ARCH CAPITAL GROUP LTD.
Form 10-Q
August 04, 2006

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION

WASHINGTON, D.C. 20549

FORM 10-Q

(Mark One)

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

For the quarterly period ended June 30, 2006

Or

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

For the transition period to

Commission file number: 0-26456

ARCH CAPITAL GROUP LTD.

(Exact name of registrant as specified in its charter)

Bermuda	**Not Applicable**
(State or other jurisdiction of incorporation or organization)	(I.R.S. Employer Identification No.)
Wessex House, 45 Reid Street **Hamilton HM 12, Bermuda**	
(Address of principal executive offices)	(Zip Code)

Registrant s telephone number, including area code: **(441) 278-9250**

(Former name, former address and former fiscal year, if changed since last report)

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 x No o

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

Large Accelerated Filer x Accelerated Filer o Non-Accelerated Filer o

Indicate by check mark whether the Registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act).

Yes o No x

Indicate the number of shares outstanding of each of the issuer s classes of common shares as of the latest practicable date.

Class	**Outstanding at July 31, 2006**
Common Shares, $0.01 par value	73,943,973

ARCH CAPITAL GROUP LTD.

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Report of Independent Registered Public Accounting Firm

To the Board of Directors and Shareholders of
Arch Capital Group Ltd.:

We have reviewed the accompanying consolidated balance sheet of Arch Capital Group Ltd. and its subsidiaries (the Company) as of June 30, 2006, the related consolidated statements of income for each of the three-month and six-month periods ended June 30, 2006 and 2005, and the consolidated statements of changes in shareholders equity, comprehensive income and cash flows for the six-month periods ended June 30, 2006 and 2005. These interim financial statements are the responsibility of the Company s management.

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

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

We have previously audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the consolidated balance sheet as of December 31, 2005, and the related consolidated statements of income, changes in shareholders equity, comprehensive income, and cash flows for the year then ended, management s assessment of the effectiveness of the Company s internal control over financial reporting as of December 31, 2005 and the effectiveness of the Company s internal control over financial reporting as of December 31, 2005; and in our report dated March 13, 2006, we expressed unqualified opinions thereon. The consolidated financial statements and management s assessment of the effectiveness of internal control over financial reporting referred to above are not presented herein. In our opinion, the information set forth in the accompanying consolidated balance sheet as of December 31, 2005, is fairly stated in all material respects in relation to the consolidated balance sheet from which it has been derived.

/s/ PricewaterhouseCoopers LLP
New York, New York
August 3, 2006

ARCH CAPITAL GROUP LTD. AND SUBSIDIARIES

CONSOLIDATED BALANCE SHEETS

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

	(Unaudited) June 30, 2006	**December 31, 2005**
Assets		
Investments:		
Fixed maturities available for sale, at fair value (amortized cost: 2006, $6,023,605; 2005, $5,310,712)	$ 5,948,595	$ 5,280,987
Short-term investments available for sale, at fair value (amortized cost: 2006, $969,886; 2005, $679,530)	973,671	681,887
Short-term investment of funds received under securities lending agreements, at fair value	762,226	893,379
Other investments, at fair value (cost: 2006, $119,136; 2005, $59,839)	132,046	70,233
Total investments	7,816,538	6,926,486
Cash	366,373	222,477
Accrued investment income	65,617	62,196
Fixed maturities and short-term investments pledged under securities lending agreements, at fair value	741,901	863,866
Premiums receivable	897,400	672,902
Funds held by reinsureds	84,860	167,739
Unpaid losses and loss adjustment expenses recoverable	1,584,824	1,389,768
Paid losses and loss adjustment expenses recoverable	96,827	80,948
Prepaid reinsurance premiums	444,586	322,435
Deferred income tax assets, net	84,021	71,139
Deferred acquisition costs, net	323,328	317,357
Receivable for securities sold	150,902	220
Other assets	430,536	390,903
Total Assets	$ 13,087,713	$ 11,488,436
Liabilities		
Reserve for losses and loss adjustment expenses	$ 6,121,878	$ 5,452,826
Unearned premiums	1,939,140	1,699,691
Reinsurance balances payable	255,644	150,451
Senior notes	300,000	300,000
Deposit accounting liabilities	46,526	43,104
Securities lending collateral	762,226	893,379
Payable for securities purchased	166,694	12,020
Other liabilities	479,825	456,438
Total Liabilities	10,071,933	9,007,909
Commitments and Contingencies		
Shareholders Equity		
Non-cumulative preferred shares ($0.01 par value, 50,000,000 shares authorized)		
- Series A (issued: 2006, 8,000,000)	80	
- Series B (issued: 2006, 5,000,000)	50	
Common shares ($0.01 par value, 200,000,000 shares authorized, issued: 2006, 73,937,973; 2005, 73,334,870)	739	733
Additional paid-in capital	1,923,156	1,595,440
Deferred compensation under share award plan		(9,646)

Retained earnings	1,168,819	901,348
Accumulated other comprehensive income (loss), net of deferred income tax	(77,064)	(7,348)
Total Shareholders Equity	3,015,780	2,480,527
Total Liabilities and Shareholders Equity	$ 13,087,713	$ 11,488,436

See Notes to Consolidated Financial Statements

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ARCH CAPITAL GROUP LTD. AND SUBSIDIARIES

CONSOLIDATED STATEMENTS OF INCOME

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

	(Unaudited) Three Months Ended June 30, 2006	2005	(Unaudited) Six Months Ended June 30, 2006	2005
Revenues				
Net premiums written	$ 794,558	$ 723,728	$ 1,668,277	$ 1,523,529
(Increase) decrease in unearned premiums	2,892	16,164	(109,226)	(86,569)
Net premiums earned	797,450	739,892	1,559,051	1,436,960
Net investment income	90,503	53,660	170,829	103,576
Net realized gains (losses)	(32,202)	2,105	(35,585)	2,566
Fee income	3,468	1,025	5,273	7,137
Total revenues	859,219	796,682	1,699,568	1,550,239
Expenses				
Losses and loss adjustment expenses	462,255	443,918	930,433	869,454
Acquisition expenses	148,581	148,538	278,253	274,671
Other operating expenses	84,367	74,985	167,344	149,160
Interest expense	5,651	5,629	11,206	11,265
Net foreign exchange (gains) losses	1,146	(10,198)	11,399	(13,435)
Total expenses	702,000	662,872	1,398,635	1,291,115
Income before income taxes	157,219	133,810	300,933	259,124
Income tax expense	14,332	7,818	25,756	17,240
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
Net income per common share				
Basic	$ 1.88	$ 3.65	$ 3.66	$ 7.02
Diluted	$ 1.81	$ 1.69	$ 3.52	$ 3.26
Weighted average common shares and common share equivalents outstanding				
Basic (1)	73,188,101	34,563,565	73,044,473	34,464,740
Diluted (1)	76,155,438	74,412,553	76,014,819	74,249,728

(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.

See Notes to Consolidated Financial Statements

ARCH CAPITAL GROUP LTD. AND SUBSIDIARIES

CONSOLIDATED STATEMENTS OF CHANGES IN SHAREHOLDERS EQUITY

(U.S. dollars in thousands)

	(Unaudited) Six Months Ended June 30, 2006	2005
Series A Convertible Preference Shares		
Balance at beginning of year	$	$ 373
Converted to common shares		(0)
Balance at end of period		373
Non-Cumulative Preferred Shares		
Series A preferred shares issued	80	
Series B preferred shares issued	50	
Balance at end of period	130	
Common Shares		
Balance at beginning of year	733	349
Common shares issued, net	6	4
Balance at end of period	739	353
Additional Paid-in Capital		
Balance at beginning of year	1,595,440	1,560,291
Cumulative effect of change in accounting for unearned stock grant compensation	(9,646)	
Series A non-cumulative preferred shares issued	193,388	
Series B non-cumulative preferred shares issued	120,866	
Common shares issued	410	1,698
Exercise of stock options	15,572	7,430
Common shares retired	(658)	(846)
Amortization of share-based compensation	7,510	
Other	274	382
Balance at end of period	1,923,156	1,568,955
Deferred Compensation Under Share Award Plan		
Balance at beginning of year	(9,646)	(9,879)
Cumulative effect of change in accounting for unearned stock grant compensation	9,646	
Restricted common shares issued		(291)
Deferred compensation expense recognized		3,781
Balance at end of period		(6,389)
Retained Earnings		
Balance at beginning of year	901,348	644,862
Dividends declared on preferred shares	(7,706)	
Net income	275,177	241,884
Balance at end of period	1,168,819	886,746
Accumulated Other Comprehensive Income (Loss)		
Balance at beginning of year	(7,348)	45,910
Change in unrealized appreciation (decline) in value of investments, net of deferred income tax	(64,272)	8,514
Foreign currency translation adjustments, net of deferred income tax	(5,444)	(1,070)
Balance at end of period	(77,064)	53,354

Total Shareholders Equity	$ 3,015,780	$ 2,503,392

See Notes to Consolidated Financial Statements

ARCH CAPITAL GROUP LTD. AND SUBSIDIARIES

CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME

(U.S. dollars in thousands)

	(Unaudited) Six Months Ended June 30,	
	2006	**2005**
Comprehensive Income		
Net income	$ 275,177	$ 241,884
Other comprehensive income (loss), net of deferred income tax		
Unrealized decline in value of investments:		
Unrealized holding gains (losses) arising during period	(97,560)	9,239
Reclassification of net realized (gains) losses, net of income taxes, included in net income	33,288	(725)
Foreign currency translation adjustments	(5,444)	(1,070)
Other comprehensive income (loss)	(69,716)	7,444
Comprehensive Income	$ 205,461	$ 249,328

See Notes to Consolidated Financial Statements

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ARCH CAPITAL GROUP LTD. AND SUBSIDIARIES

CONSOLIDATED STATEMENTS OF CASH FLOWS

(U.S. dollars in thousands)

	(Unaudited) Six Months Ended June 30, 2006	**2005**
Operating Activities		
Net income	$ 275,177	$ 241,884
Adjustments to reconcile net income to net cash provided by operating activities:		
Net realized (gains) losses	35,673	(1,022)
Share-based compensation	7,510	4,073
Changes in:		
Reserve for losses and loss adjustment expenses, net of unpaid losses and loss adjustment expenses recoverable	473,996	501,499
Unearned premiums, net of prepaid reinsurance premiums	117,298	85,143
Premiums receivable	(224,498)	(101,883)
Deferred acquisition costs, net	(5,971)	(25,785)
Funds held by reinsureds	82,879	10,663
Reinsurance balances payable	105,193	(25,664)
Paid losses and loss adjustment expenses recoverable	(15,879)	(1,593)
Deferred income tax assets, net	(5,555)	5,142
Other liabilities	18,331	18,171
Other items, net	(41,000)	(25,035)
Net Cash Provided By Operating Activities	823,154	685,593
Investing Activities		
Purchases of fixed maturity investments	(8,196,081)	(1,985,427)
Proceeds from sales of fixed maturity investments	7,440,922	1,194,890
Proceeds from redemptions and maturities of fixed maturity investments	96,360	163,973
Purchases of other investments	(63,813)	
Proceeds from sale of other investments	6,062	1,986
Net purchases of short-term investments	(279,297)	(9,528)
Change in short-term investment of funds received under securities lending agreements, at fair value	131,153	
Purchases of furniture, equipment and other	(8,679)	(7,588)
Net Cash Used For Investing Activities	(873,373)	(641,694)
Financing Activities		
Proceeds from common shares issued, net of repurchases	11,212	5,568
Proceeds from preferred shares issued, net of issuance costs	314,538	
Change in securities lending collateral	(131,153)	
Excess tax benefits from share-based compensation	3,143	
Preferred dividends paid	(4,622)	
Net Cash Provided By Financing Activities	193,118	5,568
Effects of exchange rate changes on foreign currency cash	997	(502)
Increase in cash	143,896	48,965
Cash beginning of year	222,477	113,052
Cash end of period	$ 366,373	$ 162,017
Income taxes paid, net	$ 32,407	$ 34,958
Interest paid	$ 11,067	$ 11,141

See Notes to Consolidated Financial Statements

ARCH CAPITAL GROUP LTD. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

1. General

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

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

Certain information and footnote disclosures normally included in financial statements prepared in accordance with GAAP have been condensed or omitted; however, management believes that the disclosures are adequate to make the information presented not misleading. This report should be read in conjunction with the Company s Annual Report on Form 10-K/A for the year ended December 31, 2005, including the Company s audited consolidated financial statements and related notes and the section entitled Risk Factors.

To facilitate period-to-period comparisons, certain amounts in the 2005 consolidated financial statements have been reclassified to conform to the 2006 presentation. Such reclassifications had no effect on the Company s consolidated net income.

2. Share-Based Compensation

Stock Options

Effective January 1, 2006, the Company adopted the fair value method of accounting for share-based compensation arrangements in accordance with Financial Accounting Standards Board (FASB) Statement No. 123 (revised 2004), Share-Based Payment (SFAS No. 123(R)), using the modified prospective method of transition. Under the fair value method of accounting, compensation expense is estimated based on the fair value of the award at the grant date and is recognized in net income over the requisite service period. Such compensation cost is reduced by assumed forfeitures and adjusted based on actual forfeitures until vesting. Under the modified prospective approach, the fair value based method described in SFAS No. 123(R) is applied to new awards granted after January 1, 2006. Additionally, compensation expense for unvested stock options that are outstanding as of January 1, 2006 will be recognized in net income as the requisite service is rendered based on the grant date fair value of those options as previously calculated under pro forma disclosures under SFAS No. 123, Accounting for Stock-Based Compensation (SFAS No. 123), as amended by SFAS No. 148, Accounting for Stock-Based Compensation-Transition and Disclosure. Therefore, under the modified prospective method, compensation expense is recognized beginning with the effective date of adoption of SFAS No.123(R) for all stock option awards (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.

Prior to January 1, 2006, the Company accounted for its share-based compensation related to stock option awards using the intrinsic value method of accounting in accordance with Accounting Principles Board Opinion No. 25, Accounting for Stock Issued to Employees (APB No. 25), and its related interpretations permitted by SFAS No. 123, which did not require the recognition of compensation expense related to the issuance of

stock options so long as the quoted market price of the Company s stock at the date of grant was less than or equal to the amount an employee must pay to acquire the stock.

As required by the provisions of SFAS No. 123(R), the Company recorded after-tax share-based compensation expense of $1.7 million, or $0.02 per basic and diluted share, related to stock option awards for the 2006 second quarter, net of tax benefits of $0.4 million. For the six months ended June 30, 2006, the Company recorded after-tax share-based compensation expense of $2.8 million, or $0.04 per basic and diluted share, net of tax benefits of $0.7 million. The share-based compensation expense associated with stock options 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 options 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 options. These charges had no impact on the Company s cash flows or total shareholders equity.

Under the modified prospective method of transition under SFAS No.123(R), the Company is not required to restate its prior period financial statements to reflect expensing of share-based compensation under SFAS No. 123(R). Therefore, the results for the 2006 periods are not comparable to the 2005 periods. As required by SFAS No.123(R), the Company has presented pro forma disclosures of its net income and earnings per share for the 2005 second quarter and six months ended June 30, 2005 assuming the estimated fair value of the options granted prior to January 1, 2006 is amortized to expense over the requisite service period, as indicated below:

(U.S. dollars in thousands, except share data)	**(Unaudited) Three Months Ended June 30, 2005**	**(Unaudited) Six Months Ended June 30, 2005**
Net income, as reported	$ 125,992	$ 241,884
Total share-based employee compensation expense under fair value method, net of income taxes	(1,119)	(2,196)
Pro forma net income	$ 124,873	$ 239,688
Earnings per share basic:		
As reported	$ 3.65	$ 7.02
Pro forma	$ 3.61	$ 6.95
Earnings per share diluted:		
As reported	$ 1.69	$ 3.26
Pro forma	$ 1.68	$ 3.22

For purposes of disclosure in the foregoing table and for purposes of determining estimated fair value under SFAS No. 123(R), the Company has computed the estimated fair values of share-based compensation related to stock options using the Black-Scholes option valuation model and has applied the assumptions set forth in the following table. Awards granted prior to September 2005 generally vest over a two year period: one-third immediately on the grant date and one-third on the first and second anniversaries of the grant date. In September 2005, the Company s board of directors approved a longer vesting period for future awards to vest over a three year period: one-third on the first, second and third anniversaries of the grant date. The Company increased the expected life assumption for stock options granted beginning in September 2005 to six years after considering the increase in the vesting period, the ten year contractual term of the option awards, the historical share option exercise experience, peer data and guidance from the Securities and Exchange Commission as contained in Staff Accounting Bulletin No. 107 permitting the initial application of a simplified method, which is based on the average of the vesting term and the contractual term of the option. Previously, the Company calculated the estimated life based on the expectation that options would be exercised within five years on average after consideration of the vesting and contractual terms, historical share option exercise experience and peer data.

