

Arch Insurance Company (Europe) Limited

Annual Report and Financial Statements
for the year ended 31 December 2008

Contents

Analysis of Profit and Loss Account	1
Financial Summary	2
Senior Management Team	3
Directors' Report	4-9
Management Report of Financial Risks	10-17
Independent Auditors' Report To The Members Of Arch Insurance Company (Europe) Ltd	18-19
Financial Statements Profit & Loss Account	20
Financial Statements Balance Sheet	21
Financial Statements Notes to the Accounts	22-33
Directors and Administration	34

Analysis of Profit and Loss Account

for the year ended 31 December 2008

	Arch Insurance Company (Europe) Before Cessions to Arch Reinsurance £000	Cessions to Arch Reinsurance £000	Arch Insurance Company (Europe) After Cessions to Arch Reinsurance £000
All figures in GBP			
Technical account – general business			
Earned premiums, net of reinsurance			
Gross premiums written	265,098	-	265,098
Outward reinsurance premiums	(78,720)	(164,198)	(242,918)
Net premiums written	186,378	(164,198)	22,180
Change in the gross provision for unearned premiums	1,894	-	1,894
Change in the provision for unearned premiums, reinsurers' share	(6,526)	4,624	(1,902)
Earned premiums, net of reinsurance	181,746	(159,574)	22,172
Allocated investment return transferred from the non-technical account	1,968	-	1,968
Total technical income	183,714	(159,574)	24,140
Claims incurred, net of reinsurance			
Claims paid			
-gross amount	84,374	-	84,374
-reinsurers' share	(33,019)	(40,318)	(73,337)
	51,355	(40,318)	11,037
Change in the provision for claims			
-gross amount	136,316	-	136,316
-reinsurers' share	(49,806)	(80,864)	(130,670)
	86,510	(80,864)	5,646
Claims incurred net of reinsurance	137,865	(121,182)	16,683
Net operating expenses	58,635	(46,612)	12,023
Total technical charges	196,500	(167,794)	28,706
Balance on the technical account for general business	(12,786)	8,220	(4,566)
Non-technical account			
Investment income	4,970	-	4,970
Unrealised gains on investments	719	-	719
Investment expenses and charges	(151)	-	(151)
Foreign exchange gain	1,314	-	1,314
Allocated investment return transferred to the general business technical account	(1,968)	-	(1,968)
Profit on ordinary activities before tax	(7,902)	8,220	318
Tax on profit on ordinary activities	(221)	-	(221)
Profit for the financial year	(8,123)	8,220	97

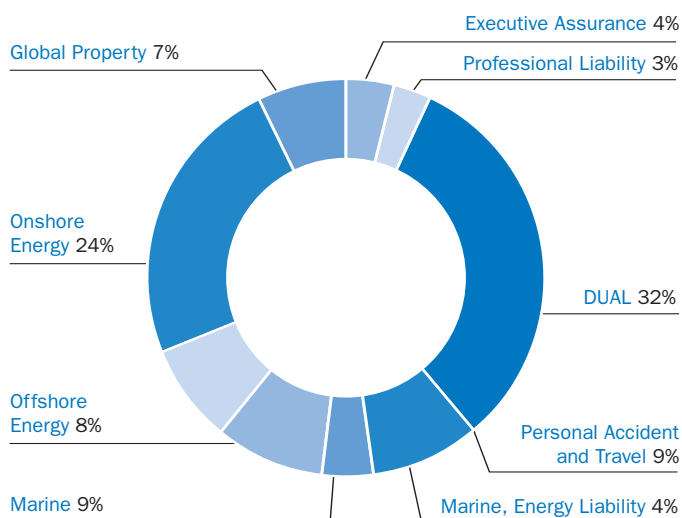
The intra-group reinsurance contract provides capital capacity to Arch Insurance Company (Europe) Ltd., supported by Arch Reinsurance Limited.

The intra-group reinsurance contract mitigates the risk exposure to the capital of Arch Insurance Company (Europe) Ltd. The reinsurance contract consists of an 85% quota share policy and a stop-loss policy limiting the downside exposure ultimate net loss to 100% of the Company's retained earned premium.

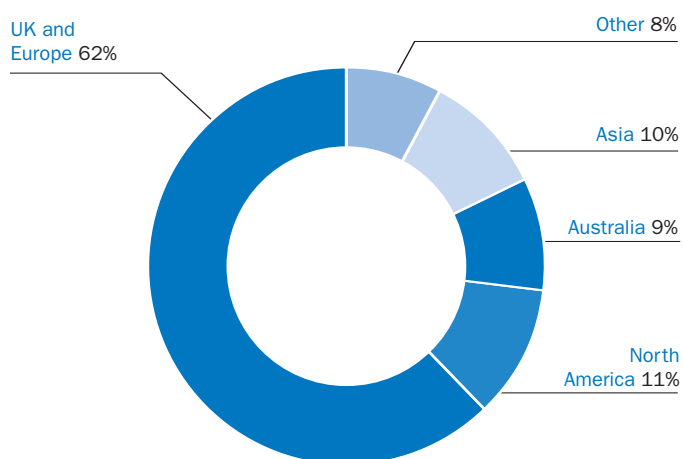
The intra-group reinsurance provided to Arch Insurance Company (Europe) Ltd. supports the 'A' rated capital adequacy by A. M. Best and Standard and Poor's.

Financial Summary

Arch Europe Classes of Business by GWP



Arch Europe Customers



The Financial Summary below reflects the Company's results before the impact of the intra-group reinsurance contract:

	2008	2007
• Gross Written Premium	£265 million	£245 million
• Net Earned Premium	£182 million	£157 million
• Loss Ratio	75.9%	65.6%
• Net Expense Ratio	32.3%	27.9%
• Net Combined Ratio	108.1%	93.5%
• Net Profit After Tax post Quota Share	£0.1 million	£2.8 million

Senior Management Team

James Weatherstone

President & Chief Executive Officer

James took over the role of President & Chief Executive Officer in April 2008, moving from the CUO position which he had assumed during 2007. James joined Arch Europe in September 2005 after 13 years with XL Capital Ltd in London as Deputy Underwriter of Syndicate 861/1209 at Lloyd's and Director of Brockbank Syndicate Management Ltd. Latterly he was responsible for establishing the London branch of XL Europe Ltd. Since joining Arch, James has established the Executive Assurance and Professional Liability division. James has underwritten a broad range of Directors & Officers Liability and Professional Liability business in the North American and International markets. Prior to XL Capital, he worked as an underwriter with the Merrett Group and as a broker with Willis Ltd.

William Beveridge

Senior Vice President

William began his career in 1989 working as a broker with Sedgwick Marine and Cargo. In 1995, he joined the Brockbank Syndicate 861 at Lloyd's as an underwriter on the Marine Hull account. William became Class Hull underwriter in 1998 and was appointed deputy underwriter of the XL London Market Ltd. Syndicate 1209 in 2002. He was responsible for Marine and Offshore business in Europe and Bermuda at XL London Market. William joined Arch in January 2005. He currently sits on the London Market Joint Hull Committee, and the International Union of Marine Insurers Ocean Hull Committee.

Knud Christensen

Senior Vice President & Chief Administration Officer

Knud joined Arch after 4 years as Human Resources Director of CNA Insurance Company Europe, prior to which he gained over 20 years' management experience at British Petroleum, latterly as Human Resources Manager for BP Oil. Knud has also spent 3 years as a consultant in management development in his native Denmark.

Elizabeth Fullerton-Rome

Senior Vice President, Operations & Compliance Manager

Elizabeth joined Arch in 2006 and leads the Operations and Compliance team. She has more than 16 years of experience in the insurance industry and is a qualified chartered accountant, having qualified at Neville Russell and gained eight years of post-qualification experience at KPMG.

David Hipkin

Senior Vice President & Chief Underwriting Officer

David joined Arch Europe in 2005. David has 28 years experience in the Insurance Market. Prior to joining Arch, David was an executive Director of Atrium Underwriters Ltd, the Lloyd's managing agency responsible for the operations of Syndicates 609 and 570. David was with Atrium for 7 years before joining Arch. David was a member of Lloyd's from 1983 to 1986. During his career at Lloyd's, David served on the Lloyd's superfund committee and the boards of Lloyd's America and Lloyd's Worldwide Markets. David was also a member of the London Market Liability Committee from 1999 to 2005. Since joining Arch, David has developed and managed the Marine and Energy Liability Underwriting practice of the company.

Paul Robotham

Senior Vice President & Chief Financial Officer

Paul qualified as a Chartered Accountant in 1989, having trained with Coopers & Lybrand. His insurance career began in 1990, when he joined the finance team at Hiscox Syndicates. Since then he has held a number of senior positions in reinsurance and broking organisations, from 2000 as Chief Financial Officer of Zurich Corporate Solutions at Zurich Insurance Company.

Budhi Singh

Senior Vice President, Actuary & Chief Risk Officer

Budhi has more than 20 years' experience in the insurance industry. Prior to Arch Europe, Budhi was Director of Risk and Capital Planning with ACE European Group Ltd where among other duties he had responsibility for risk management and capital modelling in support of the Regulatory Capital Assessment. Prior to taking on the role of Director of Risk and Capital Planning, Budhi was the Chief Actuary of ACE European Group Ltd.

