax services, tax consulting and tax compliance.

**Item 6. Exhibits**

<b>Exhibit No.</b>	<b>Description</b>
15	Accountants Awareness Letter (regarding unaudited interim financial information)
31.1	Certification of Chief Executive Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002
31.2	Certification of Chief Financial Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002
32.1	Certification of Chief Executive Officer pursuant to Section 906 of the Sarbanes-Oxley Act of 2002
32.2	Certification of Chief Financial Officer pursuant to Section 906 of the Sarbanes-Oxley Act of 2002
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***SIGNATURES***

Pursuant to the requirements of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned thereunto duly authorized.

**ARCH CAPITAL GROUP LTD.  
(REGISTRANT)**

Date: August 4, 2006

/s/ Constantine Iordanou  
Constantine Iordanou  
President and Chief Executive Officer

(Principal Executive Officer) and Director

Date: August 4, 2006

/s/ John D. Vollaro  
John D. Vollaro  
Executive Vice President, Chief Financial

Officer and Treasurer (Principal Financial and

Accounting Officer)

**EXHIBIT INDEX**

<b>Exhibit No.</b>	<b>Description</b>
15	Accountants Awareness Letter (regarding unaudited interim financial information)
31.1	Certification of Chief Executive Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002
31.2	Certification of Chief Financial Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002
32.1	Certification of Chief Executive Officer pursuant to Section 906 of the Sarbanes-Oxley Act of 2002
32.2	Certification of Chief Financial Officer pursuant to Section 906 of the Sarbanes-Oxley Act of 2002

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