The Company based its estimate of expected volatility for options granted in the 2006 second quarter and six months ended June 30, 2006 on daily historical trading data of its common shares from September 20, 2002, the date marking the completion of the Company s transition as a worldwide insurance and reinsurance company, through the last day of the applicable period. For options granted in the 2005 second quarter and six months ended June 30, 2005, the Company based its volatility estimate under the same method as the 2006 second quarter and six months ended June 30, 2006, using the period from September 20, 2002 through the last day of the applicable period.

	(Unaudited) Three Months Ended June 30, 2006		2005	
Dividend yield	0.0	%	0.0	%
Expected volatility	20.5	%	21.0	%
Risk free interest rate	4.76	%	3.70	%
Expected option life	6.0 years		5.0 years	

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

A summary of option activity under the Company s Long term Incentive and Share Award Plans during the six months ended June 30, 2006 is presented below:

	(Unaudited) Six Months Ended June 30, 2006 Number of Options		Weighted Average Exercise Price	
Outstanding, beginning of year	5,637,108		$	26.30
Granted	848,250		$	56.26
Exercised	(494,713	)	$	23.99
Forfeited or expired	(14,499	)	$	44.95
Outstanding, end of period	5,976,146		$	30.70
Exercisable, end of period	4,621,539		$	24.49

The weighted average remaining contractual life of the Company s outstanding and exercisable stock options at June 30, 2006 was 6.4 years and 5.5 years, respectively. The aggregate intrinsic value of the Company s outstanding and exercisable stock options at June 30, 2006 was $171.9 million and $161.6 million, respectively. The Company received proceeds of approximately $11.9 million from the exercise of stock options during the six months ended June 30, 2006.

The weighted average grant-date fair value of options during the six months ended June 30, 2006 was $18.13 per option based on the Black-Scholes option pricing model. The aggregate intrinsic value of options exercised during the six months ended June 30, 2006 was approximately $15.4 million and represents the difference between the exercise price of the option and the closing market price of the Company s common shares on the exercise dates. As of June 30, 2006, there was approximately $16.2 million of unrecognized

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compensation cost related to nonvested stock options. Such cost is expected to be recognized over a weighted average period of 2.02 years.

At June 30, 2006, approximately 1,586,000 and 7,000 shares are available for grant under the 2005 and 2002 share award plans, respectively. The Company issues new shares upon exercise of stock options and when granting restricted shares. For a description of the Company s share award plans and the number of shares authorized for awards of options or other equity instruments, refer to Note 13, Share Capital Long Term Incentive and Share Award Plans, of the notes accompanying the Company s consolidated financial statements contained in the Company s Annual Report on Form 10-K/A for the year ended December 31, 2005.

Restricted Common Shares and Restricted Units

As discussed above, effective January 1, 2006, the Company adopted the fair value method of accounting for share-based compensation arrangements in accordance with SFAS No.123(R), which governs the accounting for all share-based compensation. Under the fair value method of accounting pursuant to SFAS No. 123(R), the fair value for restricted shares and units is measured by the grant-date price of the Company s 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. Restricted share and unit awards granted prior to September 2005 generally vest over a two year period: one-third immediately on the grant date and one-third on the first and second anniversaries of the grant date. In September 2005, the Company s board of directors approved a longer vesting period for future restricted share and unit awards to vest over a three year period: one-third on the first, second and third anniversaries of the grant date.

Prior to January 1, 2006, the Company accounted for its share-based compensation related to restricted share and unit awards using the intrinsic value method of accounting in accordance with APB No. 25 and its related interpretations. Compensation expense equal to the market value of the restricted share awards at the measurement date was amortized and recorded in net income over the vesting period. The Company s unearned compensation balance of $9.6 million as of December 31, 2005, which was accounted for under APB No. 25, was reclassified into additional paid-in capital upon adoption of SFAS No.123(R).

The Company recorded $1.8 million of share-based compensation expense, net of a tax benefit of $0.3 million, related to restricted share and unit awards for the 2006 second quarter as required by the provisions of SFAS No.123(R), compared to $1.6 million, net of a tax benefit of $0.4 million, for the 2005 second quarter. The Company recorded $3.5 million of share-based compensation expense, net of a tax benefit of $0.5 million, related to restricted share and unit awards for the six months ended June 30, 2006, compared to $3.3 million, net of a tax benefit of $0.8 million, for the six months ended June 30, 2005. The share-based compensation expense associated with restricted share and unit awards 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 over the remaining requisite service periods of the related awards. These charges had no impact on the Company s cash flows or total shareholders equity.

A summary of restricted share activity under the Company s Long Term Incentive and Share Award Plans during the six months ended June 30, 2006 is presented below:

	(Unaudited) Six Months Ended June 30, 2006	
	Nonvested Shares	Weighted Average Grant Date Fair Value
Unvested balance, beginning of year	666,504	$ 33.14
Granted	114,740	$ 56.67
Vested	(63,965)	$ 38.92
Forfeited	(1,476)	$ 46.64
Unvested balance, end of period	715,803	$ 36.37

As of June 30, 2006, 95,419 restricted units were outstanding with an aggregate intrinsic value of $5.7 million. The aggregate intrinsic value of 6,826 restricted units converted during the six months ended June 30, 2006 was $0.4 million. As of June 30, 2006, there were $12.0 million and $0.6 million, respectively, of unrecognized compensation costs related to unvested restricted share and unit awards which are expected to be recognized over a weighted-average period of 1.16 years and 1.35 years, respectively. The total weighted average fair value of restricted shares that vested during the six months ended June 30, 2006 was $3.7 million, or $57.10 per share.

3. Share Transactions

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, the Company had declared an aggregate of $3.1 million of dividends to be paid to holders of the Preferred Shares.

4. Segment Information

The Company classifies its businesses into two underwriting segments insurance and reinsurance and a corporate and other segment (non-underwriting). The Company s insurance and reinsurance operating segments each have segment managers who are responsible for the overall profitability of their respective segments and who are directly accountable to the Company s chief operating decision makers, the President and Chief Executive Officer of ACGL and the Chief Financial Officer of ACGL. The chief operating decision makers do not assess performance, measure return on equity or make resource allocation decisions on a line of business basis. The Company determined its reportable operating segments using the management approach described in SFAS No. 131, Disclosures About Segments of an Enterprise and Related Information.

Management measures segment performance based on underwriting income or loss. The Company does not manage its assets by segment and, accordingly, investment income is not allocated to each underwriting segment. In addition, other revenue and expense items are not evaluated by segment. The accounting policies of the segments are the same as those used for the preparation of the Company s consolidated financial statements. Inter-segment insurance business is allocated to the segment accountable for the underwriting results.

The insurance segment consists of the Company s insurance underwriting subsidiaries which primarily write on both an admitted and non-admitted basis. The insurance segment consists of eight specialty product lines: casualty; construction and surety; executive assurance; healthcare; professional liability; programs; property, marine and aviation; and other (consisting of collateralized protection business).

The reinsurance segment consists of the Company s reinsurance underwriting subsidiaries. The reinsurance segment generally seeks to write significant lines on specialty property and casualty reinsurance treaties. Classes of business include: casualty; marine and aviation; other specialty; property catastrophe; property excluding property catastrophe (losses on a single risk, both excess of loss and pro rata); and other (consisting of non-traditional and casualty clash business).

The corporate and other segment (non-underwriting) includes net investment income, other fee income, net of related expenses, other expenses incurred by the Company, interest expense, net realized gains or losses, net foreign exchange gains or losses and income taxes. In addition, results for the corporate and other segment include dividends on the Company s non-cumulative preferred shares.

The following tables set forth an analysis of the Company s underwriting income by segment, together with a reconciliation of underwriting income to net income available to common shareholders:

(U.S. dollars in thousands)	(Unaudited) Three Months Ended June 30, 2006 Insurance	Reinsurance	Total
Gross premiums written (1)	$ 647,817	$ 499,241	$ 1,136,274
Net premiums written (1)	409,302	385,256	794,558
Net premiums earned (1)	$ 385,877	$ 411,573	$ 797,450
Fee income	1,253	2,215	3,468
Losses and loss adjustment expenses	(251,172)	(211,083)	(462,255)
Acquisition expenses, net	(41,275)	(107,306)	(148,581)
Other operating expenses	(63,689)	(14,179)	(77,868)
Underwriting income	$ 30,994	$ 81,220	112,214
Net investment income			90,503
Net realized losses			(32,202)
Other expenses			(6,499)
Interest expense			(5,651)
Net foreign exchange losses			(1,146)
Income before income taxes			157,219
Income tax expense			(14,332)
Net income			142,887
Preferred dividends			(5,039)
Net income available to common shareholders			$ 137,848
Underwriting Ratios			
Loss ratio	65.1 %	51.3 %	58.0 %
Acquisition expense ratio (2)	10.5 %	26.1 %	18.5 %
Other operating expense ratio	16.5 %	3.4 %	9.8 %
Combined ratio	92.1 %	80.8 %	86.3 %

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(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 nil and $10.9 million, respectively, of gross and net premiums written and $0.5 million and $12.3 million, respectively, of net premiums earned assumed through intersegment transactions.

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

(U.S. dollars in thousands)	(Unaudited) Three Months Ended June 30, 2005 Insurance	Reinsurance	Total
Gross premiums written (1)	$ 577,420	$ 376,803	$ 940,753
Net premiums written (1)	373,672	350,056	723,728
Net premiums earned (1)	$ 354,086	$ 385,806	$ 739,892
Fee income	1,003	22	1,025
Losses and loss adjustment expenses	(229,971)	(213,947)	(443,918)
Acquisition expenses, net	(35,095)	(113,443)	(148,538)
Other operating expenses	(57,543)	(11,905)	(69,448)
Underwriting income	$ 32,480	$ 46,533	79,013
Net investment income			53,660
Net realized gains			2,105
Other expenses			(5,537)
Interest expense			(5,629)
Net foreign exchange gains			10,198
Income before income taxes			133,810
Income tax expense			(7,818)
Net income			125,992
Preferred dividends			
Net income available to common shareholders			$ 125,992
Underwriting Ratios			
Loss ratio	64.9 %	55.5 %	60.0 %
Acquisition expense ratio (2)	9.7 %	29.4 %	20.0 %
Other operating expense ratio	16.3 %	3.1 %	9.4 %
Combined ratio	90.9 %	88.0 %	89.4 %

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(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 $0.7 million and $12.8 million, respectively, of gross and net premiums written and $1.2 million and $14.7 million, respectively, of net premiums earned assumed through intersegment transactions.

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

(U.S. dollars in thousands)	(Unaudited) Six Months Ended June 30, 2006 Insurance	Reinsurance	Total
Gross premiums written (1)	$ 1,263,301	$ 1,063,909	$ 2,304,088
Net premiums written (1)	806,556	861,721	1,668,277
Net premiums earned (1)	$ 766,131	$ 792,920	$ 1,559,051
Fee income	2,657	2,616	5,273
Losses and loss adjustment expenses	(499,174)	(431,259)	(930,433)
Acquisition expenses, net	(79,160)	(199,093)	(278,253)
Other operating expenses	(125,765)	(27,431)	(153,196)
Underwriting income	$ 64,689	$ 137,753	202,442
Net investment income			170,829
Net realized losses			(35,585)
Other expenses			(14,148)
Interest expense			(11,206)
Net foreign exchange losses			(11,399)
Income before income taxes			300,933
Income tax expense			(25,756)
Net income			275,177
Preferred dividends			(7,706)
Net income available to common shareholders			$ 267,471
Underwriting Ratios			
Loss ratio	65.2 %	54.4 %	59.7 %
Acquisition expense ratio (2)	10.1 %	25.1 %	17.7 %
Other operating expense ratio	16.4 %	3.5 %	9.8 %
Combined ratio	91.7 %	83.0 %	87.2 %

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(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 $0.8 million and $22.4 million, respectively, of gross and net premiums written and $1.4 million and $25.1 million, respectively, of net premiums earned assumed through intersegment transactions.

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

(U.S. dollars in thousands)	(Unaudited) Six Months Ended June 30, 2005 Insurance	Reinsurance	Total
Gross premiums written (1)	$ 1,084,164	$ 865,598	$ 1,921,445
Net premiums written (1)	695,780	827,749	1,523,529
Net premiums earned (1)	$ 675,122	$ 761,838	$ 1,436,960
Fee income	2,492	4,645	7,137
Losses and loss adjustment expenses	(436,833)	(432,621)	(869,454)
Acquisition expenses, net	(61,776)	(212,895)	(274,671)
Other operating expenses	(114,830)	(22,821)	(137,651)
Underwriting income	$ 64,175	$ 98,146	162,321
Net investment income			103,576
Net realized gains			2,566
Other expenses			(11,509)
Interest expense			(11,265)
Net foreign exchange gains			13,435
Income before income taxes			259,124
Income tax expense			(17,240)
Net income			241,884
Preferred dividends			
Net income available to common shareholders			$ 241,884
Underwriting Ratios			
Loss ratio	64.7 %	56.8 %	60.5 %
Acquisition expense ratio (2)	8.9 %	27.9 %	19.0 %
Other operating expense ratio	17.0 %	3.0 %	9.6 %
Combined ratio	90.6 %	87.7 %	89.1 %

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(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 Amount	% of Total	2005 Amount	% of Total
Net premiums written (1)				
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
Net premiums earned (1)				
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
Net premiums written by client location (1)				
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

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(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 Amount	% of Total	2005 Amount	% of Total
Net premiums written (1)				
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
Net premiums earned (1)				
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
Net premiums written by client location (1)				
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

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(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 Amount	% of Total	2005 Amount	% of Total
Net premiums written (1)				
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
Net premiums earned (1)				
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
Net premiums written (1)				
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
Net premiums earned (1)				
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
Net premiums written by client location (1)				
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

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(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.

REINSURANCE SEGMENT (U.S. dollars in thousands)	(Unaudited) Six Months Ended June 30, 2006 Amount	% of Total	2005 Amount	% of Total
Net premiums written (1)				
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
Net premiums earned (1)				
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
Net premiums written (1)				
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
Net premiums earned (1)				
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
Net premiums written by client location (1)				
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	2005	(Unaudited) Six Months Ended June 30, 2006	2005
Premiums Written				
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
Premiums Earned				
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
Losses and Loss Adjustment Expenses				
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
June 30, 2006 (unaudited):				
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
December 31, 2005:				
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

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

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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:

	(Unaudited) June 30, 2006		**December 31, 2005**	
(U.S. dollars in thousands)	**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

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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:

	(Unaudited) Three Months Ended June 30,		**(Unaudited) Six Months Ended June 30,**	
(U.S. dollars in thousands)	**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, 2006**	**2005**	**(Unaudited) Six Months Ended June 30, 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	2005	(Unaudited) Six Months Ended June 30, 2006	2005
Basic earnings per common share:				
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
Diluted earnings per common share:				
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.

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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 ACGL 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
Underwriting Ratios		
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.

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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
Underwriting Ratios		
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

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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)	**Six Months Ended June 30, 2006**	**2005**
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
Underwriting Ratios		
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
Underwriting Ratios		
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

Other Expenses

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 5.9% 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, ACGL 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 yearEffective 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.

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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
Insurance:		
Case reserves	$ 531,221	$ 421,131
IBNR reserves	1,624,407	1,413,243
Total net reserves	$ 2,155,628	$ 1,834,374
Reinsurance:		
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
Total:		
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

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
Total net reserves	$ 2,381,426	$ 2,228,684

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
June 30, 2006:	$ 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					
December 31, 2005:					
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.