Angus Watson

Senior Vice President & Head of Claims

Angus joined Arch Europe in March 2005 as Head of Claims. He has more than 18 years' experience in the insurance industry as well as 5 years' experience as a Police Officer in the Metropolitan Police. Prior to joining Arch, Angus was Head of Claims for Hiscox Insurance Company. In this role he was responsible for managing the insurance company's claims function including all UK and European offices. Prior to that Angus worked for Chubb Insurance Company of Europe in a variety of roles, primarily in the claims area.

Directors' Report

The directors have pleasure in presenting their annual report of Arch Insurance Company (Europe) Limited (“the Company” or “Arch Europe”), together with the audited financial statements for the year ended 31 December 2008.

Ownership

The Company is an ultimate wholly owned subsidiary of Arch Capital Group Ltd. (“ACGL”), a Bermuda-based company with \$3.8 billion of capital at 31 December 2008. Through operations in Bermuda, the United States, Europe and Canada, Arch Capital Group Ltd. provides insurance and reinsurance on a worldwide basis. Arch Capital Group Ltd. is listed on the NASDAQ U.S. stock exchange.

At 31 December 2008 the ownership of the Company was transferred to Arch Reinsurance Europe Underwriting Limited, which is a licensed reinsurance company in Ireland. The transfer of ownership does not impact the Company's business.

Principal Activity and Review of Business

The Company currently underwrites Marine, Property and Casualty insurance business with a focus on Specialty lines of insurance. The Company operates from its head office in London and its branches in Germany and Denmark.

We classify our business into underwriting segments comprising: Energy (Onshore and Offshore), Property, Marine, Personal Accident, Executive Assurance and Professional Liability. A part of the Executive Assurance (“EA”) and Professional Liability (“PL”) lines are written under agency agreement through DUAL International (“DUAL”). The market focus for the DUAL business is small and medium sized enterprises (“SME”) and the DUAL offices cover the UK, Spain, Portugal, Italy, Germany and Australia. In addition, a

part of the EA & PL lines are written under an agency agreement through RiskPoint A/S who are based in Denmark and operate in the Nordic countries.

Review of the Business

The Company has continued to modestly expand its premium base during 2008 showing a year on year growth of 8%. Market conditions were softening in the first half of the year, but the cat. experience combined with the early impacts from the credit crunch has halted the slide in rates across both Property and Casualty lines. Anticipated increases in rates have been slow to emerge, but Arch Europe is well positioned to take advantage of improved market conditions, having both the underwriting talent and the capital resource to expand its business.

During the second half of 2008, the financial markets have experienced significant adverse credit events and a loss of liquidity, which have reduced the amount and availability of capital in the insurance industry. In addition, certain of our competitors have experienced significant financial difficulties. We believe that the impact of such events, along with the recent catastrophic activity have begun to affect market conditions positively and may lead to rate strengthening in a number of Specialty lines in which Arch Europe operates.

We are pleased to report a number of senior management promotions. During 2008 our Chief Executive, Mr Van Gieson, was promoted to Chairman of Arch Europe. This is a role that will give strategic oversight to the expansion of companies and trading platforms for Arch in Europe. Mr Weatherstone was promoted into the role of Chief Executive Officer with day-to-day operational responsibilities. Mr Hipkin was promoted to the role of Chief Underwriting Officer. Mr Van Gieson's role as Chairman will become a non-executive Chairman's role in 2009.

Results

The results for the year ended 31 December 2008 are a net profit after tax and after intra-group reinsurance of £97,000 (2007: £2,838,000). Particulars are given on page 20. The directors do not propose a dividend for the period.

Directors' Report

The gross written premium for the year was £265.1 million (2007: £254.4 million) which represents growth of 8% on prior year. Net written premium before intra-group reinsurance was £186 million (2007: £166 million) and after intra-group reinsurance was £22 million (2007: £25 million).

2008 was one of the worst years on record for insured losses. Our ultimate gross loss estimates relating to Hurricanes Ike and Gustav are £59.7 million. Our reserves are based primarily on estimates of notified case losses which are determined by our claims personnel for the ultimate settlement amount of individual claims. The estimates reflect the judgement of claims personnel based on general corporate reserving practices, the experience and knowledge of such personnel regarding the nature and value of the specific type of claim and, where appropriate, the advice of counsel. IBNR reserves are established to determine a value estimate of ultimate losses and LAE and are generally determined by extrapolation of claim emergence and settlement patterns observed in the past that can be reasonably expected to persist into the future. In forecasting ultimate losses and LAE, reference has been made to the recent 2005 hurricane experience, to benchmark claims emergence patterns, cost inflation and settlement patterns.

Our ultimate net loss estimates relating to Hurricanes Ike and Gustav are £4.0 million. We seek to limit the amount of exposure we will assume from any one insured or from a single event in any geographic zone to a maximum pre-tax loss of approximately 25% of total shareholders' equity. We do this by the purchase of reinsurance cover and the company maintains both proportional treaties and excess of loss treaties. We also seek to limit our loss exposure by geographic diversification and geographic zone limitations which involve significant underwriting judgements. We cannot be certain that the loss limitation methods will be effective, since one or more catastrophic events could result in claims that substantially exceed our expectations, which could have a material adverse effect on our financial condition. Our estimated probable maximum pre-tax loss is determined through the use of modelling techniques and realistic disaster scenario modelling, but such estimates do not represent our total potential loss for such exposures.

The Company has the benefit of a whole account proportional (85%) reinsurance treaty with Arch Reinsurance Ltd. (Bermuda) ("Arch Re"). Arch Re is a Bermuda domiciled company with a book value of \$3.8 billion. This reinsurance protection enables capital to be provided from Bermuda to support the business written through the Company.

The Company is required to maintain assets on deposit which primarily consist of fixed maturities and cash. These are available to settle insurance and reinsurance liabilities to third parties. Our aggregate cash and invested assets at 31 December 2008 totalled £101.6 million (2007: £90.3 million). In addition, premiums paid to Arch Re under the intra-group reinsurance agreement are held in trust for the benefit of the Company's policyholders. The trust fund has been established in adherence with FSA prudential guidelines. At all times the value of the trust is more than 110% of the reinsured liabilities. The trustees of this trust are independent of the Arch group, being BNY Mellon bank, Pittsburgh. At 31 December 2008, the value of the trust fund was \$453 million (2007: \$352 million).

As a result of recent financial market disruption, which has included a lack of liquidity in the credit markets and a widening of credit spreads on fixed maturities, the market value of part of our investment portfolio at 31 December 2008 was lower than in prior periods. The distribution of our fixed maturities, cash and other investments by type is shown below:

	31 December 2008		31 December 2007	
	Estimated Market Value	Net Unrealised Gains (losses)	Estimated Market Value	Net Unrealised Gains (losses)
	£'000	£'000	£'000	£'000
UK Gilts & Treasuries	26,796	1,498	33,108	377
Other European Government bonds	1,137	38	-	-
Corporate bonds	35,203	(260)	32,780	(34)
Short term & cash equivalents	20,866	-	13,621	-
Other	58	-	58	-
Cash	17,634	-	10,775	-
	101,694	1,276	90,342	343

Directors' Report

The Company did not hold any collateralised debt obligations ("CDO"), nor any credit default swaps ("CDS"), nor any other hedge or derivative financial instruments during the year. We review securities measured at fair value and discuss proper classification with investment advisors. At 31 December 2008, we had the ability and intent to hold fixed maturities which were in an unrealised loss position, until recovery.

The credit quality distribution of our fixed maturities is shown below. 100% of the fixed maturities held by the company were rated investment grade by the major rating agencies.

	31 December 2008		31 December 2007	
	Estimated Market Value £'000	% of Total	Estimated Market Value £'000	% of Total
AAA	46,361	55.2%	57,835	72.7%
AA	25,239	30.0%	11,795	14.8%
A	10,979	13.1%	8,623	10.8%
BBB	1,423	1.7%	1,256	1.6%
Not rated	58	0.1%	58	0.1%
	84,060	100%	79,567	100%

The Company booked foreign exchange gains of £1.3 million (2007: £0.7 million loss) during the year from an uplift in net asset value due to the appreciation of the US Dollar to Pound Sterling ("GBP"). The Company maintains assets in its three settlement currencies: USD, Euro and GBP; although capital is maintained in GBP.

The expense ratio was 54.2% compared to 23.5% in 2007. The significant increase is due to profit commissions payable during the year based on the level of underwriting profits of DUAL. Operating expenses continue to be well controlled. The business model we apply is to outsource administrative services and infrastructure, where possible, which has the advantage of not having to hire and manage administrative staff. Arch Europe controls the outsourced services through service agreements which define the service standards and care is taken to regularly audit all our service providers.

Corporate and Social Responsibility

The Board recognises the importance of managing the impact of the Company's activities and takes care to maintain ethical standards and integrity in the conduct of our business.

The global Arch group of companies maintains a Code of Business Conduct, which describes our ethical principles and includes policies designed to assist in preventing violations of the Code and to allow the company to respond appropriately to any actual or potential violations. To help set the standards of behaviour expected from all staff, the Company provides a training course on the Code intended to help guide employees in the way that they conduct business.

The Company is committed to providing equal opportunities to potential and actual employees in all aspects of employment. Our employment policies are non-discriminatory on any grounds relating to selection, training, career development or any other employment matters.

Our success depends upon on having highly capable people who fit well with the Company's culture of performance, accountability, teamwork and ethical conduct. Staff are encouraged to continue professional education and each employee is encouraged to develop a personal development plan with their managers.