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

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:

Issuer Purchases of Equity Securities

Period	**Total Number of Shares Purchased (1)**	**Average Price Paid per Share**	**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**
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. Met mandatorily applicable to South Carolina corporations. In addition, each of the parties hereto (a) submits to the personal jurisdiction of the Delaware Court of Chancery in and for New Castle County, or in the event (but only in the event) that such Delaware Court of Chancery does not have subject matter jurisdiction over such dispute, the United States District Court for the District of Delaware, or in the event (but only in the event) that such United States District Court also does not have jurisdiction over such dispute, any Delaware State court sitting in New Castle County, in the event any dispute (whether in contract, tort or otherwise) arises out of this Agreement or the transactions contemplated hereby, (b) agrees that it will not attempt to deny or defeat such personal jurisdiction by motion or other request for leave from any such court, and (c) agrees that it will not bring any claim, action or proceeding relating to this Agreement or the transactions contemplated hereby in any court other than the Delaware Court of Chancery in and for New Castle County, or in the event (but only in the event) that such Delaware Court of Chancery does not have subject matter jurisdiction over such claim, action or proceeding the United States District Court for the District of Delaware, or in the event (but only in the event) that such United States District Court also does not have jurisdiction over such claim, action or proceeding, any Delaware State court sitting in New Castle County. Each party agrees that service

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of process upon such party in any such claim, action or proceeding shall be effective if notice is given in accordance with the provisions of this Agreement.

(b) EACH PARTY HEREBY WAIVES TO THE FULLEST EXTENT PERMITTED BY APPLICABLE LAW, ANY RIGHT IT MAY HAVE TO A TRIAL BY JURY IN RESPECT OF ANY CLAIM, ACTION OR PROCEEDING DIRECTLY OR INDIRECTLY ARISING OUT OF, UNDER OR IN CONNECTION WITH THIS AGREEMENT OR THE TRANSACTIONS CONTEMPLATED HEREBY. EACH PARTY (A) CERTIFIES THAT NO REPRESENTATIVE, AGENT OR ATTORNEY OF ANY OTHER PARTY HAS REPRESENTED, EXPRESSLY OR OTHERWISE, THAT SUCH OTHER PARTY WOULD NOT, IN THE EVENT OF LITIGATION, SEEK TO ENFORCE THE FOREGOING WAIVER AND (B) ACKNOWLEDGES THAT IT AND THE OTHER PARTIES HERETO HAVE BEEN INDUCED TO ENTER INTO THIS AGREEMENT, BY, AMONG OTHER THINGS, THE MUTUAL WAIVERS AND CERTIFICATIONS IN THIS SECTION 9.7.

9.8 *Specific Performance.* The parties agree that irreparable damage would occur in the event that any of the provisions of this Agreement were not performed in accordance with their specific terms or were otherwise breached. Accordingly, each of the parties shall be entitled to seek specific performance of the terms hereof, including an injunction or injunctions to prevent breaches of this Agreement and to enforce specifically the terms and provisions of this Agreement, this being in addition to any other remedy to which such party is entitled at law or in equity. Each of the parties hereby further waives any requirement under any law to post security as a prerequisite to obtaining equitable relief.

9.9 *Additional Definitions.* In addition to any other definitions contained in this Agreement, the following words, terms and phrases shall have the following meanings when used in this Agreement.

"*Business Day*" shall mean any day other than a Saturday, Sunday or day on which banking institutions in New York, New York or Columbia, South Carolina are authorized or obligated pursuant to legal requirements or executive order to be closed.

"*Company Stock Plan*" shall mean the Company 1997 Stock Option and Incentive Plan, the 2001 Stock Option Plan, the 2004 Outside Directors Stock Options-For-Fees Plan, the 2005 Stock Option Plan, the 2005 Performance Equity Plan for Non-Employee Directors, and the 2007 Equity Incentive Plan.

"*Confidentiality Agreement*" shall mean that certain letter agreement dated as of January 25, 2013, by and between Company and Parent (as it may be amended from time to time).

"*Contract*" shall mean any contract, agreement, commitment, arrangement, understanding, franchise, indenture, lease, purchase order or license.

"*Controlled Group Liability*" shall mean any and all liabilities (a) under Title IV of ERISA, (b) under Section 302 of ERISA, (c) under Sections 412, 430 and 4971 of the Code, (d) as a result of a failure to comply with the continuation coverage requirements of Section 601 et seq. of ERISA and Section 4980B of the Code and (e) under corresponding or similar provisions of foreign Laws, other than such liabilities that arise solely out of, or relate solely to, the Company Benefit Plans listed in Section 3.11(a) of the Disclosure Schedule.

"*Corporate Entity*" shall mean a bank, corporation, partnership, limited liability company, association, joint venture or other organization, whether an incorporated or unincorporated organization.

"*End Date*" shall mean December 31, 2013.

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"*ERISA Affiliate*" shall mean, with respect to any entity, trade or business, any other entity, trade or business that is, or was at the relevant time, a member of a group described in Section 414(b), (c), (m) or (o) of the Code or Section 4001(b)(1) of ERISA that includes or included the first entity, trade or business, or that is, or was at the relevant time, a member of the same "controlled group" as the first entity, trade or business pursuant to Section 4001(a)(14) of ERISA.

"*Knowledge*" with respect to Company, shall mean the actual knowledge, after due inquiry, of those individuals set forth in Section 9.9 of the Disclosure Schedule and, with respect to Parent, shall mean the actual knowledge, after due inquiry, of those individuals set forth in Section 9.9 of the Parent Disclosure Schedule.

"*Law*" or "*Laws*" shall mean any federal, state, local or foreign or provincial law, statute, ordinance, rule, regulation, order, policy, guideline or agency requirement of or undertaking to or agreement with any Governmental Entity, including common law.

"*Material Adverse Effect*" shall mean, with respect to Company any event, circumstance, development, change or effect that, individually or in the aggregate, (i) is, or is reasonably likely to be, material and adverse to the business, operations, financial condition or results of operations of Company and its Subsidiaries taken as a whole or (ii) prevents or materially impairs, or would be reasonably likely to prevent or materially impair, the ability of Company to timely consummate the Closing (including the Merger and the Bank Merger) on the terms set forth herein, or to perform its agreements or covenants hereunder; *provided* that, in the case of clause (i) only, a "Material Adverse Effect" shall not be deemed to include any event, circumstance, development, change or effect to the extent resulting from (A) changes after the date of this Agreement in GAAP, (B) changes after the date of this Agreement in Laws of general applicability to companies in the financial services industry, (C) changes after the date of this Agreement in political or regulatory conditions or general economic or market conditions in the United States or any state or territory thereof, in each case generally affecting other companies in the financial services industry, (D) a failure, in and of itself, to meet earnings projections or internal financial forecasts, but not including any underlying causes thereof, or changes in the trading price of Company Common Stock, in and of itself, but not including any underlying causes thereof, (E) the public disclosure of this Agreement or (F) any outbreak or escalation of hostilities, declared or undeclared acts of war or terrorism; except, with respect to clauses (A), (B), (C) and (F), to the extent that the effects of such change disproportionately affect Company and its Subsidiaries, taken as a whole, as compared to other companies in the industry in which Company and its Subsidiaries operate.

"Parent Material Adverse Effect" shall mean, with respect to Parent any event, circumstance, development, change or effect that, individually or in the aggregate, (i) is, or is reasonably likely to be, material and adverse to the business, operations, financial condition or results of operations of Parent and its Subsidiaries taken as a whole or (ii) prevents or materially impairs, or would be reasonably likely to prevent or materially impair, the ability of Parent to timely consummate the Closing (including the Merger and the Bank Merger) on the terms set forth herein, or to perform its agreements or covenants hereunder; *provided* that, in the case of clause (i) only, a "Parent Material Adverse Effect" shall not be deemed to include any event, circumstance, development, change or effect to the extent resulting from (A) changes after the date of this Agreement in GAAP, (B) changes after the date of this Agreement in Laws of general applicability to companies in the financial services industry, (C) changes after the date of this Agreement in political or regulatory conditions or general economic or market conditions in the United States or any state or territory thereof, in each case generally affecting other companies in the financial services industry, (D) a failure, in and of itself, to meet earnings projections or internal financial forecasts, but not including any underlying causes thereof, or changes in the trading price of Parent Common Stock, in and of itself, but not including any underlying causes thereof, (E) the public disclosure of this Agreement or (F) any outbreak or escalation of hostilities, declared or undeclared acts of war or terrorism; except, with respect to clauses (A), (B),

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(C) and (F), to the extent that the effects of such change disproportionately affect Parent and its Subsidiaries, taken as a whole, as compared to other companies in the industry in which Parent and its Subsidiaries operate.

"*Parent Share Value*" shall mean the average closing price per share of Parent Common Stock on the NASDAQ for the consecutive period of ten (10) trading days immediately preceding (but not including) the Closing Date.

"*party*" or "*parties*" shall mean Company and Parent.

"*Person*" shall mean any individual, Corporate Entity or Governmental Entity.

"*Tax*" or "*Taxes*" shall mean all federal, state, local and foreign income, excise, gross receipts, gross income, ad valorem, profits, gains, property, capital, sales, transfer, use, value-added, stamp, documentation, payroll, employment, severance, withholding, duties, license, intangibles, franchise, backup withholding, environmental, occupation, alternative or add-on minimum taxes imposed by any Governmental Entity, and other taxes, charges, levies or like assessments, and including all penalties and additions to tax and interest thereon.

"*Tax Return*" shall mean any return, declaration, report, statement, information statement and other document filed or required to be filed with respect to Taxes, including any schedule or attachment thereto, and including any amendment thereof, supplied to a Governmental Entity.

9.10 *Severability.* If any provision of this Agreement (or any portion thereof) or the application of any such provision (or any portion thereof) to any Person or circumstance shall be held invalid, illegal or unenforceable in any respect by a court of competent jurisdiction, such invalidity, illegality or unenforceability shall not affect any other provision hereof (or the remaining portion thereof) or the application of such provision to any other Persons or circumstances. Upon such determination that any term or other provision is invalid, illegal or incapable of being enforced, the parties shall negotiate in good faith to modify this Agreement so as to effect the original legal and economic intent of the parties as closely as possible in an acceptable manner to the end that the Merger and the other transactions contemplated by this Agreement are fulfilled to the fullest extent possible.

9.11 *Assignment; Third-Party Beneficiaries.* Neither this Agreement nor any of the rights, interests or obligations shall be assigned by any of the parties hereto (whether by operation of law or otherwise) without the prior written consent of the other parties; *provided*, *however*, that Parent may assign any of its rights under this Agreement to a direct or indirect wholly owned Subsidiary of Parent. Subject to the preceding sentence, this Agreement shall be binding upon, inure to the benefit of and be enforceable by the parties and their respective successors and assigns. Except as otherwise specifically provided in Section 6.7, this Agreement (including the documents and instruments referred to herein) is not intended to confer upon any Person other than the parties hereto any rights or remedies hereunder.

[*Signature page follows*]

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IN WITNESS WHEREOF, the parties hereto have caused this Agreement to be executed by their respective officers thereunto duly authorized as of the date first above written.

SCBT FINANCIAL CORPORATION

By: /s/ ROBERT R. HILL, JR.

Name: Robert R. Hill, Jr.
Title: President and Chief Executive Officer

FIRST FINANCIAL HOLDINGS, INC.

By: /s/ R. WAYNE HALL

Name: R. Wayne Hall
Title: President and Chief Executive Officer

[Signature Page to Agreement and Plan of Merger]

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Annex B

February 19, 2013

Board of Directors
First Financial Holdings, Inc.
2440 Mall Drive
Charleston, SC 29406

Ladies and Gentlemen:

First Financial Holdings, Inc. ("FFH") and SCBT Financial Corporation ("SCBT") have entered into an agreement and plan of merger dated as of February 19, 2013 (the "Agreement") pursuant to which FFH will merge with and into SCBT(the "Merger"). Pursuant to the terms of the merger, upon the effective date of the Merger, each share of FFH common stock issued and outstanding immediately before the Effective Time, except for certain shares as specified in the Agreement, will be converted into and represent the right to receive 0.4237 shares of SCBT common stock (the "Merger Consideration"), subject to certain adjustments as described in the Agreement. The other terms and conditions of the Merger are more fully set forth in the Agreement, and capitalized terms used herein without definition shall have the meanings assigned to them in the Agreement. You have requested our opinion as to the fairness, from a financial point of view, of the Merger Consideration to the holders of FFH common stock.

Sandler O'Neill & Partners, L.P., as part of its investment banking business, is regularly engaged in the valuation of financial institutions and their securities in connection with mergers and acquisitions and other corporate transactions. In connection with this opinion, we have reviewed, among other things: (i) the Agreement; (ii) certain publicly available financial statements and other historical financial information of FFH that we deemed relevant; (iii) certain publicly available financial statements and other historical financial information of SCBT that we deemed relevant; (iv) internal financial projections for FFH for the years ending December 31, 2013 through December 31, 2017 as provided by senior management of FFH; (v) publicly available consensus earnings estimates for the years ending December 31, 2013 and December 31, 2014 and a publicly available estimated long term growth rate for the years thereafter as discussed with senior management of SCBT; (vi) the pro forma financial impact of the Merger on SCBT based on assumptions relating to transaction expenses, purchase accounting adjustments, cost savings and other synergies as determined by the senior management of SCBT; (vii) the relative contribution of assets, liabilities, equity and earnings of FFH and SCBT to the combined entity; (viii) a comparison of certain stock trading, financial and other information for FFH and SCBT with similar publicly available information for certain other commercial banks, the securities of which are publicly traded; (ix) the terms and structures of other recent mergers and acquisition transactions in the commercial banking sector; (x) the current market environment generally and in the commercial banking sector in particular; and (xi) such other information, financial studies, analyses and investigations and financial, economic and market criteria as we considered relevant. We also discussed with certain members of senior management of FFH the business, financial condition, results of operations and prospects of FFH and held similar discussions with the senior management of SCBT regarding the business, financial condition, results of operations and prospects of SCBT.

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In performing our review, we have relied upon the accuracy and completeness of all of the financial and other information that was available to us from public sources, that was provided to us by FFH and SCBT or that was otherwise reviewed by us and have assumed such accuracy and completeness for purposes of preparing this letter. We have further relied on the assurances of the senior management of FFH and SCBT that they are not aware of any facts or circumstances that would make any of such information inaccurate or misleading in any material respect. We did not make an independent evaluation or appraisal of the specific assets, the collateral securing assets or the liabilities (contingent or otherwise) of FFH or SCBT or any of their respective subsidiaries. We did not make an independent evaluation of the adequacy of the allowance for loan losses of FFH, SCBT or the combined entity after the Merger and we have we not reviewed any individual credit files relating to FFH or SCBT. We have assumed, with your consent, that the respective allowances for loan losses for both FFH and SCBT are adequate to cover such losses and will be adequate on a pro forma basis for the combined entity.

In preparing its analyses, Sandler O'Neill used internal financial projections as provided by the senior management of FFH and publicly available consensus earnings estimates for SCBT. Sandler O'Neill also received and used in its analyses certain projections of transaction costs, purchase accounting adjustments, expected cost savings and other synergies which were prepared by and/or reviewed with the senior management of SCBT. With respect to these projections, the respective senior managements of FFH and SCBT confirmed to us that those projections reflected the estimates and judgments of those respective managements of the future financial performance of FFH and SCBT, respectively, and we assumed that such performance would be achieved. We express no opinion as to such estimates or the assumptions on which they are based. We have assumed that there has been no material change in the respective assets, financial condition, results of operations, business or prospects of FFH and SCBT since the date of the most recent financial data made available to us, as of the date hereof. We have also assumed in all respects material to our analysis that FFH and SCBT would remain as a going concern for all periods relevant to our analyses and that the Merger will be consummated as a tax-free reorganization under Section 368 of the Internal Revenue Code. We express no opinion as to any of the legal, accounting and tax matters relating to the Merger and any other transactions contemplated in connection therewith.

Our analyses and the views expressed herein are necessarily based on financial, economic, regulatory, market and other conditions as in effect on, and the information made available to us as of, the date hereof. Events occurring after the date hereof could materially affect our views. We have not undertaken to update, revise, reaffirm or withdraw this letter or otherwise comment upon events occurring after the date hereof. We render no opinion as to the trading values of each of FFH's and SCBT's common shares and render no opinion as to the prices SCBT's or FFH's common shares may trade at any time.

We have acted as financial advisor to the Board of Directors of FFH in connection with the Merger and a significant portion of our fees are contingent upon the closing of the Merger. We also will receive a fee for providing this opinion. In connection with our engagement, we were not asked to, and did not, solicit indications of interest in a potential transaction from other parties. FFH has also agreed to indemnify us against certain liabilities arising out of our engagement. In the ordinary course of our business as a broker-dealer, we may purchase securities from and sell securities to FFH and SCBT and their affiliates. We may also actively trade the securities of FFH and SCBT or their affiliates for our own account and for the accounts of our customers.