Directors

The directors of the Company during the period were:

R T. Van Gieson	Chairman
J Weatherstone Appointed 14 April 2008	Chief Executive Officer
P Robotham	Chief Financial Officer
R Jones III Resigned 22 July 2008	Non Executive
T Kaiser Resigned 1 July 2008	Non Executive
M Lyons	Non Executive
M Nilsen	Non Executive
M Quinn	Non Executive
D Brand Appointed 22 July 2008	Non Executive
M Murphy Appointed 22 July 2008	Non Executive

Directors' Report

Directors' Interests

None of the directors had any beneficial interest in the issued share capital of the Company at any time during the period.

Under the provisions of section 1177 of Companies Act 2006, the directors of the Company are exempt from disclosing to this Company any interests they may have in the parent Company, Arch Capital Group Ltd.

Policy and Practice on Payment of Creditors

It is the policy of the Company to accept and abide by London insurance market practices or the terms of trade established by its suppliers and agents unless otherwise agreed.

Settlements with fellow subsidiaries are governed by intra-group agreements.

Financial Risk Management

The Board of Directors has ultimate responsibility for the Company's risk management. This includes approval for the business plan, the maintenance of financial resources and for ensuring the adequacy of the systems and internal controls across Arch Europe, including risk governance arrangements. The Board gains assurance from a number of sources that include Internal Audit, Legal & Compliance and internal controls testing.

The Company has a Risk Committee whose purpose is:

- To review the risk management framework and the capital adequacy to ensure the Company is capitalised at a level that reflects the needs and potential financial impact of risks to which the Company is exposed
- To review the catastrophe risk analysis of geographical exposures, natural catastrophe exposures and realistic disaster scenarios
- To monitor risk controls and record any control failures

The Company manages its risks through business owner responsibility for controls (e.g. underwriting line sizes, price

modelling, reinsurance, catastrophe modelling, investment policies, exception reporting, peer review, compliance, the business planning process and through capital management). The approach is documented in the "Risk Register" within which is used a common language for risks, including the definition of the risk groups under which Arch Europe assesses risks. Arch Europe has chosen to use the six FSA Prudential risk categories in this regard. This approach ensures consistency in the identification, measurement and mitigation of risk. Through the Risk Committee we are able to identify, measure, transfer and control risks at the point that they occur.

The Risk Register is a key input into the capital modelling regime and any material changes in the underlying risks will be modelled for potential impact upon the Company's capital requirements. Such changes include but are not limited to changes in business mix, reinsurance strategy and investment policy. Arch Europe uses a combination of stochastic modelling techniques and stress and scenario analysis to regularly assess its Individual Capital Adequacy (ICA).

Risk management, internal audit and compliance processes are closely coordinated so that their activity is complementary. Internal audits are based on a risk-based approach and provide independent assurance over the effectiveness of the controls. Our Compliance team ensures that activities of the Company comply with all applicable regulations.

Further details about the financial risk management are given in the Management Report of Financial Risks on page 10.

Underwriting Risk and Uncertainty

The process of selecting and pricing insurance risks is addressed through a framework of policies, procedures and internal controls. Risk selection is our business and our procedures are designed to ensure that the evaluation of risk is transparent and logical. The Board of Directors approves risk appetite, values and standards which are clearly documented and shape the underwriting strategy.

The Company's long-term underwriting strategy is to seek a diverse and balanced portfolio of risks in order to limit

Directors' Report

volatility. This is achieved by accepting a spread of business over time, segmented between different classes of business and geography.

The annual business plans for each underwriting team reflect the Company's underwriting strategy and set out the following:

- Maximum line sizes for each class of business and underwriting authorities
- Net retention limits
- Aggregate exposure limits and catastrophe costs to both natural and man-made events
- Classes of business to be written and premium income limits
- Territories within which the Company is authorised to underwrite direct business

These plans are approved and monitored by the Management Committee. The Committee oversees the procedures for delegating underwriting authorities to the Company's staff. Additionally, the Risk Committee is tasked with identifying all significant risks relevant to their respective areas and identifying unacceptable levels of risk when they arise.

The Company has large aggregate exposures to natural and man-made catastrophic events. These risks are inherently uncertain as it is difficult to predict the timing of such events with statistical certainty or estimate the amount of loss which any given occurrence will generate. The Company regularly monitors its exposure to catastrophic events, including earthquake, wind and terrorism, using the RMS system (Property, Terrorism and Onshore Energy) and the INTEC system (Offshore Energy), both locally and at Group level. Additionally, the Company regularly monitors its exposure to man-made realistic disaster scenarios.

Rate monitoring details, including limits, deductibles, exposures, terms and conditions and risk characteristics are also captured and the results are combined to monitor the rating environment for each class of business.

Donations

During the year the Company made charitable donations of £14,216 (2007: £37,059). No donations were made for political purposes.

Statement of Disclosure of Information to Auditors

Each of the persons who is a director at the date of this report confirms that:

- So far as each of them is aware, there is no information relevant to the audit of the Company's consolidated financial statements for the year ended 31 December 2008 of which the auditors are unaware;
- The director has taken all steps that he ought to have taken in his duty as a director in order to make himself aware of any relevant audit information and to establish that the Company's auditors are aware of that information.

Statement of Directors' Responsibilities

Company law requires the directors to prepare financial statements for each financial year that give a true and fair view of the state of affairs of the Company and of the profit or loss of the Company for that period. In preparing those financial statements, the directors are required to:

- Select suitable accounting policies and then apply them consistently, with the exception of changes arising on the adoption of new accounting standards in the year;
- Make judgements and estimates that are reasonable and prudent;
- State whether applicable accounting standards have been followed, subject to any material departures disclosed and explained in the financial statements; and
- Prepare the financial statements on a going concern basis, unless it is inappropriate to presume that the Company will continue in business.

Directors' Report

The directors confirm they have complied with the above requirements in preparing the financial statements.

The directors are responsible for keeping proper accounting records that disclose with reasonable accuracy at any time the financial position of the Company and to enable them to ensure that the financial statements comply with the Companies Act 1985. They are also responsible for safeguarding the assets of the Company, and hence for taking reasonable steps for the prevention and detection of fraud and other irregularities.

The directors are responsible for the maintenance and integrity of the archinsurance.co.uk web-site. Legislation in the UK concerning the preparation and dissemination of financial statements may differ from legislation in other jurisdictions.

Auditors

The auditors, PricewaterhouseCoopers LLP, have indicated their willingness to continue in office and a resolution that they be re-appointed will be proposed at the annual general meeting.

Outlook

The market overall is beginning to improve and rates are increasing in certain classes. The reduction in capital in the industry is now a trend that is widely expected to continue during 2009 and this, we believe, will provide additional momentum to the upswing in rates.

The credit crunch has caused a number of financial scandals to surface from which we expect liability claims to develop. We insure a number of banks and financial institutions for Directors & Officers and Professional Indemnities. The slow emergence of claims for these lines is normal. We have received a number of claims notifications against some of the banks subject to "bail-outs" and also a number of notifications in respect of Madoff related claims. At this time, given the information available and the uncertainty of some of these claims notifications, we believe that the Company carries adequate reserves in its IBNR provisions to meet expected liabilities.

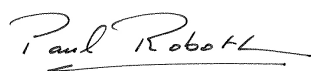
In March 2009, Arch received authority from Lloyd's and the FSA to set-up a Lloyd's Managing Agency and a syndicate at Lloyd's – Syndicate 2012. Permission to underwrite was granted to commence from April 2009. The Lloyd's operations will have a shared management with the Company. Syndicate 2012 will be an alternative underwriting platform to the Company. The management welcome the entry in to the Lloyd's market and eagerly anticipate the opportunities that Lloyd's international licensing and brand will offer to expand our insurance business. The development of Syndicate 2012, which has an underwriting stamp capacity of £100m, will entail renewal of certain lines of business into the Syndicate on policy expiry in the Company. These lines of business are mainly Marine, Personal Accident and some Property lines.

The worldwide financial collapse will continue to place stress on our investment portfolio, particularly in terms of fair market valuations. However, the conservative product selection and good credit rating of our securities have so far proved our assets to be robust in the face of the market volatility. In view of our current liquidity, and supported by the assets placed in trust under the intra-group reinsurance protections, we believe that the Company will continue to have the ability to hold its fixed maturity investments which are in an unrealised loss position, until recovery.

In spite of uncertain economic conditions, market conditions in Property and Casualty insurance markets are showing improvement. Arch Europe continues to look for geographic diversification and spread of risk in areas that satisfy our corporate goal of 15% return on capital over market cycles.

We employ experienced underwriters who typically have seen at least one complete cycle. Since our inception, Arch Europe has not seen turnover of senior management and underwriting staff. We believe that the Company is a positive and genuinely good place to come to work.

By order of the Board



P. Robotham
Finance Director

25 March 2009

Management Report of Financial Risks

The Company enters into contracts that directly transfer insurance risk and by seeking to match its assets against future liabilities, is exposed to financial and other risks. The Company has identified its risk groups and established risk management policies to manage these risks in accordance with its risk appetite. The main sources of risk together with an explanation of how they are managed are set out below.

Insurance Risk

Arch Europe's insurance business assumes the risk of loss from persons or organisations that are directly exposed to an underlying loss. Our insurance risk arises from this risk transfer due to the inherent uncertainties about the occurrence, amount and timing of insurance liabilities. The two key components of insurance risk are: underwriting risk, and reserving and claims risk. Each element is considered below.

(i) Underwriting Risk arises from the:

- Adequacy of the Company's pricing, taking the insurance premium cycle into account and the high level of uncertainty in pricing in new or emerging markets;
- Adequacy of the reinsurance programme and whether it is appropriate for the risks selected by the Company and adequately takes account of the underwriting and business plans;
- Prospect of reinsurance rates increasing substantially or reinsurance being unavailable;
- Uncertainty of claims experience;
- Dependence on intermediaries for a disproportionate share of the premium income;
- Geographical or jurisdictional concentrations;
- Appropriateness of policy wordings;
- Risk of mis-selling;
- Tolerance for variations in expenses (including indirect costs).

The Company seeks to limit its loss exposure by purchasing reinsurance limits up to its maximum line sizes and accumulations and, in the case of catastrophes, cover is purchased up to modelled 1 in 250 year event. The Company also seeks to limit its loss exposure by geographic diversification.

For natural catastrophe exposed business, Arch Europe seeks to limit the amount of exposure it will assume from any one insured or reinsured and the amount of the exposure to catastrophe losses in any geographic zone.

Management Report of Financial Risks

The Company's largest exposures to natural catastrophe 1 in 250 year stress events are:

Country	Event	Gross (\$m)	Net Pre Cat Pre 85% QS (\$m)	Net Pre Cat Post 85% QS (\$m)
US Onshore	1:250 RMS Return Period Windstorm	115.7	44.5	6.7
GOM - Offshore	1:250 RMS Return Period Windstorm	42.6	23.7	3.6
Europe	1:250 RMS Return Period Windstorm	37.8	20.7	3.1
Australia	1:250 RMS Return Period Windstorm	35.5	15.7	2.4
Caribbean	1:250 RMS Return Period Windstorm	47.1	14.9	2.2
Japan	1:250 RMS Return Period Windstorm	8.3	3.9	0.6
Germany	1:250 RMS Return Period Windstorm	7.0	3.5	0.5
US California	1:250 RMS Return Period Earthquake	38.2	20.4	3.1
US New Madrid	1:250 RMS Return Period Earthquake	24.9	9.0	1.3
Taiwan	1:250 RMS Return Period Earthquake	45.3	24.4	3.7
Japan	1:250 RMS Return Period Earthquake	37.7	19.6	2.9
Greece	1:250 RMS Return Period Earthquake	30.6	16.3	2.5
Chile	1:250 RMS Return Period Earthquake	23.9	11.4	1.7
Mexico	1:250 RMS Return Period Earthquake	19.4	10.4	1.6
Portugal	1:250 RMS Return Period Earthquake	20.4	10.1	1.5
Caribbean	1:250 RMS Return Period Earthquake	18.7	9.0	1.4
Italy	1:250 RMS Return Period Earthquake	18.3	6.7	1.0
Australia	1:250 RMS Return Period Earthquake	10.4	5.3	0.8
UK	1:250 RMS Return Period Flood	42.1	14.6	2.2
Germany	1:250 RMS Return Period Flood	33.7	15.9	2.4

In the case of our Terrorism business we monitor our accumulations within a circle of 200 metre radius and our 5 largest of these by geographic zone are as follows (\$m):

Country	Event	Gross (\$m)	Net Pre 85% QS	Net Post 85% QS
USA & Canada	Toronto, ON M5X1J3, CA	62.6	42.6	6.4
	Toronto, ON M5J2S4, CA	60.7	40.7	6.1
	New York, NY 10104, US	49.4	29.4	4.4
	Anderson, SC 29625, US	47.8	27.8	4.2
	Montréal, QC H3B2L3, CA	50.4	30.4	4.6
Rest of the World	Moskva, 125047, RU	37.7	17.7	2.6
	Bern, 05 3006, CH	35.3	15.3	2.3
	Schiphol, 72 1118, NL	32.4	12.4	1.9
	Singapore, 048580, SG	31.8	11.8	1.8
	London, W1A 2AA, GB	31.0	11.0	1.6

In 2008, the normal maximum gross line that any one underwriter could commit the Company to was \$100m. In many cases, maximum lines for classes of business were much lower than this.

Management Report of Financial Risks

Product Line	Maximum Line (USD million)	Product Line Leader	Experience (years)	2008 Actual GWP (USD million)
Onshore Energy	100	Bill O'Malley	23	125.1
Marine	30	William Beveridge	20	48.3
Offshore Energy	75	Kelan Hunt	20	43.3
Marine and Energy Liability	30	David Hipkin	28	19.9
Personal Accident/Travel	20	Lino Leoni	17	23.4
Professional Lines	10	Richard Whitfield	23	15.2
Executive Assurance	20	Calum McPherson	19	17.2
Global Property	75	Jonathan Speedman	23	19.9
Other (DUAL and other binding authority business)	20	Duncan Smith	19	175.4
Total				487.7

These authority limits are enforced through a comprehensive sign-off process for underwriting transactions including dual sign-off for all line underwriters. Automated exception reports are also run regularly covering line size, class and industry.

In common with all insurers, the Company is exposed to price volatility. However, the Company is firm in its resolve to reject business that is unlikely to generate underwriting profit. Additionally, the Company alters its appetite for the lines of business and the layers it writes within them in response to market conditions.

Arch Europe writes a significant amount of premium income through a single agent to whom binding authority is given to accept risks on behalf of the Company. This delegation is strictly controlled through tight underwriting guidelines and limits, and extensive monitoring, review and auditing.

The risk features specific to the business segments that the Company writes are as follows:

Executive Assurance

This segment mainly underwrites Professional Liability, Directors and Officers Liability and Employment Practices Liability. Whilst most of this business is domiciled in the UK, the team also has a presence in Continental Europe and the US.

The Liability insurance which is written on a worldwide basis is considered medium tail because claims in this class typically take 3 to 9 years before they are fully reported and paid by the Company for a given accident year. The speed of claim reporting and claim settlement is a function of the specific coverage provided, the jurisdiction and specific policy provisions such as self-insured retentions. Other inherent uncertainties encountered through this class include:

- Whether the event triggering coverage is confined to only one time period or is spread over multiple time periods;
- The potential financial costs arising from individual claim actions;
- Whether such claims were reasonably foreseeable and intended to be covered at the time the contracts were written; and
- The potential for mass claim actions.

Management Report of Financial Risks

Marine

This segment underwrites a broad spectrum of Marine classes. Specialised cover offered includes Hull, Offshore Energy, Cargo, Terrorism, Specie and War risks and the majority of these risks are exposed to catastrophes. For example, a significant portion of the energy business is exposed to the Gulf of Mexico and thus has significant hurricane exposure. Some areas of the Marine business overlap with other segments which can result in accumulation of losses. These accumulations, including exposures to catastrophes, are regularly monitored and managed by our reinsurance programmes.

Property

Our Property segment, which includes Onshore Energy, Power, Utilities and processing industries underwrites property exposures on a worldwide basis. Property insurance indemnifies, subject to any limits or excesses, the policyholder against loss or damage to their own material property and business interruption arising from this damage. The event giving rise to a claim for damage to buildings or contents usually occurs suddenly (as for natural perils, fire and burglary). The claim will thus usually be notified promptly and can be settled promptly (an exception to this is subsidence and business interruption claims). Significant geographical concentrations of risk can exist within property portfolios meaning that natural perils such as adverse windstorms or earthquakes may expose large segments of the Company's property risks. In the event of an earthquake, the portfolio expects to receive claims for both structural damage and business interruption.

(ii) Reserving and Claims Risks arise from:

- The frequency and size of large claims;
- Possible outcomes relating to any disputed claims, particularly where the outcome is subject to legal proceedings;
- The ability of the Company to withstand catastrophic events, increases in unexpected exposures, latent claims or aggregation of claims;
- The possible exhaustion of reinsurance arrangements, both on a per risk and per event basis;
- Social and societal factors driving an increase in the propensity to claim and to sue;
- Other social, economic and technological changes;
- The adequacy and uncertainty of the technical claims provisions;
- The adequacy of other underwriting provisions, such as the provisions for unearned premium and unexpired risk reserves;
- The appropriateness of catastrophe models and underlying assumptions used, such as possible maximum loss (PML) factors used;
- Unanticipated legal judgements and legal change with retrospective effect specifically with regard to the claims reserves; and
- The effects of inflation.

The Company's claims teams are focused upon delivering quality, reliability and speed of service to both internal and external clients. Their aim is to adjust and process claims in a fair, efficient and timely manner, in accordance with the policy's terms

Management Report of Financial Risks

and conditions, the regulatory environment, and the Company's broader interests. Our objective is to set prompt and accurate case reserves for all known claims liabilities, including provisions for expenses.

The Company operates to a best estimate reserving philosophy. Reserve estimates are derived by the internal actuary after consultation with individual underwriters, claims team, actuarial analysis of the loss reserve development and comparison with market benchmarks. The objective is to produce reliable and appropriate estimates that are consistent over time and across classes of business. The internal actuary's loss assessments are peer reviewed by ACGL actuaries, and the reserves also are subject to review by external actuaries. Generally, reserves are established without regard to whether the claim may be subsequently contested and reserves are not discounted for the time value of money.