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This letter is directed to the Board of Directors of FFH in connection with its consideration of the Merger and does not constitute a recommendation to any shareholder of FFH as to how such shareholder should vote at any meeting of shareholders called to consider and vote upon the Merger. Our opinion is directed only to the fairness, from a financial point of view, of the Merger Consideration to the holders of FFH common stock and does not address the underlying business decision of FFH to engage in the Merger, the relative merits of the Merger as compared to any other alternative business strategies that might exist for FFH or the effect of any other transaction in which FFH might engage. This opinion shall not be reproduced or used for any other purposes, without Sandler O'Neill's prior written consent, which consent will not be unreasonably withheld. This Opinion has been approved by Sandler O'Neill's fairness opinion committee. We do not express any opinion as to the fairness of the amount or nature of the compensation to be received in the Merger by FFH's officers, directors, or employees, or class of such persons, relative to the compensation to be received in the Merger by any other shareholders of FFH.

Based upon and subject to the foregoing, it is our opinion that, as of the date hereof, the Merger Consideration is fair to the holders of FFH common stock from a financial point of view.

Very truly yours,

/s/ Sandler O'Neill & Partners

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Annex C

February 19, 2013

The Board of Directors
SCBT Financial Corporation
520 Gervais Street
Columbia, South Carolina 29201

Members of the Board:

You have requested our opinion as investment bankers as to the fairness, from a financial point of view, to SCBT Financial Corporation ("SCBT") of the Merger Consideration (as defined below), in the proposed merger (the "Merger") of First Financial Holdings, Inc. ("First Financial") with and into SCBT, pursuant to the draft Agreement and Plan of Reorganization, dated as of February 18, 2013, by and between First Financial and SCBT (the "Agreement"). Pursuant to the terms of the Agreement, each outstanding share of common stock, $0.01 par value per share, of First Financial not owned by SCBT or any of its wholly-owned subsidiaries, other than shares held by them in a fiduciary capacity or as a result of debts previously contracted, shall receive in respect thereof, 0.4237 shares of SCBT common stock (the "Merger Consideration"), as more fully described in the Agreement.

Keefe, Bruyette & Woods, Inc. has acted as financial advisor to SCBT and not as an advisor to or agent of any other person. As part of our investment banking business, we are continually engaged in the valuation of bank and bank holding company securities in connection with acquisitions, negotiated underwritings, secondary distributions of listed and unlisted securities, private placements and valuations for various other purposes. As specialists in the securities of banking companies, we have experience in, and knowledge of, the valuation of banking enterprises. In the ordinary course of our business as a broker-dealer, we may, from time to time purchase securities from, and sell securities to, SCBT and First Financial, and as a market maker in securities, we may from time to time have a long or short position in, and buy or sell, debt or equity securities of SCBT and First Financial for our own account and for the accounts of our customers. To the extent we have any such position as of the date of this opinion it has been disclosed to SCBT. We have acted exclusively for the Board of Directors of SCBT in rendering this fairness opinion and will receive a fee from SCBT for our services. Our fee is contingent upon the successful completion of the Merger.

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During the past two years we have provided investment banking and financial advisory services to SCBT, and have received compensation for such services. In addition, during the past two years we have provided investment banking and financial advisory services to First Financial, but have not received compensation for such services. We may in the future provide investment banking and financial advisory services to SCBT and receive compensation for such services.

In connection with this opinion, we have reviewed, analyzed and relied upon material bearing upon the financial and operating condition of SCBT and First Financial and the Merger, including among other things, the following: (i) a draft of the Agreement dated February 18, 2013 (the most recent draft made available to us); (ii) the Annual Reports to Stockholders and Annual Reports on Form 10-K for the three years ended December 31, 2011 and September 30, 2011, of SCBT and First Financial, respectively; (iii) certain interim reports to stockholders and Quarterly Reports on Form 10-Q of SCBT and First Financial and certain other communications from SCBT and First Financial to their respective stockholders; and (iv) other financial information concerning the businesses and operations of SCBT and First Financial furnished to us by SCBT and First Financial for purposes of our analysis. We have also held discussions with senior management of SCBT and First Financial regarding the past and current business operations, regulatory relations, financial condition and future prospects of their respective companies and such other matters as we have deemed relevant to our inquiry. In addition, we have compared certain financial and stock market information for SCBT and First Financial with similar information for certain other companies the securities of which are publicly traded, reviewed the financial terms of certain recent business combinations in the banking industry and performed such other studies and analyses as we considered appropriate.

In conducting our review and arriving at our opinion, we have relied upon the accuracy and completeness of all of the financial and other information provided to us or publicly available and we have not independently verified the accuracy or completeness of any such information or assumed any responsibility for such verification or accuracy. We have relied upon the management of SCBT and First Financial as to the reasonableness and achievability of the financial and operating forecasts and projections (and the assumptions and bases therefore) provided to us, and we have assumed that such forecasts and projections reflect the best currently available estimates and judgments of such managements and that such forecasts and projections will be realized in the amounts and in the time periods currently estimated by such managements. We are not experts in the independent verification of the adequacy of allowances for loan and lease losses and we have assumed, with your consent, that the aggregate allowances for loan and lease losses for SCBT and First Financial are adequate to cover such losses. In rendering our opinion, we have not made or obtained any evaluations or appraisals of the property, assets or liabilities of SCBT or First Financial, nor have we examined any individual credit files.

We have assumed that, in all respects material to our analyses, the following: (i) the Merger will be completed substantially in accordance with the terms set forth in the Agreement (the final version of which will not differ in any respect material to our analyses from the draft reviewed) with no additional payments or adjustments to the Merger Consideration; (ii) the representations and warranties of each party in the Agreement and in all related documents and instruments referred to in the Agreement are true and correct; (iii) each party to the Agreement and all related documents will perform all of the covenants and agreements required to be performed by such party under such documents; (iv) all conditions to the completion of the Merger will be satisfied without any waivers or modifications to the Agreement; and (v) in the course of obtaining the necessary regulatory, contractual, or other consents or approvals for the Merger, no restrictions, including any divestiture requirements, termination or other payments or amendments or modifications, will be imposed that will have a material adverse effect on the future results of operations or financial condition of the combined entity or the contemplated benefits of the Merger, including the cost savings, revenue enhancements and related expenses expected to result from the Merger.

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We have considered such financial and other factors as we have deemed appropriate under the circumstances, including, among others, the following: (i) the historical and current financial position and results of operations of SCBT and First Financial; (ii) the assets and liabilities of SCBT and First Financial; and (iii) the nature and terms of certain other merger transactions involving banks and bank holding companies. We have also taken into account our assessment of general economic, market and financial conditions and our experience in other transactions, as well as our experience in securities valuation and knowledge of the banking industry generally. Our opinion is necessarily based upon conditions as they exist and can be evaluated on the date hereof and the information made available to us through the date hereof. Our opinion does not address the underlying business decision of SCBT to engage in the Merger, or the relative merits of the Merger as compared to any strategic alternatives that may be available to SCBT,

This opinion addresses only the fairness, from a financial point of view, as of the date hereof, of the Merger Consideration in the Merger to SCBT, We express no view or opinion as to any terms or other aspects of the Merger.

Further, we are not expressing any opinion about the fairness of the amount or nature of the compensation to any of First Financial's or SCBT's officers, directors or employees, or any class of such persons, relative to the compensation to the public shareholders of First Financial in connection with the Merger.

In addition, this opinion dots not in any manner address the prices at which the SCBT common stock will trade following the consummation of the Merger and we express no view or opinion as to how the stockholders of First Financial or SCBT should vote at the stockholders meeting to be held in connection with the Merger.

This opinion has been reviewed and approved by our Fairness Opinion Committee in conformity with our policies and procedures established under the requirements of Rule 5150 of the Financial Industry Regulatory Authority.

Based upon and subject to the foregoing, it is our opinion that, as of the date hereof, the Merger Consideration in the Merger is fair, from a financial point of view, to SCBT.

Very truly yours,

Keefe, Bruyette & Woods, Inc.

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Annex D

FORM OF ADVISORY BOARD MEMBER AGREEMENT

THIS ADVISORY BOARD MEMBER AGREEMENT (this "*Agreement*"), dated as of [ ], 2013, by and between SCBT Financial Corporation (the "*Company*"), a bank holding company organized and existing under the laws of the State of South Carolina, and [NAME] (the "*Member*") and is effective as of the Effective Date (as defined below). If the Effective Date does not occur, this Agreement shall be null and void *ab initio* and of no further force and effect.

WITNESSETH:

WHEREAS, the Company has entered into an Agreement and Plan of Merger with First Financial Holdings, Inc. (together, as applicable, with its subsidiaries and affiliates referred to herein as "*First Financial*"), dated as of February 19, 2013 (the "*Merger Agreement*") pursuant to which First Financial shall merge with and into the Company effective as of the Closing Date (as defined in the Merger Agreement);

WHEREAS, the Company and First Financial have determined that it is in the best interests of the Company, First Financial and the Company's and First Financial's shareholders to establish an advisory board consisting of certain legacy directors of First Financial, together with additional individuals, if any, appointed by the Company in its sole discretion (the "*South Carolina Advisory Board*"); and

WHEREAS, the Member has invaluable knowledge and expertise regarding the business of First Financial and the Company wishes to appoint the Member to serve on the South Carolina Advisory Board on the terms and subject to the conditions specified hereinafter.

NOW, THEREFORE, for good and valuable consideration, the receipt and sufficiency of which is hereby acknowledged, the Company and the Member hereby agree as follows:

1. *Advisory Period.* The Member shall be appointed to serve on the South Carolina Advisory Board commencing on the Closing Date (as defined in the Merger Agreement) (the "*Effective Date*") and shall continue to serve until the third anniversary of the Effective Date, unless terminated earlier as provided herein (the "*Advisory Period*").

2. *Advisory Services.* During the Advisory Period, the Member shall (a) attend South Carolina Advisory Board meetings, (b) make himself or herself reasonably available to the Company to discuss matters relating to the business of its banking interests in certain markets served by First Financial as of the Closing Date (the "*First Financial Markets*"), and (c) advise on specific projects for the Company relating to business opportunities in the First Financial Markets, in each case, as may be reasonably requested from time to time by the Company.

3. *Consideration.* In consideration for agreeing to provide the advisory services set forth in Section 2 and in consideration of the Member's compliance with the Restrictive Covenants set forth in Section 7, the Member shall be paid an advisory fee of $40,000 annually, to be paid on a monthly basis, in arrears (the "*Advisory Fee*"). The Advisory Fee shall be paid to the Member, in accordance with the payment schedule set forth in the previous sentence, beginning on the Effective Date and continuing until the third anniversary of the Effective Date, regardless of whether the Advisory Period is terminated on an earlier date.

4. *Expenses.* The Company shall reimburse the Member pursuant to the Company's reimbursement policies for any applicable reasonable business expenses incurred by the Member in connection with the performance of the advisory services described in Section 2.

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5. *Sole Consideration.* Except as specifically provided in Section 3 of this Agreement, the Member shall be entitled to no compensation or benefits from the Company with respect to the advisory services.

6. *Status as an Independent Contractor.* The Company and the Member acknowledge and agree that the Member shall be acting and shall act at all times as an independent contractor only and not as an employee, agent, partner or joint venturer of or with the Company or any entity for which the Company provides services. The Member acknowledges that he is solely responsible for the payment of all Federal, state, local and foreign taxes that are required by applicable laws or regulations to be paid with respect to the Advisory Fees payable hereunder.

7. *Restrictive Covenants*.

(a) **Restrictive Covenants**. The Member shall not take any of the following actions during the period beginning on the Effective Date and ending on the third anniversary of the Effective Date (the "*Restricted Period*").

(i) Become employed by (as an officer, director, employee, consultant or otherwise), involved or engaged in, provide service to, or otherwise become commercially or financially interested in or affiliated with (other than as a less than 1% equity owner of any corporation traded on any national, international or regional stock exchange or in the over-the-counter market) any person or entity that participates in, or proposes to enter the, business of providing banking, lending, investment advisory, financial planning, depositary, trust, brokerage or similar services in, or to customers or clients located in, the Territory (as such term is defined below) (any such person a "*Competing Party*"), without the advance written permission of the Company;

(ii) Solicit, divert or take away, or attempt to solicit, divert or take away, or in association with any other person, solicit, divert or take away or attempt to solicit, divert or takeaway, for competitive purposes, the business of any of the clients or customers of the Company, SCBT Bank, or an affiliate thereof (including, without limitation, First Financial and its affiliates) (collectively "*Company Affiliates*"), or otherwise induce such customers or clients or prospective customers or clients to reduce, terminate, restrict or alter their business relationship with the Company or any Company Affiliate in any fashion, including, without limitation, customers or prospective customers to refrain from maintaining or acquiring from or through the Company or any Company Affiliate any product or service which was provided or offered by the Company during the period of the Member's service with the Company; or

(iii) Induce or attempt to induce, or in association with any other person, induce or attempt to induce, any employee of the Company or any Company Affiliate to leave the Company or any Company Affiliate for the purpose of engaging in a business operation that is competitive with the Company or Company Affiliate or is or would be a Competing Party.

(b) **Geographic Scope**. The restrictions on competition set forth in Section 7(a)(i) of this Agreement shall apply to any county in the State of South Carolina or any other county in any state in which the Company or any Company Affiliate is conducting business operations during the Restricted Period (such counties collectively the "*Territory*").

(c) **Member's Representation**. The Member acknowledges and agrees that the restrictions of this Section 7 are necessary and vital to protect the legitimate business interests of the Company and its Affiliates, are fair and reasonable in all respects, and are not overbroad or unduly burdensome to him or her. If a court determines that this Agreement or any covenant contained herein is unreasonable, void or unenforceable, for any reason whatsoever, then in such event the parties hereto agree that the duration, geographical or other limitation imposed herein should be such as the court determines to be fair and reasonable; it being the intent of each of the parties

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hereto be subject to an agreement that is necessary for the protection of the legitimate interest of the Company and/or Company Affiliate and its successors or assigns and that is not unduly harsh in curtailing the legitimate rights of the Member.

(d) **Remedies**. The Member acknowledges that the Company or any Company Affiliate will have no adequate means of protecting its rights under this Agreement other than by securing an injunction. The Member agrees that the Company or Company Affiliate is entitled to enforce this Agreement by obtaining a preliminary and permanent injunction and any other appropriate equitable relief in any court of competent jurisdiction. The Member acknowledges that the Company's or Company Affiliate's recovery of damages will not be an adequate means to redress a breach of this Agreement. Nothing contained in this Section 7 shall prohibit the Company or Company Affiliate from obtaining any appropriate remedies in addition to injunctive relief, including recovery of damages.

(e) **Obligations Survive**. The Member's obligations under this Section 7 shall survive any early termination of the Advisory Period with the Company.

8. *Termination of Arrangement.* The parties hereto expect that this advisory arrangement will continue for the full term of the Advisory Period, but either the Member or the Company may choose to terminate the Advisory Period for any reason prior to the end of the scheduled Advisory Period upon written notice provided to the other party hereto. The parties hereto acknowledge that, regardless of the reason for any such termination, the Member shall continue to receive Advisory Fees through the third anniversary of the Effective Date, and the parties further agree and acknowledge that the Restricted Period shall continue to apply to the Member for the Restricted Period (as defined in Section 7) irrespective of any earlier termination of the Advisory Period; *provided*, *however*, that in addition to any other remedy that the Company may seek, the Company shall cease to pay Advisory Fees to the Member upon any breach of Section 7(a) hereof.

9. *Miscellaneous.*

(a) *Successors and Assigns.* This Agreement will be binding upon, inure to the benefit of and be enforceable by, as applicable, the Company and the Member and their respective personal or legal representatives, executors, administrators, successors, assigns, heirs, distributees and legatees. This Agreement is personal in nature and the Member shall not, without the written consent of the Company, assign, transfer or delegate this Agreement or any rights or obligations hereunder.

(b) *Governing Law.* This Agreement shall be governed by and construed in accordance with the laws of the State of South Carolina without giving effect to such state's laws and principles regarding the conflict of laws.

(c) *Amendment.* No provision of this Agreement may be amended, modified, waived or discharged unless such amendment, waiver, modification or discharge is agreed to in writing and such writing is signed by the Member and the Company.

(d) *Notice.* All notices and other communications hereunder shall be in writing and shall be given by hand delivery to the other party or by registered or certified mail, return receipt requested, postage prepaid, addressed as follows:

if to the Member:

At the address most recently on the books and records of the Company.