Reinsurance Risk

Reinsurance risk to the Company arises where reinsurance contracts put in place to reduce gross insurance risk do not perform as anticipated; resulting in coverage disputes or prove inadequate in terms of the vertical or horizontal limits purchased. The Company's reinsurance programmes are determined from the underwriting team business plans and seek to protect Company capital from an adverse volume or volatility of claims on both a per risk and per event basis. In 2008, the Company bought a combination of proportional and non-proportional reinsurance treaties and facultative reinsurance to reduce the maximum net exposure on any one risk to \$14.75m (pre 85% quota share). In most classes of business the maximum net exposure is much lower than this. The Company aims to establish appropriate retention levels and limits of protection that are consistent with keeping within the board's risk tolerance and achieving the target rates of return. The efficacy of protection sought is assessed against the cost of reinsurance, taking into consideration current and expected market conditions.

The Company's reinsurance philosophy is to:

- Provide stable, sustainable core capacity for each product line with non-core reinsurance purchased when market conditions allow;
- Reduce volatility;
- Achieve a broad spread of well rated security;
- Purchase limits up to maximum lines / accumulations with Catastrophe limits purchased up to modelled 1 in 250 year event;
- Utilise RMS and INTEC standard models throughout ACGL;
- Comply with the guidance from the ACGL Security Committees;
- Apply common standards throughout ACGL;
- Consider hard and soft factors such as ability to pay and willingness to pay;
- Set cession limits by reinsurer and by lines of business;
- Strive for 100% of security rated A- or higher.

Arch Europe also benefits from an internal quota share with Arch Reinsurance Ltd., the level of which is set at 85%. In addition, there is also an internal stop loss with Arch Reinsurance providing £17.5m cover in excess of 100% ultimate Net Loss Ratio.

Management Report of Financial Risks

Credit Risk

Exposure to credit risk arises from financial transactions with counterparties including debtors, borrowers, brokers, policyholders, reinsurers and guarantors. The Company uses the credit ratings assigned to particular counterparties to measure credit risk.

To lessen the risk of the Company's exposure to any particular reinsurer, exposure limits by class of business are approved. On behalf of the Company, ACGL has developed processes to formally examine all reinsurers before entering into new business arrangements. New reinsurers are approved by the Reinsurance Security Committee, which also reviews arrangements with all existing reinsurers at least annually. Vulnerable or slow paying reinsurers are examined more frequently.

With regard to premium debtor risk, the Company ensures that all brokers are subject to a due diligence protocol and that they have terms of business agreements in place. An approval system also exists for new brokers, and broker performance is regularly reviewed. System exception reports highlight trading with non-approved brokers, and the Company's credit control team regularly monitors the ageing and collectibility of debtor balances. Large and aged items are prioritised.

The Company has established guidelines for its investment managers regarding the type, duration and quality of investments within ACGL guidelines. The performance of investment managers is regularly reviewed to confirm adherence to these guidelines.

Following is a breakdown of loss recoverable amounts by A.M. Best financial strength rating at 31 December 2008.

A.M. Best Rating	2008 Loss Recoverable £000	2008 % of Total	2007 Loss Recoverable £000	2007 % of Total
A++ rated	8,990	1.0%	12,269	4.9%
A+ rated	190,863	19.9%	33,347	13.3%
A rated	704,508	73.3%	173,185	69.0%
A- rated	18,184	1.9%	18,590	7.4%
NR-4 rated	328	0.0%	5,025	2.0%
Lloyd's	37,685	3.9%	8,455	3.4%
Total loss recoverable	960,558	100%	250,871	100%

Management Report of Financial Risks

Market Risk

Market risk typically refers to the risk that arises from fluctuations in the values of or income from assets, from interest rates or exchange rates.

Arch Europe incurs market risk only through holding assets to meet insurance liabilities. As such, Arch Europe does not have an appetite for market risk, and its investment strategy is designed to limit market risk through investment in what are considered to be conservative high quality assets that reduce exposure. The current investment guidelines and approach focus on total return, preservation of capital and market liquidity. The duration of assets is designed to match the duration of liabilities which is around 3.5 years on average. The Company does not invest in hedging or derivative financial instruments.

Exposure to interest rate risk arises from the investments in fixed interest securities. The Company monitors interest rate risk by calculating the mean duration of the investment portfolio and of the policyholder liabilities. Any gap between the mean duration of the assets and the estimated mean duration of the liabilities is minimised by buying and selling fixed interest securities of different durations.

The Company is exposed to currency risk in respect of liabilities under insurance policies and reinsurance recoverable debtors under reinsurance policies, denominated in currencies other than Sterling. The most significant currencies to which the Company is exposed are the U.S. Dollar and the Euro. The Company seeks to mitigate the risk by matching the estimated foreign currency denominated liabilities with assets denominated in the same currency. Assets and liabilities are appropriately matched.

Liquidity Risk

The Company is exposed to daily calls on its available cash resources, principally from claims arising from its insurance business. Liquidity risk arises where cash may not be available to pay obligations when due at a reasonable cost. The Company's approach is to manage its liquidity position so that it can reasonably survive a significant loss event. This means that the Company maintains sufficient liquid assets, or assets that can be translated into liquid assets at short notice and without capital loss, to meet expected cash flow requirements. These liquid funds are regularly monitored using cash flow forecasting to ensure that surplus funds are invested to achieve a higher rate of return. Regular cash flow monitoring ensures that maturing deposits are sufficient to meet cash calls. Additionally, intra-group reinsurance obligations are secured by funds deposited into a trust account to fund an amount equal to at least 110% of the obligations to Arch Europe.

Management Report of Financial Risks

The Company has maintained and continues to maintain excellent liquidity. Recent large losses, including the 2005 hurricanes, did not result in liquidity issues for the Company.

The Company reviews currency asset and liability positions on a quarterly basis. This process is designed to ensure currency matching is maintained. In addition, as part of this process, currency trades may be made to maintain the desired currency net asset allocations. The Company has established foreign exchange facilities with a number of banks to cater for these transactions.

The Company has access to up to \$300 million secured letter of credit facility provided to ACGL and its collective subsidiary companies. The principal purpose of the LOC facility is to issue, as required, evergreen standby letters of credit in favour of insurance counterparties with which it has entered into reinsurance arrangements or otherwise to comply with United States jurisdictions, as required under insurance regulations in the United States.

The liquidity position is reinforced through the investment strategy which ensures the availability of adequate highly liquid funds, with limits on duration of assets and counterparty exposures.

Capital

The Company's Individual Capital Assessment (ICA) by Risk Category is shown in the table below. The table also sets out the Individual Capital Guidance (ICG) that was granted by the FSA.

All figures in \$millions.

\$M	Risk Category	31/12/2006	31/12/2007	31/12/2008
	Insurance Risk } Market Risk }	38.7	53.9	48.3
	Credit Risk	3.04	5.5	4.9
	Liquidity Risk	0.0	0.0	0.0
	Operational Risk	9.6	7.7	6.9
	Group Risk	1.5	2.0	1.8
	Total	52.8	69.0	61.8
ICG	Total	52.8	85.9	61.8

The Company has excellent rating agency financial strength ratings as follows:

A.M. Best A (Excellent) - Stable
Standard & Poor's A (Strong) - Stable

Independent Auditors' Report

To The Members Of Arch Insurance Company (Europe) Limited

We have audited the financial statements of Arch Insurance Company (Europe) Limited for the year ended 31 December 2008 which comprise the Profit and Loss Account, the Balance Sheet, the Statement of Total Recognised Gains and Losses and the related notes. These financial statements have been prepared under the accounting policies set out therein.

Respective Responsibilities of Directors and Auditors

The directors' responsibilities for preparing the Annual Report and the financial statements in accordance with applicable law and United Kingdom Accounting Standards (United Kingdom Generally Accepted Accounting Practice) are set out in the Statement of Directors' Responsibilities in the Directors' Report.

Our responsibility is to audit the financial statements in accordance with relevant legal and regulatory requirements and International Standards on Auditing (UK and Ireland). This report, including the opinion, has been prepared for and only for the Company's members as a body in accordance with Section 235 of the Companies Act 1985 and for no other purpose. We do not, in giving this opinion, accept or assume responsibility for any other purpose or to any other person to whom this report is shown or into whose hands it may come save where expressly agreed by our prior consent in writing.

We report to you our opinion as to whether the financial statements give a true and fair view and are properly prepared in accordance with the Companies Act 1985. We also report to you whether in our opinion the information given in the Directors' Report is consistent with the financial statements. The information given in the Directors' Report includes that specific information presented in the Management Report of Financial Risks that is cross referred from the Business Review section of the Directors' Report.

In addition we report to you if, in our opinion, the Company has not kept proper accounting records, if we have not received all the information and explanations we require for our audit, or if information specified by law regarding directors' remuneration and other transactions is not disclosed.

We read other information contained in the Annual Report, and consider whether it is consistent with the audited financial statements. This other information comprises only the Analysis of Profit and Loss Account, Financial Summary, Directors' Report, and the Management Report of Financial Risks. We consider the implications for our report if we become aware of any apparent misstatements, or material inconsistencies with the Financial Statements. Our responsibilities do not extend to any other information.

Basis of Audit Opinion

We conducted our audit in accordance with International Standards on Auditing (UK and Ireland) issued by the Auditing Practices Board. An audit includes examination, on a test basis, of evidence relevant to the amounts and disclosures in the financial statements. It also includes an assessment of the significant estimates and judgments made by the directors in the preparation of the financial statements, and of whether the accounting policies are appropriate to the Company's circumstances, consistently applied and adequately disclosed.

Independent Auditors' Report

To The Members Of Arch Insurance Company (Europe) Limited

We planned and performed our audit so as to obtain all the information and explanations which we considered necessary in order to provide us with sufficient evidence to give reasonable assurance that the financial statements are free from material misstatement, whether caused by fraud or other irregularity or error. In forming our opinion we also evaluated the overall adequacy of the presentation of information in the financial statements.

Opinion

In our opinion:

- the financial statements give a true and fair view, in accordance with United Kingdom Generally Accepted Accounting Practice, of the state of the Company's affairs as at 31 December 2008 and of its profit for the year then ended;
- the financial statements have been properly prepared in accordance with the Companies Act 1985; and
- the information given in the Directors' Report is consistent with the financial statements.

PricewaterhouseCoopers LLP

PricewaterhouseCoopers LLP
Chartered Accountants and Registered Auditors
London

25 March 2009

Profit and Loss Account

for the year ended 31 December 2008

	Notes	2008 £000	2007 £000
Technical account - general business			
Earned premiums, net of reinsurance			
Gross premiums written	2	265,098	245,360
Outward reinsurance premiums		(242,918)	(220,679)
Net premiums written		22,180	24,681
Change in the gross provision for unearned premiums		1,894	(14,752)
Change in the provision for unearned premiums, reinsurers' share		(1,902)	13,523
Change in unearned premiums		(8)	(1,229)
Earned premiums, net of reinsurance		22,172	23,452
Allocated investment return transferred from the non-technical account		1,968	2,438
Total technical income		24,140	25,890
Claims incurred, net of reinsurance			
Claims paid			
-gross amount		84,374	49,637
-reinsurers' share		(73,337)	(39,941)
		11,037	9,696
Change in the provision for claims			
-gross amount	21	136,316	95,670
-reinsurers' share	21	(130,670)	(86,748)
		5,646	8,922
Claims incurred, net of reinsurance		16,683	18,618
Net operating expenses	3	12,023	5,514
Total technical charges		28,706	24,132
Balance on the technical account for general business		(4,566)	1,758
Non-technical account			
Balance on the general business technical account		(4,566)	1,758
Investment income	4	4,970	4,961
Unrealised gains on investments	4	719	580
Investment expenses and charges	4	(151)	(189)
Foreign exchange gain / (loss)		1,314	(716)
Allocated investment return transferred to the general business technical account	4	(1,968)	(2,438)
Profit on ordinary activities before tax	7	318	3,956
Tax on profit on ordinary activities	7	(221)	(1,118)
Profit for the financial year		97	2,838
All amounts reflect continuing operations.			
Statement of total recognised gains and losses			
For the year ended 31 December 2008			
Profit for the financial year		97	2,838
Foreign currency translation (losses)/gains		(329)	446
Total recognised (loss)/gains during the year	18	(232)	3,284

The notes on pages 22 to 33 form part of these financial statements.

Balance Sheet

as at 31 December 2008

	Notes	2008 £000	2007 £000
ASSETS			
Investments			
Other financial investments	11	84,002	79,509
Other investments		58	58
		84,060	79,567
Reinsurers' share of technical provisions			
Provision for unearned premiums	21	107,029	84,405
Claims outstanding	21	459,287	239,169
		566,316	323,574
Debtors			
Debtors arising out of direct insurance operations		70,848	56,095
Debtors arising out of reinsurance operations	12	16,194	11,702
Other debtors	9	2,216	648
		89,258	68,445
Other assets			
Tangible assets	10	2,246	2,319
Cash at bank and in hand		17,634	10,775
		19,880	13,094
Prepayments and accrued income			
Accrued interest and rent		1,316	1,262
Deferred acquisition costs	3	28,523	22,389
Other prepayments and accrued income	13	4,005	3,215
		33,844	26,866
TOTAL ASSETS		793,358	511,546
LIABILITIES			
Capital and reserves			
Called up share capital	17	50,000	50,000
Other reserves	18	1,041	272
Profit and loss account		7,065	7,297
Shareholders' Funds	18	58,106	57,569
Technical provisions			
Provision for unearned premiums	21	120,351	94,875
Claims outstanding	21	517,937	279,377
		638,288	374,252
Creditors			
Creditors arising out of reinsurance operations	12	58,744	42,537
Other creditors including taxation	15	4,129	8,679
		62,873	51,216
Accruals and deferred income	16	34,091	28,509
TOTAL LIABILITIES		793,358	511,546

The financial statements were approved by the Board of Directors on 20 March 2009 and were signed on their behalf by



James Weatherstone
Chief Executive Officer

The notes on pages 22 to 33 form part of these financial statements

Notes to the Financial Statements

1 ACCOUNTING POLICIES

(a) Basis of presentation

The financial statements have been prepared in accordance with section 255 of, and Schedule 9A to, the Companies Act 1985, applicable accounting standards and the Statement of Recommended Practice on Accounting for Insurance Business issued by the Association of British Insurers dated December 2005, as amended in December 2006.

The Company has adopted Financial Reporting Standard No.1 (Revised 1996), and is therefore exempt from the requirement to prepare a cash flow statement as it is a 100% owned subsidiary of Arch Capital Group Ltd., and its cash flows are included within the consolidated cash flow statement of Arch Capital Group Ltd. Advantage has been taken of the exemption in FRS 8 not to disclose transactions with entities that are part of the Arch Capital Group Ltd. Group.

(b) Basis of accounting

The results are determined on an annual basis whereby the incurred cost of claims, commission and related expenses are charged against the earned proportion of premiums, net of reinsurance as follows:

Premiums written relate to business incepted during the year, together with any differences between booked premiums for prior years and those previously accrued, and include estimates of premiums due but not yet receivable or notified to the Company, less an allowance for cancellations. Premiums written are shown gross of commission payable to intermediaries and exclude Insurance Premium Tax.

Outward reinsurance premiums are accounted for in the same accounting period as the premiums for the related direct insurance or inwards reinsurance business. Reinsurance contracts that operate on a 'losses occurring' basis are accounted for in full over the period of coverage whilst 'risk attaching' policies are expensed using the earnings period as the underlying premiums on a daily pro rata basis.

Unearned premiums represent the proportion of premiums written in the year that relate to unexpired terms of policies in force at the balance sheet date calculated on a time apportionment basis. In the opinion of the directors the resulting provision is not materially different from one based on the pattern of incidence of risk.

Acquisition costs which represent commission and other related expenses are deferred over the period in which the related premiums are earned. To the extent that acquisition costs are deferred and considered irrecoverable against the related unearned premiums, they are written off to net operating expenses as incurred.

Claims incurred comprise notified claims and related expenses in the year together with changes in the estimates of what we ultimately expect to pay on claims; based on facts and circumstances known at the balance sheet date. The insurance reserves reflect the Company's total cost of claims incurred but not reported to it ('IBNR').

The Company's reserving policy is to use recognised actuarial techniques appropriate to the loss experience that exists. Where there is limited loss experience our choice of method has primarily been the expected loss method. We select the initial expected loss and loss adjustment expense ratios based on information derived by our underwriters and actuaries during the initial pricing of the business, supplemented by industry data where appropriate. These ratios consider, among other things, rate changes and changes in terms and conditions that have been observed in the market. For a given underwriting year, additional weight is given to the historic paid and incurred loss development methods in the reserving process, assuming that case reserving practices are consistently applied over time. This reserving process makes some key assumptions that historical paid and reported development patterns are stable.

Notes to the Financial Statements

For catastrophe-exposed business, our reserving process also includes the use of catastrophe models for known events, a heavy reliance on analysis of individual catastrophic events and management judgement. The development of property losses can be unstable, especially for policies characterised by high severity, low frequency losses.

Reinsurance recoveries in respect of estimated claims incurred but not reported are booked in line with the underlying programme, adjusted to reflect changes in the nature and extent of the Company's reinsurance programme over time. An assessment is also made of the recoverability of reinsurance recoveries having regard to market data on the financial strength of each of the reinsurance companies. Reinsurance liabilities are primarily premiums payable for reinsurance.

(c) Investments

All investments are stated in the balance sheet at market value. Listed investments are stated at mid-market value at close of business on the balance sheet date or on the last stock exchange trading day before the balance sheet date. Non-listed investments are stated at the directors' estimate of current value.

(d) Investment return

Investment return comprises all investment income, realised investment gains and losses and movements in unrealised gains and losses, net of investment expenses. Investment income and expenses are accounted for on an accrual basis.

Realised gains and losses on investments carried at fair value through profit and loss are calculated as the difference between net sales proceeds and purchase price. In the case of investments included at amortised cost, realised gains and losses are calculated as the difference between sale proceeds and their latest carrying value. Movements in unrealised gains and losses on investments represent the difference between the fair value at the balance sheet date and their purchase price or their fair value at the last balance sheet date, together with the reversal of unrealised gains and losses recognised in earlier accounting periods in respect of investment disposals in the current period.

Investment return is initially recorded in the non-technical account. A transfer is made from the non-technical account to the technical account to reflect that proportion of the investment return arising on technical provisions and related shareholders' funds.

This transfer is made so that the balance on the technical account is based on a longer-term rate of investment return and is not subject to distortion from short-term fluctuations in investment return.