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if to the Company:

520 Gervais Street
Columbia, South Carolina 29201
ATTN: Corporate Secretary

or to such other address as either party shall have furnished to the other in writing in accordance herewith. Notice and communications shall be effective when actually received by the addressee.

(e) *Headings.* The headings of this Agreement are for reference purposes only and shall not affect in any way the meaning or interpretation of this Agreement.

(f) *Counterparts.* This Agreement may be executed in one or more counterparts, each of which shall be deemed an original but all of which together will constitute one and the same instrument.

10. *Internal Revenue Code Section 409A*.

(a) *General.* This Agreement shall be interpreted and administered in a manner so that any amount or benefit payable hereunder shall be paid or provided in a manner that is either exempt from or compliant with the requirements Section 409A of the Internal Revenue Code of 1986, as amended (the "*Code*") and applicable Internal Revenue Service guidance and Treasury Regulations issued thereunder (and any applicable transition relief under Section 409A of the Code). Nevertheless, the tax treatment of the benefits provided under the Agreement is not warranted or guaranteed. Neither the Company nor its directors, officers, employees or advisers (other than the Member) shall be held liable for any taxes, interest, penalties or other monetary amounts owed by the Member as a result of the application of Section 409A of the Code.

(b) *Definitional Restrictions.* Notwithstanding anything in this Agreement to the contrary, to the extent that any amount or benefit that would constitute non-exempt "deferred compensation" for purposes of Section 409A of the Code ("*Non-Exempt Deferred Compensation*") would otherwise be payable or distributable hereunder by reason of the Member's termination of service, such Non-Exempt Deferred Compensation will not be payable or distributable to the Member unless the circumstances giving rise to such termination of service meet any description or definition of "separation from service" in Section 409A of the Code and applicable regulations (without giving effect to any elective provisions that may be available under such definition). This provision does not prohibit the *vesting* of any Non-Exempt Deferred Compensation upon a termination of service, however defined. If this provision prevents the payment or distribution of any Non-Exempt Deferred Compensation, such payment shall be made on the date on which an event occurs that constitutes a Section 409A-compliant "separation from service."

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IN WITNESS WHEREOF, the parties have caused this Agreement to be duly executed and delivered as of the date first above written.

SCBT FINANCIAL CORPORATION

By: ______________________________

Name:
Title:

[MEMBER]

By: ______________________________

Name:
Title:

[*Signature Page to Advisory Board Member Agreement*]

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Annex E

FORM OF PROPOSED
ARTICLES OF AMENDMENT
TO
ARTICLES OF INCORPORATION
OF
SCBT FINANCIAL CORPORATION

In accordance with Section 33-10-106 of the South Carolina Business Corporation Act of 1988 (the "Code"), SCBT FINANCIAL CORPORATION (the "Corporation"), a corporation duly organized and existing under and by virtue of the Code, DOES HEREBY CERTIFY:

1. The name of the Corporation is: SCBT Financial Corporation.

2. Date of Incorporation: February 22, 1985.

3. Agent's Name and Address: Robert R. Hill, Jr., 520 Gervais Street, Columbia, SC 29201.

4. On [ ], 2013, the Corporation's shareholders approved an amendment to the Corporation's Amended and Restated Articles of Incorporation to delete the first paragraph of the Articles of Incorporation in its entirety and replace it with the following:

FIRST: The name of the corporation is First Financial Holdings, Inc.

5. N/A.

6. As of the date of adoption of the Amendment, the number of outstanding shares of each voting group entitled to vote separately on the Amendment, and the vote of such shares was:

Voting Group	Number of Outstanding Shares	Number of Votes Entitled to be Cast	Number of Votes Represented at the meeting	Number of Undisputed Shares Voted For / Against
Common Stock, par value $2.50 per share	[ ]	[ ]	[ ]	[ ] / [ ]

7. The effective date of these Articles of Amendment shall be [ ] in accordance with the provisions of Section 33-1-230 of the Code.

IN WITNESS WHEREOF, the undersigned, being duly authorized thereto, does hereby affirm, under penalties of perjury, that this certificate is the act and deed of the Corporation and that the facts herein stated are true, and accordingly has hereunto set his hand this as of the [ ] day of [ ], 2013.

SCBT FINANCIAL CORPORATION

By: ____________________________

Name: Robert R. Hill, Jr.

Title: President and Chief Executive Officer

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Annex F

THE SAVANNAH BANCORP, INC. AND SUBSIDIARIES
FINANCIAL STATEMENT SECTION
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REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

To the Board of Directors and Shareholders
of The Savannah Bancorp, Inc.:

We have audited the accompanying consolidated balance sheets of The Savannah Bancorp, Inc. and subsidiaries as of December 31, 2011 and 2010 and the related consolidated statements of operations, other comprehensive income (loss), changes in shareholders' equity and cash flows for each of the three years in the period ended December 31, 2011. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these consolidated financial statements based on our audits.

We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. The Company is not required to have, nor were we engaged to perform, an audit of its internal control over financial reporting. Our audit included consideration of internal control over financial reporting as a basis for designing audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the Company's internal control over financial reporting. Accordingly, we express no such opinion. An audit also includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the consolidated financial position of The Savannah Bancorp, Inc. and its subsidiaries as of December 31, 2011 and 2010 and the results of its operations and its cash flows for each of the three years in the period ended December 31, 2011, in conformity with accounting principles generally accepted in the United States of America.

/s/ Mauldin & Jenkins, LLC

Albany, Georgia
March 20, 2012

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THE SAVANNAH BANCORP, INC. AND SUBSIDIARIES

Consolidated Balance Sheets

($ in thousands, except share data)

	December 31, 2011	December 31, 2010
Assets		
Cash and due from banks	**$ 13,225**	$ 17,990
Federal funds sold	**535**	110
Interest-bearing deposits in banks	**81,717**	40,836
Cash and cash equivalents	**95,477**	58,936
Securities available for sale, at fair value (amortized cost of $81,764 and $136,980)	**83,653**	138,099
Loans, net of allowance for loan losses of $21,917 and $20,350	**737,761**	806,212
Premises and equipment, net	**14,286**	15,056
Other real estate owned	**20,332**	13,199
Bank-owned life insurance	**6,510**	6,309
Goodwill and other intangible assets, net	**3,562**	3,786
Other assets	**23,654**	25,333
Total assets	**$ 985,235**	$ 1,066,930
Liabilities		
Deposits:		
Noninterest-bearing	**$ 106,939**	$ 95,725
Interest-bearing demand	**147,716**	140,531
Savings	**20,062**	20,117
Money market	**255,285**	265,840
Time deposits	**316,927**	401,532
Total deposits	**846,929**	923,745
Short-term borrowings	**14,384**	15,075
Other borrowings	**8,581**	10,536
Federal Home Loan Bank advances	**16,653**	17,658
Subordinated debt to nonconsolidated subsidiaries	**10,310**	10,310
Other liabilities	**4,248**	3,803
Total liabilities	**901,105**	981,127
Commitments and contingencies (Notes 17 and 20)		
Shareholders' equity		
Preferred stock, par value $1 per share: authorized 10,000,000 shares, none issued		
Common stock, par value $1 per share: shares authorized 20,000,000, issued 7,201,346	**7,201**	7,201
Additional paid-in capital	**48,656**	48,634
Retained earnings	**27,103**	29,275
Treasury stock, at cost, 2,210 and 2,483 shares	**(1)**	(1)
Accumulated other comprehensive income, net	**1,171**	694
Total shareholders' equity	**84,130**	85,803
Total liabilities and shareholders' equity	**$ 985,235**	$ 1,066,930

The accompanying notes are an integral part of these consolidated financial statements.

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THE SAVANNAH BANCORP, INC. AND SUBSIDIARIES

Consolidated Statements of Operations

($ in thousands, except per share data)

	For the Years Ended December 31,		
	2011	**2010**	**2009**
Interest and dividend income			
Loans, including fees	**$ 41,935**	$ 45,001	$ 47,081
Investment securities:			
Taxable	**2,663**	2,401	3,220
Tax-exempt	**257**	313	154
Dividends	**78**	47	45
Deposits with banks	**127**	147	45
Federal funds sold	**3**	20	18
Total interest and dividend income	**45,063**	47,929	50,563
Interest expense			
Deposits	**8,016**	12,460	16,454
Short-term and other borrowings	**821**	1,138	1,045
Federal Home Loan Bank advances	**348**	458	397
Subordinated debt	**303**	306	362
Total interest expense	**9,488**	14,362	18,258
Net interest income	**35,575**	33,567	32,305
Provision for loan losses	**20,035**	21,020	13,065
Net interest income after provision for loan losses	**15,540**	12,547	19,240
Noninterest income			
Trust and asset management fees	**2,646**	2,599	2,351
Service charges on deposit accounts	**1,458**	1,788	1,809
Mortgage related income, net	**183**	398	432
Gain on sale of securities	**763**	608	2,119
Gain (loss) on hedges	**(1)**	2	873
Other operating income	**1,597**	1,916	1,238
Total noninterest income	**6,646**	7,311	8,822
Noninterest expense			
Salaries and employee benefits	**11,282**	11,948	12,146
Occupancy and equipment	**3,683**	3,945	3,716
Information technology	**1,708**	2,101	1,810
Loan collection and OREO expense	**1,500**	815	848
FDIC deposit insurance	**1,303**	1,688	1,886
Amortization of intangibles	**224**	171	144
Loss on sales and write-downs of foreclosed assets	**2,679**	2,472	2,566
Other operating expense	**3,874**	3,837	3,862
Total noninterest expense	**26,253**	26,977	26,978

ncome (loss) before income taxes		**(4,067)**		(7,119)		1,084
ncome tax expense (benefit)		**(1,895)**		(3,130)		155
Net income (loss)	**$**	**(2,172)**	$	(3,989)	$	929
Net income (loss) per share:						
Basic	**$**	**(0.30)**	$	(0.60)	$	0.16
Diluted	**$**	**(0.30)**	$	(0.60)	$	0.16
Dividends per share	**$**	**0.00**	$	0.02	$	0.185
Average basic shares (000s)		**7,199**		6,625		5,933
Average diluted shares (000s)		**7,199**		6,625		5,936

The accompanying notes are an integral part of these consolidated financial statements.

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THE SAVANNAH BANCORP, INC. AND SUBSIDIARIES

Consolidated Statements of Other Comprehensive Income (Loss)

($ in thousands)

	For the Years Ended December 31,		
	2011	**2010**	**2009**
Net income (loss)	**$ (2,172)**	$ (3,989)	$ 929
Other comprehensive income (loss):			
Change in unrealized holding gains on securities available for sale arising during period, net of tax of $582, $153 and $480	**950**	250	783
Reclassification adjustment for net gains on securities available for sale included in net income (loss), net of taxes of $290, $231 and $805	**(473)**	(377)	(1,314)
Change in fair value and gains on termination of derivative instruments, net of tax of $0, $172 and $777		(287)	(1,295)
Other comprehensive loss	**$ (1,695)**	$ (4,403)	$ (897)

The accompanying notes are an integral part of these consolidated financial statements.

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THE SAVANNAH BANCORP, INC. AND SUBSIDIARIES

Consolidated Statements of Changes in Shareholders' Equity

($ in thousands, except share data)

	For the Years Ended December 31,		
	2011	**2010**	**2009**
Common shares issued			
Shares, beginning of year	**7,201,346**	5,933,789	5,933,789
Common stock issued		1,267,557	
Shares, end of year	**7,201,346**	7,201,346	5,933,789
Treasury shares owned			
Shares, beginning of year	**2,483**	1,443	318
Treasury stock issued	**(273)**	(943)	
Unredeemed common stock		36	
Unvested restricted stock		1,947	1,125
Shares, end of year	**2,210**	2,483	1,443
Common stock			
Balance, beginning of year	**$ 7,201**	$ 5,934	$ 5,934
Common stock issued		1,267	
Balance, end of year	**7,201**	7,201	5,934
Additional paid-in capital			
Balance, beginning of year	**48,634**	38,605	38,516
Common stock issued, net of issuance costs	**2**	9,980	
Stock-based compensation expense, net	**20**	49	89
Balance, end of year	**48,656**	48,634	38,605
Retained earnings			
Balance, beginning of year	**29,275**	33,383	33,552
Net income (loss)	**(2,172)**	(3,989)	929
Dividends paid		(119)	(1,098)
Balance, end of year	**27,103**	29,275	33,383
Treasury stock			
Balance, beginning of year	**(1)**	(4)	(4)
Treasury stock issued		3	
Balance, end of year	**(1)**	(1)	(4)
Accumulated other comprehensive income, net			
Balance, beginning of year	**694**	1,108	2,934
Change in unrealized gains/losses on securities available for sale, net of reclassification adjustment	**477**	(127)	(531)
Change in fair value and gains on termination of derivative instruments, net of tax		(287)	(1,295)

Balance, end of year	**1,171**	694	1,108
Total shareholders' equity	**$ 84,130**	$ 85,803	$ 79,026

The accompanying notes are an integral part of these consolidated financial statements.

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THE SAVANNAH BANCORP, INC. AND SUBSIDIARIES

Consolidated Statements of Cash Flows

	For the Years Ended December 31,		
	2011	**2010**	**2009**
	($ in thousands)		
Operating activities			
Net income (loss)	**$ (2,172)**	$ (3,989)	$ 929
Adjustments to reconcile net income (loss) to cash provided by operating activities:			
Provision for loan losses	**20,035**	21,020	13,065
Proceeds from sale of loans originated for sale			291
Net amortization of securities	**1,010**	1,922	432
Depreciation and amortization	**1,349**	1,454	1,513
Accretion of gain on termination of derivatives		(453)	(1,962)
Proceeds from termination of derivatives			1,299
Non cash stock-based compensation expense	**20**	79	144
Increase in deferred income taxes, net	**(2,427)**	(1,759)	(1,748)
Gain on sale of securities, net	**(763)**	(608)	(2,119)
Loss on sales and write-downs of foreclosed assets	**2,679**	2,472	2,566
Equity in net (income) loss of nonconsolidated subsidiary	**(35)**	50	(43)
Gain on sale of partnership interest		(255)	
Increase in CSV of bank-owned life insurance policies	**(201)**	(183)	(218)
Decrease (increase) in prepaid FDIC deposit insurance assessment	**1,292**	1,545	(5,037)
Decrease (increase) in income taxes receivable/payable	**2,014**	(3,758)	1,068
Change in other assets and other liabilities, net	**987**	(1,965)	(673)
Net cash provided by operating activities	**23,788**	15,572	9,507
Investing activities			
Activity in available for sale securities			
Purchases	**(3,654)**	(100,897)	(88,741)
Sales	**38,434**	52,483	62,076
Maturities, calls and paydowns	**20,189**	22,547	21,203
Loan originations and principal collections, net	**33,573**	22,644	(35,442)
Proceeds from sale of foreclosed assets	**5,031**	9,120	5,048
Disposition of premises and equipment			305
Proceeds from life insurance and sale of partnership interest		1,002	
Additions to premises and equipment	**(355)**	(765)	(6,141)
Net cash received from FDIC-assisted transaction		190,253	
Net cash provided by (used in) investing activities	**93,218**	196,387	(41,692)
Financing activities			
Net increase (decrease) in noninterest-bearing deposits	**11,214**	4,837	(166)
Net (decrease) increase in interest-bearing deposits	**(88,030)**	(166,516)	52,720
Net decrease in short-term borrowings	**(691)**	(8,478)	(10,083)
Net (decrease) increase in other borrowings	**(1,955)**	(5,452)	3,837
Net decrease in FHLB advances	**(1,005)**	(29,006)	(505)
Payment on note payable		(74)	(86)
Dividends paid		(119)	(1,098)
Issuance of common stock, treasury stock and exercise of options	**2**	11,250	
Net cash (used in) provided by financing activities	**(80,465)**	(193,558)	44,619
Increase in cash and cash equivalents	**36,541**	18,401	12,434
Cash and cash equivalents, beginning of year	**58,936**	40,535	28,101
Cash and cash equivalents, end of year	**$ 95,477**	$ 58,936	$ 40,535

Supplemental disclosures of cash flow information			
Cash paid (received) during the year for:			
Interest on deposits and other borrowings	**$ 9,909**	$ 14,881	$ 18,826
Income taxes	**(1,911)**		550
Non cash investing activity:			
Transfer to other real estate owned from loans	**(17,067)**	(16,462)	(7,843)

The accompanying notes are an integral part of these consolidated financial statements.

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THE SAVANNAH BANCORP, INC. AND SUBSIDIARIES

Notes to Consolidated Financial Statements

Note 1 Organization and Summary of Significant Accounting Policies

Principles of Consolidation The consolidated financial statements include the accounts of The Savannah Bancorp, Inc. ("the Company") and its wholly-owned subsidiaries, The Savannah Bank, N.A. ("Savannah"), Bryan Bank & Trust ("Bryan"), Minis & Co., Inc. ("Minis") and SAVB Holdings, LLC ("SAVB Holdings"). Minis is a registered investment advisory firm and SAVB Holdings was formed for the purpose of holding problem loans and other real estate owned ("OREO"). The two bank subsidiaries, together, are referred to as the "Subsidiary Banks." All significant intercompany balances and transactions have been eliminated in consolidation. Certain prior year balances have been reclassified to conform to the current year presentation.

Nature of Operations The Company is a bank holding company headquartered in Savannah, Georgia that operates two banks and a registered investment advisory firm. The Company has eleven banking offices and thirteen ATMs in Savannah, Garden City, Skidaway Island, Whitemarsh Island, Tybee Island, Pooler, and Richmond Hill, Georgia and Hilton Head Island and Bluffton, South Carolina. The Company also has mortgage lending offices in Savannah and Richmond Hill and an investment management office in Savannah. Through the subsidiaries, the Company offers a full range of lending, deposit, residential mortgage origination, fiduciary, trust and investment advisory products. The primary service areas of the Company are Chatham County and Bryan County, Georgia and southern Beaufort County in South Carolina. In 2005, the Company formed a nonconsolidated subsidiary, SAVB Properties, LLC, which purchased a 50 percent interest in two real estate partnerships that own the Company's headquarters building and the adjacent parking lot. This investment is accounted for using the equity method of accounting. The Company's sold its interest in the parking lot in 2010.

Use of Estimates In preparing consolidated financial statements in conformity with generally accepted accounting principles ("GAAP") in the United States, management is required to make estimates and assumptions that affect the reported amounts of assets and liabilities as of the date of the balance sheet and reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates. Material estimates that are particularly susceptible to significant change in the near term relate to the determination of the allowance for loan losses, the valuation of other real estate owned, fair value of financial instruments, other-than-temporary impairment analysis and the evaluation of the realization of deferred tax assets.

Cash and Cash Equivalents For purposes of the consolidated statements of cash flows, cash and cash equivalents include cash and balances due from banks, federal funds sold and interest-bearing deposits in banks, all of which mature within ninety days.

Securities Available for Sale Management has classified the entire investment securities portfolio as available for sale. Securities available for sale are carried at estimated fair value with unrealized gains and losses, net of deferred income taxes, recorded as a separate component of shareholders' equity. Purchase premiums and discounts are recognized in interest income using the interest method over the life of the securities. Gains and losses on the sale of securities are recorded on the trade date and are determined using the specific identification method.

The Company evaluates its investment securities to determine if the decline in fair value of a security below its amortized cost is deemed to be other-than-temporary. Other-than-temporary impairment losses are recognized on securities when: (i) the holder has an intention to sell the security; (ii) it is more likely than not that the security will be required to be sold prior to recovery; or (iii) the

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THE SAVANNAH BANCORP, INC. AND SUBSIDIARIES

Notes to Consolidated Financial Statements (Continued)

Note 1 Organization and Summary of Significant Accounting Policies (Continued)

holder does not expect to recover the entire amortized cost basis of the security. Other-than-temporary impairment losses are recorded as a charge to earnings to the extent the impairment is related to credit losses. The amount of the impairment related to other factors is recognized in other comprehensive income (loss).

Loans and Loan Fees The Subsidiary Banks underwrite mortgage, commercial and consumer loans to customers. A substantial portion of the loan portfolio consists of real estate secured loans throughout the coastal Georgia and South Carolina areas. Loans that management has the intent and ability to hold for the foreseeable future or until maturity or pay-off are generally reported at their outstanding unpaid principal balances adjusted for charge-offs, the allowance for loan losses, and any deferred fees or origination costs. Interest income is accrued on the unpaid principal balance. Loan origination fees, net of certain direct origination costs, are deferred and recognized as an adjustment of the related loan yield on a straight-line basis, which approximates the interest method.

The accrual of interest on mortgage and commercial loans is discontinued at the time the loan is 90 days past due unless the credit is well-secured and in process of collection. Revolving credit loans and other personal loans are typically charged-off when payments are 120 days past due. Past due status is based on the contractual terms of the loan. Loans are placed on nonaccrual status or charged-off at an earlier date if collection of principal or interest in full becomes doubtful. All interest accrued in the current year but not collected for loans that are placed on nonaccrual status or charged-off is reversed against interest income. The interest on these loans is accounted for on the cash-basis or cost-recovery method until qualifying for return to accrual. Loans are returned to accrual status when all the principal and interest amounts contractually due are brought current and future payments are reasonably assured.

A loan is considered impaired when, based on current information and events, it is probable that the Company will be unable to collect the scheduled payments of principal or interest when due according to the contractual terms of the loan agreement. Factors considered by management in determining impairment include payment status, collateral value, and the probability of collecting scheduled principal and interest payments when due. Loans that experience insignificant payment delays and payment shortfalls generally are not classified as impaired. Management determines the significance of payment delays and payment shortfalls on a case-by-case basis, taking into consideration all of the circumstances surrounding the loan and the borrower, including the length of the delay, the reasons for the delay, the borrower's prior payment record, and the amount of the shortfall in relation to the principal and interest owed. Impairment is measured on a loan by loan basis by either the present value of expected future cash flows discounted at the loan's effective interest rate, the loan's obtainable market price, or the fair value of the collateral if the loan is collateral dependent. Management charges down the loan or establishes a valuation allowance when management determines the value is less than the carrying amount.

The Company designates loan modifications as troubled debt restructurings ("TDRs") when, for economic and legal reasons related to the borrower's financial difficulties, it grants a concession to the borrower that it would not otherwise consider. TDRs can involve loans remaining on nonaccrual, moving to nonaccrual, or continuing on accrual status, depending on the individual facts and circumstances of the borrower. In circumstances where the TDR involves charging off a portion of the loan balance, the Company typically classifies these as nonaccrual.

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THE SAVANNAH BANCORP, INC. AND SUBSIDIARIES

Notes to Consolidated Financial Statements (Continued)

Note 1 Organization and Summary of Significant Accounting Policies (Continued)

In connection with restructurings, the decision to maintain a loan that has been restructured on accrual status is based on a current, well documented credit evaluation of the borrower's financial condition and prospects for repayment under the modified terms. This evaluation includes consideration of the borrower's current capacity to pay, which, among other things, may include a review of the borrower's current financial statements, an analysis of global cash flow sufficient to pay all debt obligations, a debt to income analysis, and an evaluation of secondary sources of payment from the borrower and any guarantors. This evaluation also includes an evaluation of the borrower's current willingness to pay, which may include a review of past payment history, an evaluation of the borrower's willingness to provide information on a timely basis, and consideration of offers from the borrower to provide additional collateral or guarantor support. The credit evaluation also reflects consideration of the borrower's future capacity and willingness to pay, which may include evaluation of cash flow projections, consideration of the adequacy of collateral to cover all principal and interest, and trends indicating improving profitability and collectability of receivables.

Restructured nonaccrual loans may be returned to accrual status based on a current, well-documented credit evaluation of the borrower's financial condition and prospects for repayment under the modified terms. This evaluation must include consideration of the borrower's sustained historical repayment for a reasonable period, generally a minimum of six months, prior to the date on which the loan is returned to accrual status.

Allowance for Loan Losses The allowance for loan losses is established through a provision for loan losses charged to earnings resulting from measurements of inherent credit risk in the loan portfolio and estimates of probable losses or impairments of individual loans. The adequacy of the allowance is based on management's continuing evaluation of the loan portfolio considering current economic conditions, underlying collateral value securing loans and other relevant qualitative and quantitative factors that deserve recognition in estimating loan losses. Actual future losses may be different from estimates due to unforeseen events. Loans that are determined to be uncollectible are charged-off against the allowance and subsequent recoveries, if any, are credited to the allowance.

The adequacy of the allowance for loan losses is evaluated on a regular basis by management and reported to and approved by the Audit Committee of the Board of Directors ("Board") quarterly. The evaluation is based upon management's periodic review of the collectability of specific loans, adverse situations that may affect specific borrowers' ability to repay, the estimated value of any underlying collateral, the composition and size of the loan portfolio, emerging credit trends, regulatory guidance and prevailing economic conditions. In addition, on a regular basis, management and the Board review loan ratios. These ratios include the allowance for loan losses as a percentage of total loans, net charge-offs as a percentage of average loans, nonperforming loans as a percentage of total loans and the allowance coverage on nonperforming loans. Also, management reviews past due ratios by officer, Subsidiary Bank and the Company as a whole. This evaluation is inherently subjective as it requires estimates that are susceptible to significant revision as more information becomes available.

The Company has a number of documented loan policies and procedures that set forth the approval and monitoring process of the lending function. Adherence to these policies and procedures is monitored by management and the Board. Several committees and an underwriting staff oversee the lending operations of the Company. These include the Board Credit Committee and Special Assets Committee. Credit administration personnel monitor and, if necessary, adjust the grades assigned to

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THE SAVANNAH BANCORP, INC. AND SUBSIDIARIES

Notes to Consolidated Financial Statements (Continued)

Note 1 Organization and Summary of Significant Accounting Policies (Continued)

oans through periodic examination. In addition, the Company contracts with an independent third party for loan review which reports to he Audit Committee of the Board.

In compliance with loan policy, the lending staff is given lending limits based on their knowledge and experience. Loan quality or 'risk-rating" grades are assigned to each loan based upon certain factors. This information is used to assist management in monitoring the credit quality of the portfolio. Loan requests of amounts greater than an officer's lending limits are reviewed by senior credit officers, n-house loan committees or the Board.

Credit quality, adherence to policies and loss mitigation are focal points of credit administration. Credit administration reviews and approves third-party appraisals obtained by the Company on real estate collateral and monitors loan maturities to ensure updated appraisals are obtained.

Our allowance for loan losses consists of two components, a general reserve and a specific reserve. For the general component, isk-rating grades are assigned by lending or credit administration, based on an analysis of the financial and collateral strength and other credit attributes underlying each loan. Loan grades range from 1 to 8, with 1 being loans with the least credit risk. Allowance factors established by management are applied to the total balance of loans in each grade to determine the amount needed in the allowance for oan losses. The allowance factors are established based on historical loss ratios experienced by the Company for these loan types, as well as the credit quality criteria underlying each grade, adjusted for trends and expectations about losses inherent in our existing portfolios. In making these adjustments to the allowance factors, management takes into consideration factors which it believes are causing, or are likely n the future to cause, losses within our loan portfolio but which may not be fully reflected in our historical loss ratios. Allowance factors established by management are then multiplied by loan balances for each grade or homogeneous portfolio of loans to determine the amount needed in the allowance for loan losses. The specific component relates to loans that are deemed to be impaired. Impairment is measured on a loan-by-loan basis for loans above a minimum dollar amount. For such loans that are classified as impaired, an allowance is established or the loan is charged-down when the discounted cash flows (or value of related collateral or observable market price) of the mpaired loan is lower than the carrying value of that loan. Large groups of smaller balance homogeneous loans are evaluated collectively for impairment.

Premises and Equipment Buildings, furniture, banking equipment and leasehold improvements are stated at cost less accumulated depreciation and amortization. Depreciation and amortization of these assets are computed using the straight-line method over the estimated useful lives or estimated lease terms including expected lease renewals, ranging from three to fifty years, of the respective assets for financial reporting purposes and accelerated methods for income tax purposes. Additions and major improvements are capitalized, while routine maintenance and repairs and gain or loss on dispositions are recognized currently.

Other Real Estate Owned Assets acquired through loan foreclosure are held for sale and are initially recorded at fair value less estimated disposal costs at the date of foreclosure, establishing a new cost basis. Subsequent to foreclosure, valuations are periodically performed by management and the assets are carried at the lower of carrying amount or fair value less estimated disposal costs. Valuation allowances are established or the asset is written-down when subsequent valuations are less than

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THE SAVANNAH BANCORP, INC. AND SUBSIDIARIES

Notes to Consolidated Financial Statements (Continued)

Note 1 Organization and Summary of Significant Accounting Policies (Continued)

current carrying amounts. Expenses from operations, changes in the valuation allowance, write-downs and net expenses from holding these assets are included in noninterest expense.

Bank-Owned Life Insurance Bank-owned life insurance policies are recorded at the net realizable value of the underlying insurance contracts. The change in contract value during the year represents the contract earnings during the period less the mortality costs and administrative costs of the underlying life insurance contracts. The increase in cash surrender value from bank-owned life insurance contracts is included as a component of other operating income and the mortality costs and administrative fees are recorded as noninterest expense.

Intangible Assets Intangible assets include goodwill and other identifiable assets, such as client lists and deposits. Client list and deposit premium intangibles are amortized on a straight-line basis over estimated useful lives of ten and five years, respectively, and evaluated for impairment whenever events or changes in circumstances indicate the carrying amount of the assets may not be recoverable. Goodwill is not amortized but tested annually for impairment or at any time an event occurs or circumstances change that may trigger a decline in the value of the reporting unit. Examples of such events or circumstances include an adverse change in operations, legal factors, business climate, unanticipated competition, change in regulatory environment, or loss of key personnel. The core deposit premium intangible was evaluated for impairment as of June 30, 2011. The goodwill and client list intangible assets were evaluated for impairment as of August 31, 2011. Based on those evaluations it was determined that there was no impairment.

Income Taxes The income tax accounting guidance results in two components of income tax expense: current and deferred. Current income tax expense reflects taxes to be paid or refunded for the current period by applying the provisions of the enacted tax law to the taxable income or excess of deductions over revenues. The Company determines deferred income taxes using the liability (or balance sheet) method. Under this method, the net deferred tax asset or liability is based on the tax effects of the differences between the book and tax bases of assets and liabilities. Enacted changes in tax rates and laws are recognized in the period in which they occur.

Deferred income tax expense results from changes in deferred tax assets and liabilities between periods. Deferred tax assets are recognized if it is more likely than not, based on the technical merits, that the tax position will be realized or sustained upon examination. The term more likely than not means a likelihood of more than 50 percent; the terms examined and upon examination also include resolution of the related appeals or litigation processes, if any. A tax position that meets the more-likely-than-not recognition threshold is initially and subsequently measured as the largest amount of tax benefit that has a greater than 50 percent likelihood of being realized upon settlement with a taxing authority that has full knowledge of all relevant information. The determination of whether or not a tax position has met the more-likely-than-not recognition threshold considers the facts, circumstances, and information available at the reporting date and is subject to management's judgment. Deferred tax assets may be reduced by deferred tax liabilities and a valuation allowance if, based on the weight of evidence available, it is more likely than not that some portion or all of a deferred tax asset will not be realized.

Earnings (Loss) Per Share Basic earnings (loss) per share represent net income (loss) divided by the weighted average number of common shares outstanding during the period. Diluted earnings (loss) per share reflect additional common shares that would have been outstanding if dilutive potential

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THE SAVANNAH BANCORP, INC. AND SUBSIDIARIES

Notes to Consolidated Financial Statements (Continued)

Note 1 Organization and Summary of Significant Accounting Policies (Continued)

common shares had been issued, as well as any adjustment to income that would result from the assumed issuance. Potential common shares that may be issued by the Company relate solely to outstanding stock options, and are determined using the treasury stock method.

Earnings (loss) per common share have been computed based on the following:

	For the Years Ended December 31,		
(amounts in thousands)	2011	2010	2009
Average number of common shares outstanding basic	7,199	6,625	5,933
Effect of dilutive options			3
Average number of common shares outstanding diluted	7,199	6,625	5,936

Stock option shares in the amount of 149,968, 174,328 and 194,814 for the years ended 2011, 2010 and 2009, respectively, were excluded from the diluted earnings per share calculation due to their anti-dilutive effect.

Derivative Instruments and Hedging Activities Accounting principles provide the disclosure requirements for derivatives and hedging activities with the intent to provide users of financial statements with an enhanced understanding of: (i) how and why an entity uses derivative instruments, (ii) how derivative instruments and related hedged items are accounted for, and (iii) how derivative instruments and related hedged items affect an entity's financial position, financial performance, and cash flows. Accounting principles require qualitative disclosures about objectives and strategies for using derivatives, quantitative disclosures about the fair value of and gains and losses on derivative instruments, and disclosures about credit-risk-related contingent features in derivatives.