(e) Deferred taxation

Provision is made for deferred tax liabilities using the liability method on all material timing differences, including revaluation gains and losses on investments recognised in the profit and loss account. Deferred tax assets are recognised to the extent that it is regarded as more likely than not that they will be recoverable. Deferred tax is calculated at the rates at which it is expected that the tax will arise. Deferred tax is recognised in the profit and loss account for the period, except to the extent that it is attributable to a gain or loss that is recognised directly in the statement of total recognised gains and losses. Deferred tax balances are not discounted.

Notes to the Financial Statements

(f) Translations of foreign currencies

The Company's assets and liabilities are maintained in multi-currency denominations of USD, EUR or GBP ("functional currencies"). The financial statements herein are presented in Sterling ("reporting currency").

All transactions in underlying non-functional currencies are settled in one of the three functional currencies and are translated into a functional currency at average rates. Monetary assets and liabilities are translated to the functional currency using the closing rate. Foreign exchange differences are reported in the non-technical account.

The results and financial positions of the non-Sterling functional currencies are translated into the reporting currency as follows:

- assets and liabilities are translated at the closing rate at the balance sheet date and;
- income and expenses are translated at the average rate of exchange during the year and;
- all resulting exchange differences are recognised through the Statement of Total Recognised Gains and Losses as a separate component of equity.

(g) Tangible assets

Tangible assets are capitalised and depreciated by equal annual instalments over their estimated useful lives. The principal rates used for this are as follows:

Leasehold improvements – over the term of the lease (currently 10 years).

Furniture and Fixtures – 5 years.

Computer Software under Service Contract – over the term of the contract (currently 6 years).

Other Computer Hardware and Software – 3 years.

Motor Vehicles – 3 years.

(h) Pension costs

All employees are eligible to become members of a defined contribution Grouped Personal Pension Plan. The assets of the scheme are held separately from those of the Company in an independently administered fund. The amount charged to the profit and loss account represents the contributions payable to the scheme in respect of the accounting period.

(i) Leases

Rentals payable under operating leases are charged to the profit and loss account in equal annual instalments over the period of the lease.

(j) Share based payments

Share based payments are in respect of Arch Capital Group Ltd. and recharges to the Company are expensed. The Long-Term Incentive and Share Award Plan, is measured at the fair value of the award at date of grant and charged in the profit and loss account over the vesting period. The corresponding entry is recognised within equity.

Notes to the Financial Statements

2 SEGMENTAL INFORMATION

Segmental information required by the Companies Act 1985 is as follows:

	Gross Premium Written 2008 £000	Gross Premium Earned 2008 £000	Gross Claims Incurred 2008 £000	Gross Operating Expenses 2008 £000	Reinsurance Balance 2008 £000
Direct					
Accident & Health	11,973	12,607	6,342	4,835	(2,494)
Marine	47,193	44,920	32,129	9,448	(1,591)
Property	83,063	91,150	97,049	14,567	23,974
Third Party Liability	122,869	118,315	85,170	44,721	2,323
Unallocated	-	-	-	-	(1,476)
	265,098	266,992	220,690	73,571	20,736

	Gross Premium Written 2007 £000	Gross Premium Earned 2007 £000	Gross Claims Incurred 2007 £000	Gross Operating Expenses 2007 £000	Reinsurance Balance 2007 £000
Direct					
Accident & Health	13,190	13,418	6,781	5,444	(2,911)
Marine	40,027	35,799	19,969	7,548	(7,921)
Property	90,851	87,419	71,107	12,110	(1,154)
Third Party Liability	101,292	93,969	47,449	32,300	(15,091)
Unallocated	-	-	-	-	(1,500)
	245,360	230,605	145,306	57,402	(28,577)

The reinsurance balance represents the credit/(charge) to the technical account from the aggregate of all items relating to reinsurance outwards.

Unallocated represents an internal stop loss treaty with Arch Reinsurance Limited (an affiliate) and is applicable across all lines of business.

Accident & Health includes Personal Accident and Travel. Marine includes Marine and Offshore lines. Property includes Global Property and Onshore Energy. Third party liability includes Professional Liability, Executive Assurance, Casualty and Marine Liability.

Analysis by geographic area

Geographic location is determined by the location where the contract is concluded. Segmental analysis by geographic area required by the Companies Act 1985 is as follows:

	Gross Written Premiums 2008 £000	2007 £000
United Kingdom	192,145	190,291
Other EU member states	55,653	44,289
Other Countries	17,300	10,780
	265,098	245,360

Notes to the Financial Statements

3 NET OPERATING EXPENSES

	Gross 2008 £000	Reinsurance 2008 £000	Net 2008 £000
Year ended 31 December 2008			
Acquisition costs	60,800	(61,423)	(623)
Deferred acquisition costs brought forward	22,389	(23,245)	(856)
Deferred acquisition costs carried forward	(28,523)	29,778	1,255
Foreign exchange adjustment	6,150	(6,657)	(507)
Change in deferred acquisition costs	16	(124)	(108)
Incurred acquisition costs	60,816	(61,547)	(731)
Administrative expenses			12,754
Net operating expenses			12,023

	Gross 2007 £000	Reinsurance 2007 £000	Net 2007 £000
Year ended 31 December 2007			
Acquisition costs	50,879	(55,915)	(5,036)
Deferred acquisition costs brought forward	18,016	(18,938)	(922)
Deferred acquisition costs carried forward	(22,389)	23,245	856
Foreign exchange adjustment	262	(280)	(18)
Change in deferred acquisition costs	(4,111)	4,027	(84)
Incurred acquisition costs	46,768	(51,888)	(5,120)
Administrative expenses			10,634
Net operating expenses			5,514

Total commissions for direct insurance accounted for by the Company during the year amounted to £56m (2007: £43m).

4 INVESTMENT RETURN

	2008 £000	2007 £000
Investment income		
Income from other financial investments:		
- Interest income on fixed maturities	4,324	4,671
- Interest income on cash equivalents	147	211
Total interest income on financial assets	4,471	4,882
Gain on realisation of investments	499	79
Total investment income	4,970	4,961
Investment expenses and charges		
Investment management expenses including interest	(151)	(189)
Net unrealised gains on investments	719	580
Total investment return	5,538	5,352
Investment return is analysed between:		
- Allocated investment return transferred to the general business technical account	1,968	2,438
- Net investment return included in the non-technical account	3,570	2,914
Total investment return	5,538	5,352

Notes to the Financial Statements

5 PROFIT AND LOSS ACCOUNT

Profit on ordinary activities before tax is stated:

	2008 £000	2007 £000
After crediting		
Income from listed investments	4,379	4,272
After charging		
Depreciation	584	665
Operating lease rentals:		
- Land and buildings	911	933
Directors' emoluments:		
- Remuneration as executives	1,480	1,434
- Pension contributions	44	66

Auditors' Remuneration

During the year, the Company obtained the following services from the Company's auditor at costs as detailed below:

	2008 £000	2007 £000
Audit services		
Fees payable to the Company's auditor for the audit of the Company:		
Audit for UK GAAP reporting	51	50
Non-audit services		
Fees payable to the Company's auditor for other services:		
(a) Fees payable to the Company's auditor for the audit of the parent company:		
(i) agreed upon procedures for US GAAP SAS 100 review Q1 to Q4 in 2007 and Q3 and Q4 in 2006	100	98
(ii) agreed upon procedures internal controls over financial reporting	41	40
(b) Other services pursuant to legislation, including the audit of the regulatory return	18	17
(c) Tax services	54	11
Sub-total	213	166
Total	264	216

6 OFFICERS' REMUNERATION

	2008 £000	2007 £000
Directors' Emoluments		
Aggregate Emoluments	1,480	1,434
Amounts receivable under long-term incentive schemes	100	-
Company pension contributions to money purchase schemes	44	66
Compensation for loss of office	132	150

Four of the executive directors received shares in the Parent Company during the year under a long-term incentive scheme. Two directors participated in the Company money purchase pension schemes.

	2008 £000	2007 £000
Highest paid director		
Aggregate of emoluments and awards under long term incentive schemes, including nil pension contributions	698	766

The highest paid director received share allocations during the year under a long-term incentive award.

There were no transactions between Arch Insurance Company (Europe) Limited and its Directors and Officers during the year ended 31 December 2008 which require disclosure.

Notes to the Financial Statements

7 TAXATION

	2008	2007
	£000	£000
(a) Tax rate reconciliation		
UK corporation tax at 28.5% (2007: 30%)		
Current tax on income for the period	276	1,360
Adjustment in respect of prior years	479	222
Total current tax (see note 7(b))	755	1,582
Deferred tax - Origination and reversal of timing differences	(534)	(464)
Tax charge on profit on ordinary activities	221	1,118

	2008	2007
	£000	£000
(b) Factors affecting tax charges for the year		
Profit on ordinary activities before tax	318	3,957
Profit on ordinary activities multiplied by standard rate of corporation tax in the UK of 28.5% (2007: 30%)	91	1,187
Expenses not deductible for tax purposes	107	130
Timing differences	76	43
Adjustment in respect of prior year tax computations	479	222
Effect of rate changes	2	-
Total current tax (see note 7(a))	755	1,582

8 STAFF NUMBERS AND COSTS

The average number of persons employed by the Company (including executive directors) during the period, analysed by category, is as follows:

	2008	2007
	No.	No.
Underwriting	37	37
Administration and Finance	29	28
Claims	9	8
	75	73

The aggregate payroll costs of these persons were as follows:

	2008	2007
	£000	£000
Wages and salaries	6,373	6,034
Social security costs	905	860
Other pension costs	707	569
	7,985	7,463

Notes to the Financial Statements

9 OTHER DEBTORS

	2008 £000	2007 £000
Deferred taxation (Note 14)	768	234
Other debtors	1,448	414
	2,216	648

A portion of the deferred tax assets are likely to be realised beyond 12 months as the timing differences crystallise.