As required by accounting principles, the Company records all derivatives on the balance sheet at fair value. The accounting for changes in the fair value of derivatives depends on the intended use of the derivative, whether the Company has elected to designate a derivative in a hedging relationship and apply hedge accounting and whether the hedging relationship has satisfied the criteria necessary to apply hedge accounting. Derivatives designated and qualifying as a hedge of the exposure to changes in the fair value of an asset, liability, or firm commitment attributable to a particular risk, such as interest rate risk, are considered fair value hedges. Derivatives designated and qualifying as a hedge of the exposure to variability in expected future cash flows, or other types of forecasted transactions, are considered cash flow hedges. Hedge accounting generally provides for the matching of the timing of gain or loss recognition on the hedging instrument with the recognition of the changes in the fair value of the hedged asset or liability that are attributable to the hedged risk in a fair value hedge or the earnings effect of the hedged forecasted transactions in a cash flow hedge. The Company may enter into derivative contracts that are intended to economically hedge certain of its risk, even though hedge accounting does not apply or the Company elects not to apply hedge accounting.

Accounting for Stock-Based Compensation Accounting principles require that the compensation cost relating to share-based payment transactions be recognized in financial statements. That cost will be measured based on the grant date fair value of the equity or liability instruments issued. The stock compensation accounting guidance covers a wide range of share-based compensation arrangements including stock options, restricted share plans, performance-based awards, share appreciation rights, and employee share purchase plans.

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THE SAVANNAH BANCORP, INC. AND SUBSIDIARIES

Notes to Consolidated Financial Statements (Continued)

Note 1 Organization and Summary of Significant Accounting Policies (Continued)

The stock compensation accounting guidance requires that compensation cost for all stock awards be calculated and recognized over the employees' service period, generally defined as the vesting period. For awards with graded-vesting, compensation cost is recognized on a straight-line basis over the requisite service period for the entire award. A Black-Scholes model is used to estimate the fair value of stock options, while the market price of the Company's common stock at the date of grant is used for restricted stock awards and stock grants.

The 1995 Incentive Stock Option Plan ("1995 Plan") authorized the Company to issue both incentive and non-qualified stock options to certain key officers for the purchase of shares at the fair market value of the stock at the date of grant. In 2000, the shareholders authorized additional option shares under the 1995 Plan. All authorized shares have been awarded from the 1995 Plan.

In 2005, shareholders approved the 2005 Omnibus Stock Ownership and Long-Term Incentive Plan ("2005 Omnibus Plan") and authorized 250,000 option or restricted shares to be available for issuance. The total number of remaining options or awards available for issuance at December 31, 2011 under the 2005 Omnibus Plan was 144,151 shares of common stock. Options granted under both plans have a term of ten years and generally become fully vested over periods ranging from three to ten years. Performance based options granted to directors vest over three quarters from the date of grant.

The following table summarizes compensation costs related to the Company's stock-based compensation plans for the years ended December 31:

($ in thousands)	2011	2010	2009
Salaries and employee benefits	$ 20	$ 52	$ 94
Directors' stock-based compensation		27	50
Pre-tax stock-based compensation expense	20	79	144
Income tax benefit	8	(30)	(55)
Total stock-based compensation expense, net of tax	$ 12	$ 49	$ 89

During 2011, 2010 and 2009 no income tax benefits were realized on stock option exercises.

The Company recognizes stock-based compensation expense using the graded vesting attribution method. The remaining unrecognized compensation cost related to unvested incentive stock option and restricted share awards at December 31, 2011 is approximately $108,000. The weighted-average period of time over which this cost will be recognized is approximately 4.8 years. This amount does not include the cost of any additional options that may be granted in future periods nor any reduction in cost for potential forfeitures.

The fair value of each option grant is estimated on the date of grant using the Black-Scholes option pricing model with the following assumptions.

	2011	2010	2009
Weighted average fair value of options granted	$ 2.44	$ 3.41	$ 1.87
Expected volatility	49%	45%	39.1%
Dividend yield	0.00%	1.47%	2.67%
Risk-free interest rate	0.80%	2.43%	1.82%
Expected life	6.0 years	6.0 years	6.0 years

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THE SAVANNAH BANCORP, INC. AND SUBSIDIARIES

Notes to Consolidated Financial Statements (Continued)

Note 1 Organization and Summary of Significant Accounting Policies (Continued)

Risks and Uncertainties In the normal course of its business, the Company encounters two significant types of risk: economic and regulatory. There are three main components of economic risk: interest rate risk, credit risk and market risk. The Company is subject to interest rate risk to the degree that our interest-bearing liabilities mature or reprice at different speeds, or on different indexes, than our interest-earning assets. Credit risk is the risk of default on the loan portfolio that results from borrowers' inability or unwillingness to make contractually required payments. Market risk reflects changes in the value of collateral underlying loans receivable and the valuation of other real estate owned, investment securities available for sale and mortgage servicing rights.

The Company is subject to the regulations of various government agencies. These regulations can and do change significantly from period to period. The Company also undergoes periodic examinations by the regulatory agencies, which may subject the Company to further changes with respect to asset valuations, amounts of required loss allowances and operating restrictions resulting from the regulators' judgments on information available to them at the time of their examination.

Recent Accounting Pronouncements

Accounting Standards Update ("ASU") No. 2011-02, *"Receivables (Topic 310) A Creditor's Determination of Whether a Restructuring Is a Troubled Debt Restructuring,"* ("ASU 2011-02") amends Topic 310 of the Financial Accounting Standards Board ("FASB") Accounting Standards Codification ("ASC") to clarify when creditors should classify loan modifications as TDRs. As amended, the guidance states that a TDR occurs when a creditor, for economic or legal reasons related to a debtor's financial difficulties, grants a concession to the debtor that it would not otherwise consider. For public entities, the amendments promulgated by ASU 2011-02 are effective for the first interim or annual period beginning on or after June 15, 2011 and should be applied retrospectively to the beginning of the annual period of adoption. For purposes of measuring impairment of those receivables, an entity should apply the amendments prospectively for the first interim or annual period beginning on or after June 15, 2011. The Company adopted the provisions of ASU 2011-02 on July 1, 2011 and has presented the related disclosures in Note 5.

ASU No. 2011-04, "*Fair Value Measurement (Topic 820): Amendments to Achieve Common Fair Value Measurement and Disclosure Requirements in U.S. GAAP and IFRSs"* ("ASU 2011-04") amends the Fair Value Measurement topic of the ASC by clarifying the application of existing fair value measurement and disclosure requirements and by changing particular principles or requirements for measuring fair value or for disclosing information about fair value measurements. The amendments will be effective for the Company beginning January 1, 2012. The Company is evaluating the impact that the adoption of ASU 2011-04 will have on its financial position, results of operations and cash flows.

ASU No. 2011-05, "*Presentation of Comprehensive Income"* ("ASU 2011-05") eliminates the current option to report other comprehensive income and its components in the statement of changes in shareholders' equity and is intended to enhance comparability between entities that report under GAAP and those that report under International Financial Reporting Standards and to provide a more consistent method of presenting non-owner transactions that impact an entity's equity. Additionally, ASU 2011-05 requires entities to present, on the face of the financial statements, reclassification adjustments for items that are reclassified from other comprehensive income to net income in the statement or statements where the components of net income and the components of other comprehensive income are presented. The option to present components of other comprehensive

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THE SAVANNAH BANCORP, INC. AND SUBSIDIARIES

Notes to Consolidated Financial Statements (Continued)

Note 1 Organization and Summary of Significant Accounting Policies (Continued)

income as part of the statement of changes in stockholders' equity was eliminated. ASU 2011-05 requirements are effective for the Company as of January 1, 2012 and interim and annual periods thereafter. Early adoption is permitted, but full retrospective application is required under both sets of accounting standards. The Company early adopted the provision to separately report other comprehensive income as of December 31, 2011.

ASU No. 2011-08, "*Intangibles Goodwill and Other (Topic 350) Testing Goodwill for Impairment*" ("ASU 2011-08"), amends Topic 350 to permit entities to first assess qualitative factors to determine whether it is more likely than not that the fair value of a reporting unit is less than its carrying amount as a basis for determining whether it is necessary to perform the two-step goodwill impairment test described in Topic 350. The more-than-likely-than-not threshold is defined as having a likelihood of more than 50 percent. If, after assessing the totality of events or circumstances, an entity determines it is not more likely than not that the fair value of a reporting unit is less than its carrying amount, then performing the two-step impairment test is unnecessary. However, if an entity concludes otherwise, then it is required to perform the first step of the two-step impairment test by calculating the fair value of the reporting unit and comparing the fair value with the carrying amount of the reporting unit. If the carrying amount of the reporting unit exceeds its fair value, then the entity is required to perform the second step of the goodwill impairment test to measure the amount of impairment loss, if any. ASU 2011-08 is effective for annual and interim impairment tests beginning after December 15, 2011, and is not expected to have a significant impact on the Company's financial statements.

ASU No. 2011-12, "*Comprehensive Income (Topic 220): Deferral of the Effective Date for Amendments to the Presentation of Reclassifications of Items Out of Accumulated Other Comprehensive Income in Accounting Standards Update No. 2011-05*" ("ASU 2011-12") defers changes in ASU 2011-05 that relate to the presentation of reclassification adjustments to allow the FASB time to reconsider whether to require presentation of such adjustments on the face of the financial statements to show the effects of reclassifications out of accumulated other comprehensive income on the components of net income and other comprehensive income. ASU 2011-12 allows entities to continue to report reclassifications out of accumulated other comprehensive income consistent with the presentation requirements in effect before ASU 2011-05. All other requirements in ASU 2011-05 are not affected by ASU 2011-12. ASU 2011-12 is effective for annual and interim periods beginning after December 15, 2011 and is not expected to have a significant impact on the Company's financial statements.

Note 2 Acquisitions

On June 25, 2010, Savannah entered into an agreement with the Federal Deposit Insurance Corporation ("FDIC") to purchase substantially all deposits and certain liabilities and assets of First National Bank, Savannah ("First National"). Savannah acquired approximately $42 million in assets and assumed $216 million in liabilities, including $201 million in customer deposits. The assets primarily include cash and due from accounts and investment securities. Savannah acquired the local, non-brokered deposits of approximately $105 million at a premium of 0.11 percent, or approximately $116,000. In connection with the closing, Savannah received a cash payment from the FDIC totaling $174 million, based on the differential between liabilities assumed and assets acquired, taking into account the deposit premium.

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THE SAVANNAH BANCORP, INC. AND SUBSIDIARIES

Notes to Consolidated Financial Statements (Continued)

Note 2 Acquisitions (Continued)

The following table summarizes the estimated fair values of the assets acquired and liabilities assumed at the date of the acquisition.

($ in thousands)	June 25, 2010
Assets acquired	
Cash and due from banks	$ 7,330
Interest-bearing deposits in banks	8,851
Securities available for sale	25,937
Loans	131
Premises and equipment	11
Deposit premium intangible	387
Other assets	128
Total assets acquired	42,775
Liabilities assumed	
Deposits	200,843
Federal Home Loan Bank advances	15,271
Due to the FDIC	266
Accrued interest and other liabilities	432
Total liabilities assumed	216,812
Net liabilities assumed	$ (174,037)

The only loans assumed by Savannah were deposit-secured loans which are not subject to FDIC loss-share. In its assumption of the deposit liabilities, the Company believes that the customer relationships associated with the local deposits have intangible value. In addition, the Company determined that the recorded amount of the deposits approximates fair value primarily due to the fact that the Company can re-price all customer deposits to current market rates.

Note 3 Restrictions on Cash and Demand Balances Due from Banks and Interest-Bearing Bank Balances

The Subsidiary Banks are required by the Federal Reserve Bank ("FRB") to maintain minimum cash reserves based upon reserve requirements calculated on their deposit balances. Cash reserves of $571,000 and $581,000 are required as of December 31, 2011 and 2010, respectively. At times, the Company pledges interest-bearing cash balances at the Federal Home Loan Bank of Atlanta ("FHLB") in addition to investment securities to secure public fund deposits and securities sold under repurchase agreements. The Company did not have any cash pledged at the FHLB at December 31, 2011 or 2010, respectively.

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THE SAVANNAH BANCORP, INC. AND SUBSIDIARIES

Notes to Consolidated Financial Statements (Continued)

Note 4 Securities Available for Sale

The aggregate amortized cost and fair value of securities available for sale as of December 31, 2011 and 2010 are as follows:

	2011			
($ in thousands)	**Amortized Cost**	**Unrealized Gains**	**Unrealized Losses**	**Fair Value**
Investment securities:				
U.S. government-sponsored enterprises ("GSE")	$ 1,433	$ 13	$	$ 1,446
Mortgage-backed securities GSE	66,464	1,583	(35)	68,012
State and municipal securities	10,329	339	(11)	10,657
Restricted equity securities	3,538			3,538
Total investment securities	$ 81,764	$ 1,935	$ (46)	$ 83,653

	2010			
($ in thousands)	**Amortized Cost**	**Unrealized Gains**	**Unrealized Losses**	**Fair Value**
Investment securities:				
U.S. government-sponsored enterprises	$ 1,821	$ 4	$	$ 1,825
Mortgage-backed securities GSE	120,998	1,628	(435)	122,191
State and municipal securities	10,285	76	(154)	10,207
Restricted equity securities	3,876			3,876
Total investment securities	$ 136,980	$ 1,708	$ (589)	$ 138,099

The distribution of securities by contractual maturity at December 31, 2011 is shown below. Actual maturities may differ from contractual maturities because issuers may have the right to call or prepay obligations with or without call or prepayment penalties.

($ in thousands)	**Amortized Cost**	**Fair Value**
Securities available for sale:		
Due in one year or less	$ 579	$ 590
Due after one year through five years	2,211	2,235
Due after five years through ten years	3,621	3,871
Due after ten years	5,351	5,407
Mortgage-backed securities GSE	66,464	68,012
Restricted equity securities	3,538	3,538
Total investment securities	$ 81,764	$ 83,653

At December 31, 2011 and 2010, investment securities with a carrying value of $51,318,000 and $61,728,000, respectively, are pledged as collateral to secure public funds, securities sold under repurchase agreements and FHLB borrowings.

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THE SAVANNAH BANCORP, INC. AND SUBSIDIARIES

Notes to Consolidated Financial Statements (Continued)

Note 4 Securities Available for Sale (Continued)

Gains and losses on sales of securities available for sale consist of the following for the years ended December 31:

($ in thousands)	2011	2010	2009
Gross gains	$ 766	$ 684	$ 2,170
Gross losses	(3)	(76)	(51)
Net realized gains	$ 763	$ 608	$ 2,119

The restricted equity securities consist of the following at December 31:

($ in thousands)	2011	2010
FHLB stock	$ 2,716	$ 3,054
FRB stock	822	822
Total	$ 3,538	$ 3,876

The following tables show the gross unrealized losses and fair value of the Company's investments with unrealized losses that are not deemed to be other-than-temporarily impaired, aggregated by investment category and length of time that individual securities have been in a continuous unrealized loss position. Available for sale securities that have been in a continuous unrealized loss position are as follows at December 31, 2011 and 2010:

	2011					
	Less Than 12 Months		12 Months or More		Total	
($ in thousands)	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses
Mortgage-backed securities GSE	$ 5,585	$ (35)	$	$	$ 5,585	$ (35)
State and municipal securities	800	(11)			800	(11)
Total temporarily impaired securities	$ 6,385	$ (46)	$	$	$ 6,385	$ (46)

	2010					
	Less Than 12 Months		12 Months or More		Total	
($ in thousands)	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses
Mortgage-backed securities GSE	$ 37,606	$ (435)	$	$	$ 37,606	$ (435)
State and municipal securities	3,853	(154)			3,853	(154)
Total temporarily impaired securities	$ 41,459	$ (589)	$	$	$ 41,459	$ (589)

The unrealized losses at December 31, 2011 on the Company's investment in GSE mortgage-backed securities were caused by interest rate increases. The Company purchased those investments at a premium relative to their face amount, and the contractual cash flows of those investments are guaranteed by an agency of the U.S. Government. Accordingly, it is expected that the securities would not be settled at a price less than the amortized cost bases of the Company's investments. The Company also has two municipal securities with unrealized losses for less than twelve months.