10 TANGIBLE ASSETS

	Leasehold Improvements £000	Fixtures, Fittings & Equipment £000	Motor Vehicles £000	Total £000
Book cost:				
At 1 January 2008	1,169	2,692	126	3,987
Additions	25	481	-	506
Disposals	-	-	(37)	(37)
At 31 December 2008	1,194	3,173	89	4,456
Depreciation:				
At 1 January 2008	87	1,515	66	1,668
Charge for the year	120	440	19	584
Disposals	-	-	(37)	(42)
At 31 December 2008	207	1,955	48	2,210
Net book value:				
31 December 2008	987	1,218	41	2,246
31 December 2007	1,082	1,177	60	2,319

Tangible assets are capitalised and are depreciated over their estimated useful life.

The depreciation charge for the year ended 31 December 2008 was £584k (2007: £665k)

11 OTHER FINANCIAL INVESTMENTS

	2008 £000	2007 £000
Market value		
Debt securities and other fixed income securities	63,136	65,888
Deposits with credit institutions	20,866	13,621
Total Market Value	84,002	79,509
	2008 £000	2007 £000
Included in the above market value were investments:		
Listed on the UK Stock Exchange	34,067	39,096
Listed on the US Stock Exchange	4,175	5,104
Listed on European exchanges	14,523	18,922
Listed on other exchanges	10,371	2,766
	63,136	65,888

Notes to the Financial Statements

12 AMOUNTS DUE TO AND FROM GROUP UNDERTAKINGS

The following amounts due (to)/from group undertakings are included within:

	2008 £000	2007 £000
Debtors arising out of reinsurance operations	10,796	6,779
Reinsurers' share of technical provisions	345,987	197,394
Creditors arising out of reinsurance operations	(37,460)	(30,326)
Intercompany creditors	(522)	(3,105)
Deferred acquisition costs	(23,540)	(17,344)
	295,261	153,398

13 OTHER PREPAYMENTS AND ACCRUED INCOME

	2008 £000	2007 £000
Prepayments	4,005	3,215

14 PROVISION FOR OTHER RISKS AND CHARGES

Deferred tax

The provision for deferred taxation in the financial statements is as follows:

	Capital Allowances £000	Other Timing Differences £000	Total 2008 £000
Opening balance	33	(267)	(234)
Movement for the financial year	(10)	(524)	(534)
Closing balance	23	(791)	(768)

There is no unprovided deferred tax.

15 OTHER CREDITORS INCLUDING TAXATION

	2008 £000	2007 £000
Insurance premium tax payable	1,343	4,181
Amounts owed to group undertakings	522	3,105
Corporation tax payable	160	380
Other creditors	2,104	1,013
	4,129	8,679

Notes to the Financial Statements

16 ACCRUALS AND DEFERRED INCOME

	2008 £000	2007 £000
Deferred ceded acquisition costs (Note 3)	29,778	23,245
Other accruals	4,313	5,264
	34,091	28,509

17 SHARE CAPITAL

	2008 £000	2007 £000
Authorised:		
10 million ordinary shares of £10 each	100,000	100,000
Issued and fully paid:		
5 million ordinary shares of £10 each	50,000	50,000

18 RECONCILIATION OF MOVEMENTS IN SHAREHOLDERS' FUNDS

	Share Capital £000	Profit and Loss Account £000	Other Reserves £000	Total 2008 £000
2008				
Opening shareholders' funds	50,000	7,297	272	57,569
Profit for the financial year	-	97	-	97
Foreign currency translation differences	-	(329)	-	(329)
Movement in other reserves	-	-	769	769
Net addition to shareholders' funds	-	(232)	769	537
Closing shareholders' funds	50,000	7,065	1,041	58,106

	Share Capital £000	Profit and Loss Account £000	Other Reserves £000	Total 2007 £000
2007				
Opening shareholders' funds	50,000	4,013	119	54,132
Profit for the financial year	-	2,838	-	2,838
Foreign currency translation differences	-	446	-	446
Movement in other reserves	-	-	153	153
Net addition to shareholders' funds	-	3,284	153	3,437
Closing shareholders' funds	50,000	7,297	272	57,569

The other reserves amount of £1,041k relates to a Long Term Incentive and Share Award Plan (the "2005 Plan") adopted by ACGL in June 2005 and an Employee Share Purchase Plan ("ESPP") adopted by ACGL in June 2007.

The 2005 Plan is intended to provide for competitive compensation opportunities, to encourage long-term service, to promote the creation of long-term value for shareholders by aligning the interests of such persons with those of shareholders. The compensation expense is estimated based on the fair value of the award at the grant date.

The ESPP allows all employees with an opportunity to share in the success of the company by purchasing ACGL shares at a 15% discount of the fair market value per share at the beginning of the applicable offering period.

The current year effect of the 2005 Plan and the ESPP scheme on the profit and loss account is an expense of £523k.

Notes to the Financial Statements

19 GUARANTEES AND FINANCIAL COMMITMENTS

Annual commitments in respect of operating leases are as follows:

	2008	2007
	£000	£000
Expiring within five to ten years	608	608
	608	608

The Company has outstanding letters of credit of £1,128,220 (2007: £880,088) issued in favour of cedants, collateralised by cash deposits, with a market value of £1,423,787 (2007: £1,211,878) held in trust.

20 PENSION COSTS

The Company contributes to a defined contribution Grouped Personal Pension Plan. The assets of the scheme are held separately from those of the company in an independently administered fund. The unpaid contributions outstanding at the period end were nil (2007: nil).

21 CHANGES IN THE PROVISION FOR CLAIMS

(a) Insurance liabilities	2008	2007
	£000	£000
Gross		
Claims reported and loss adjustment expenses	340,888	165,613
Claims incurred but not reported	177,049	113,764
Unearned premiums	120,351	94,875
Total insurance liabilities	638,288	374,252
Recoverable from reinsurers		
Claims reported and loss adjustment expenses	(303,655)	(144,177)
Claims incurred but not reported	(155,632)	(94,992)
Unearned premiums	(107,029)	(84,405)
Total insurance liabilities	(566,316)	(323,574)
Net		
Claims reported and loss adjustment expenses	37,233	21,436
Claims incurred but not reported	21,417	18,772
Unearned premiums	13,322	10,470
Total insurance liabilities net	71,973	50,678

Notes to the Financial Statements

21 CHANGES IN THE PROVISION FOR CLAIMS - continued

(b) Development of insurance liabilities

The following table represents the estimated amounts of losses and LAE arising in all prior years that are unpaid at the balance sheet date including IBNR reserves.

	2008	2007	2006	2005
	£000	£000	£000	£000
Gross				
Insurance liabilities	638,288	374,252	259,284	147,688
Reserves re-estimated as of:				
- One year later		363,403	270,779	166,111
- Two years later			247,458	185,624
- Three years later				175,523
Cumulative redundancy/(deficiency)		10,849	11,826	(27,835)
Net				
Insurance liabilities	71,973	50,678	39,859	34,674
Reserves re-estimated as of:				
- One year later		49,371	40,049	36,500
- Two years later			36,039	36,873
- Three years later				32,977
Cumulative redundancy (deficiency)		1,307	3,820	1,697

22 ULTIMATE PARENT COMPANY

The directors regard Arch Capital Group Ltd., a Company incorporated in Bermuda, as the ultimate holding Company. Copies of the consolidated financial statements of Arch Capital Group Ltd. can be obtained from The Secretary, Arch Capital Group Ltd., Wessex House, 45 Reid Street, Hamilton HM12, Bermuda. Advantage has been taken of the exemption in FRS 8 not to disclose transactions with entities that are part of the Arch Capital Group Ltd. Group.

At 31 December 2008 the ownership of the Company was transferred to Arch Reinsurance Europe Underwriting Limited, which is a licensed reinsurance company in Ireland. The transfer of ownership does not impact the Company's business.

Directors and Administration

Directors

R T. Van Gieson	(Chairman)	
J Weatherstone	(Chief Executive Officer)	(appointed: 14 April 2008)
D Brand		(appointed: 22 July 2008)
R Jones III		(resigned: 22 July 2008)
T Kaiser		(resigned: 1 July 2008)
M Lyons		
M Murphy		(appointed: 22 July 2008)
M Nilsen		
M Quinn		
P Robotham		

Secretary

K Christensen

Registered Number

4977362

Registered Office

6th Floor
Plantation Place South
60 Great Tower Street
London
EC3R 5AZ

Principal Bankers

Barclays Bank Plc, London
Bankhaus Neelmeyer AG, Bremen

Investment Managers

Black Rock Inc., New York

Auditors

PricewaterhouseCoopers LLP, London

Financial Strength Ratings

A. M. Best: A (Excellent)
Standard & Poor's: A (Strong)

Website

www.archinsurance.co.uk

Arch Insurance Company (Europe) Ltd

Telephone + 44 (0)20 7621 4500
Facsimile + 44 (0)20 7621 4501
E-mail info@archinsurance.co.uk
Web www.archinsurance.co.uk