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THE SAVANNAH BANCORP, INC. AND SUBSIDIARIES

Notes to Consolidated Financial Statements (Continued)

Note 4 Securities Available for Sale (Continued)

Management has reviewed these two bonds and believes that the decrease in value is due to interest rate fluctuations and not credit quality. One of the municipal bonds is rated AAA and the other bond is not rated. Because the decline in market value is attributable to changes in interest rates and not credit quality, and because the Company does not intend to sell the investments and it is not more likely than not that the Company will be required to sell the investments before recovery of their amortized cost bases, which may be maturity, the Company does not consider those investments to be other-than-temporarily impaired at December 31, 2011.

Note 5 Loans

The composition of the loan portfolio at December 31, 2011 and 2010 is presented below:

($ in thousands)	2011	Percent of Total	2010	Percent of Total
Commercial real estate				
Construction and development	$ 22,675	3.0%	$ 20,819	2.5%
Owner-occupied	110,900	14.6	120,797	14.6
Non owner-occupied	221,128	29.1	231,641	28.0
Residential real estate mortgage	324,365	42.7	363,390	44.0
Commercial	68,304	9.0	74,889	9.1
Installment and other consumer	12,306	1.6	15,026	1.8
Gross loans	759,678	100.0%	826,562	100.0%
Allowance for loan losses	(21,917)		(20,350)	
Net loans	$ 737,761		$ 806,212	

For purposes of the disclosures required pursuant to accounting standards, the loan portfolio was disaggregated into segments and then further disaggregated into classes for certain disclosures. A portfolio segment is defined as the level at which an entity develops and documents a systematic method for determining its allowance for loan losses. There are four loan portfolio segments that include commercial real estate, residential real estate-mortgage, commercial and installment and other consumer. Commercial real estate has three classes including construction and development, owner-occupied and non owner-occupied. The construction and development class includes residential and commercial construction and development loans. Land and lot development loans are included in the non owner-occupied commercial real estate class or residential real estate segment depending on the property type.

Changes in the allowance for loan losses are summarized as follows:

($ in thousands)	2011	2010	2009
Balance, beginning of year	$ 20,350	$ 17,678	$ 13,300
Provision for loan losses	20,035	21,020	13,065
Charge-offs	(18,974)	(18,765)	(8,893)
Recoveries	506	417	206
Balance, end of year	$ 21,917	$ 20,350	$ 17,678

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THE SAVANNAH BANCORP, INC. AND SUBSIDIARIES

Notes to Consolidated Financial Statements (Continued)

Note 5 Loans (Continued)

The following tables detail the change in the allowance for loan losses on the basis of the Company's impairment methodology by loan segment:

	2011					
($ in thousands)	Commercial Real Estate	Residential Real Estate	Commercial	Consumer	Unallocated	Total
Allowance for loan losses						
Beginning balance	$ 4,722	$ 13,582	$ 1,528	$ 518	$	$ 20,350
Charge-offs	(3,777)	(14,026)	(843)	(328)		(18,974)
Recoveries	27	407	30	42		506
Provision	5,190	14,232	556	(39)	96	20,035
Ending balance	$ 6,162	$ 14,195	$ 1,271	$ 193	$ 96	$ 21,917
Ending balance: individually evaluated for impairment	$ 1,108	$ 5,813	$ 145	$	$	$ 7,066
Ending balance: collectively evaluated for impairment	$ 5,054	$ 8,382	$ 1,126	$ 193	$ 96	$ 14,851
Loans						
Ending balance	$ 354,703	$ 324,365	$ 68,304	$ 12,306	$	$ 759,678
Ending balance: individually evaluated for impairment	$ 10,936	$ 24,941	$ 522	$	$	$ 36,399
Ending balance: collectively evaluated for impairment	$ 343,767	$ 299,424	$ 67,782	$ 12,306	$	$ 723,279

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THE SAVANNAH BANCORP, INC. AND SUBSIDIARIES

Notes to Consolidated Financial Statements (Continued)

Note 5 Loans (Continued)

	2010					
($ in thousands)	Commercial Real Estate	Residential Real Estate	Commercial	Consumer	Unallocated	Total
Allowance for loan losses						
Beginning balance	$ 5,740	$ 10,690	$ 977	$ 227	$ 44	$ 17,678
Charge-offs	(5,840)	(11,729)	(1,080)	(116)		(18,765)
Recoveries	20	352	17	28		417
Provision	4,802	14,269	1,614	379	(44)	21,020
Ending balance	$ 4,722	$ 13,582	$ 1,528	$ 518	$	$ 20,350
Ending balance: individually evaluated for impairment	$ 285	$ 4,055	$ 540	$ 257	$	$ 5,137
Ending balance: collectively evaluated for impairment	$ 4,437	$ 9,527	$ 988	$ 261	$	$ 15,213
Loans						
Ending balance	$ 373,257	$ 363,390	$ 74,889	$ 15,026	$	$ 826,562
Ending balance: individually evaluated for impairment	$ 3,865	$ 25,669	$ 596	$ 257	$	$ 30,387
Ending balance: collectively evaluated for impairment	$ 369,392	$ 337,721	$ 74,293	$ 14,769	$	$ 796,175

A loan is considered impaired, in accordance with the impairment accounting guidance, when based on current information and events, it is probable that the Company will be unable to collect all amounts due from the borrower in accordance with the contractual term of the loan. Impaired loans include loans modified in TDRs where concessions have been granted to borrowers experiencing financial difficulties. These concessions could include a reduction in the interest rate on the loan, payment extensions, forgiveness of principal, forbearance or other actions intended to maximize collection.

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THE SAVANNAH BANCORP, INC. AND SUBSIDIARIES

Notes to Consolidated Financial Statements (Continued)

Note 5 Loans (Continued)

The following is a summary of information pertaining to impaired loans as of and for the year ended December 31, 2011:

($ in thousands)	Recorded Investment	Unpaid Principal Balance	Related Allowance
Impaired loans without a valuation allowance			
Commercial real estate			
Construction and development	$	$	$
Owner-occupied	710	758	
Non owner-occupied	5,998	6,507	
Residential real estate mortgage	12,940	19,556	
Commercial	294	351	
Installment and other consumer			
Total impaired loans without a valuation allowance	19,492	27,172	
Impaired loans with a valuation allowance			
Commercial real estate			
Construction and development	2,325	3,325	751
Owner-occupied	2,946	3,034	425
Non owner-occupied	3,239	3,742	481
Residential real estate mortgage	22,889	24,958	6,776
Commercial	721	778	215
Installment and other consumer	99	103	13
Total impaired loans with a valuation allowance	32,219	35,940	8,661
Total impaired loans	$ 51,711	$ 63,112	$ 8,661
Average investment in impaired loans	$ 55,324		
Interest income recognized on impaired loans	$ 818		

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THE SAVANNAH BANCORP, INC. AND SUBSIDIARIES

Notes to Consolidated Financial Statements (Continued)

Note 5 Loans (Continued)

The following is a summary of information pertaining to impaired loans as of and for the year ended December 31, 2010:

($ in thousands)	Recorded Investment	Unpaid Principal Balance	Related Allowance
Impaired loans without a valuation allowance			
Commercial real estate			
Construction and development	$ 152	$ 177	$
Owner-occupied	1,075	1,374	
Non owner-occupied	301	3,979	
Residential real estate mortgage	12,906	18,476	
Commercial			
Installment and other consumer			
Total impaired loans without a valuation allowance	14,434	24,006	
Impaired loans with a valuation allowance			
Commercial real estate			
Construction and development	2,218	3,218	265
Owner-occupied	1,647	1,667	186
Non owner-occupied	2,926	3,353	372
Residential real estate mortgage	30,634	33,471	6,316
Commercial	1,196	1,425	619
Installment and other consumer	814	818	349
Total impaired loans with a valuation allowance	39,435	43,952	8,107
Total impaired loans	$ 53,869	$ 67,958	$ 8,107
Average investment in impaired loans for the year	$ 53,962		
Income recognized on impaired loans for the year	$ 821		

For 2009, the Company had an average investment of $45,892,000 in impaired loans and recognized interest income of $957,000 on impaired loans.

Impaired loans with a valuation allowance include pools of impaired loans.

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THE SAVANNAH BANCORP, INC. AND SUBSIDIARIES

Notes to Consolidated Financial Statements (Continued)

Note 5 Loans (Continued)

The following table presents the aging of the recorded investment in past due and nonaccrual loans as of December 31, 2011 by class of loans:

($ in thousands)	30-59 days past due	60-89 days past due	Accruing greater than 90 days past due	Nonaccrual	Total past due and nonaccrual
Commercial real estate					
Construction and development	$	$	$	$ 2,325	$ 2,325
Owner-occupied	77	931		1,232	2,240
Non owner-occupied	1,217	260		7,054	8,531
Residential real estate mortgage	10,322	2,107	213	23,376	36,018
Commercial	23	162		652	837
Installment and other consumer	20	13		29	62
Total	$ 11,659	$ 3,473	$ 213	$ 34,668	$ 50,013

The following table presents the aging of the recorded investment in past due and nonaccrual loans as of December 31, 2010 by class of loans:

($ in thousands)	30-59 days past due	60-89 days past due	Accruing greater than 90 days past due	Nonaccrual	Total past due and nonaccrual
Commercial real estate					
Construction and development	$	$	$	$ 2,370	$ 2,370
Owner-occupied	1,471		251	1,194	2,916
Non owner-occupied	309	12	803	1,595	2,719
Residential real estate mortgage	4,114	4,894	1,855	26,446	37,309
Commercial	120	85	151	760	1,116
Installment and other consumer	147	12	4	471	634
Total	$ 6,161	$ 5,003	$ 3,064	$ 32,836	$ 47,064

Internal risk-rating grades are assigned to each loan by lending or credit administration, based on an analysis of the financial and collateral strength and other credit attributes underlying each loan. Management analyzes the resulting ratings, as well as other external statistics and factors, such as delinquency, to track the migration performance of the portfolio balances. Loan grades range between 1 and 8, with 1 being loans with the least credit risk. Loans that migrate toward the "Pass" grade (those with a risk rating between 1 and 4) or within the "Pass" grade generally have a lower risk of loss and therefore a lower risk factor. The "Special Mention" grade (those with a risk rating of 5) is utilized on a temporary basis for "Pass" grade loans where a significant risk-modifying action is anticipated in the near term. Substantially all of the "Special Mention" loans are performing. Loans that migrate toward the "Substandard" or higher grade (those with a risk rating between 6 and 8) generally have a higher risk of loss and therefore a higher risk factor applied to those related loan balances.

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THE SAVANNAH BANCORP, INC. AND SUBSIDIARIES

Notes to Consolidated Financial Statements (Continued)

Note 5 Loans (Continued)

The following table presents the Company's loan portfolio by risk-rating grades at December 31, 2011:

($ in thousands)	Pass (1-4)	Special Mention (5)	Sub-standard (6)	Doubtful (7)	Loss (8)	Total
Commercial real estate						
Construction and development	$ 19,749	$ 147	$ 2,779	$	$	$ 22,675
Owner-occupied	101,004	3,444	6,452			110,900
Non owner-occupied	201,960	4,833	14,335			221,128
Residential real estate mortgage	260,301	19,190	44,874			324,365
Commercial	64,406	622	3,276			68,304
Installment and other consumer	11,760	67	479			12,306
Total	$ 659,180	$ 28,303	$ 72,195	$	$	$ 759,678

The following table presents the Company's loan portfolio by risk-rating grades at December 31, 2010:

($ in thousands)	Pass (1-4)	Special Mention (5)	Sub-standard (6)	Doubtful (7)	Loss (8)	Total
Commercial real estate						
Construction and development	$ 17,792	$ 577	$ 2,450	$	$	$ 20,819
Owner-occupied	114,603	1,851	4,343			120,797
Non owner-occupied	216,744	9,017	5,880			231,641
Residential real estate mortgage	290,894	19,936	51,317	1,243		363,390
Commercial	71,361	666	2,562	300		74,889
Installment and other consumer	14,011	78	762	175		15,026
Total	$ 725,405	$ 32,125	$ 67,314	$ 1,718	$	$ 826,562

As a result of adopting the accounting standards related to TDRs, the Company reassessed all restructurings that occurred on or after January 1, 2011 for identification as TDRs. The Company identified no additional loans for which the allowance for loan losses had previously been measured under a general allowance for loan losses methodology. The accounting standards require prospective application of the impairment measurement guidance for those loans newly identified as impaired. At December 31, 2011, there was no recorded loan investment for which the allowance for loan losses was previously measured under a general allowance for loan losses methodology that was previously not considered impaired.

TDRs of $16.1 million and $26.1 million were performing to their agreed terms at December 31, 2011 and 2010, respectively. There was $2.0 million and $4.2 million in specific reserves established for these loans at December 31, 2011 and 2010, respectively. The total amount of TDRs that subsequently defaulted at December 31, 2011 and 2010 was $11.2 million and $6.6 million, respectively. There was $4.2 million and $719,000 in specific reserves established for these loans at December 31, 2011 and 2010, respectively. The Company has committed to lend additional amounts totaling up to $79,000 as of December 31, 2011 to customers with outstanding loans that are classified as TDRs.

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THE SAVANNAH BANCORP, INC. AND SUBSIDIARIES

Notes to Consolidated Financial Statements (Continued)

Note 5 Loans (Continued)

During the year ended December 31, 2011, the terms of certain loans were modified as TDRs. The modification of the terms of such loans included one or a combination of the following: a reduction of the stated interest rate of the loan; an extension of the maturity date at a stated rate of interest lower than the current market rate for new debt with similar risk; or a permanent reduction of the recorded investment in the loan. The following table presents additional information on TDRs including the number of loan contracts restructured and the pre- and post-modification recorded investment for the year ended December 31, 2011:

($ in thousands)	Number of Contracts	Pre-Modification Outstanding Recorded Investment	Post-Modification Outstanding Recorded Investment
Troubled Debt Restructurings			
Commercial real estate			
Construction and development	0	$	$
Owner-occupied	3	1,492	1,492
Non owner-occupied	2	245	245
Residential real estate mortgage	13	3,863	3,646
Commercial	3	435	435
Installment and other consumer	0		
Total	21	$ 6,035	$ 5,818

There were specific reserves established for loans that were restructured during the twelve months ended December 31, 2011 of approximately $74,000.

One TDR with a recorded investment of $66,000 subsequently defaulted during the twelve months ended December 31, 2011 that had been restructured over the past twelve months.

The Company has granted loans to certain directors and executive officers of the Company and to their related interests. The aggregate amount of loans was $42,318,000 and $42,590,000 at December 31, 2011 and 2010, respectively. During 2011, new loans of $24,680,000 were made and repayments of $24,952,000 were received. Unfunded commitments of credit available to related parties aggregated $9,364,000 and $7,917,000 at December 31, 2011 and 2010, respectively. Related party loans are made on substantially the same terms, including interest rates and collateral, as those prevailing at the time for comparable transactions with unrelated persons and do not involve more than normal risk of collection.

As of December 31, 2011 and 2010, the Subsidiary Banks have pledged loans under blanket liens of approximately $304 million and $360 million, respectively, to the FHLB and the FRB for secured borrowing lines.

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THE SAVANNAH BANCORP, INC. AND SUBSIDIARIES

Notes to Consolidated Financial Statements (Continued)

Note 6 Premises and Equipment

Premises and equipment at December 31, 2011 and 2010 are summarized as follows:

($ in thousands)	Depreciable Lives	2011	2010
Land		$ 2,635	$ 2,635
Buildings and improvements	5 - 50	11,449	11,419
Furniture and banking equipment	3 - 15	7,701	8,039
Leasehold improvements	5 - 32	1,917	1,972
Total cost		23,702	24,065
Less accumulated depreciation and amortization		9,416	9,009
Premises and equipment, net		$ 14,286	$ 15,056

Depreciation expense was $1,125,000, $1,283,000, and $1,369,000 for the years ended December 31, 2011, 2010 and 2009, respectively.

Note 7 Other Real Estate Owned

Other real estate owned at December 31, 2011 and 2010 is summarized as follows:

($ in thousands)	2011	2010
Balance, beginning of year	$ 13,199	$ 8,329
Additions	17,067	16,462
Disposals	(8,151)	(10,167)
Additional write-downs	(1,783)	(1,425)
Balance, end of year	$ 20,332	$ 13,199

Note 8 Goodwill and Other Intangible Assets

Following is a summary of information related to acquired intangible assets:

	As of December 31, 2011		As of December 31, 2010	
	Gross Amount	Accumulated Amortization	Gross Amount	Accumulated Amortization
	($ in thousands)			
Amortized intangible assets				
Client list	$ 1,400	$ 624	$ 1,400	$ 480
Core deposit premium	387	107	387	27
Total carrying value	$ 1,787	$ 731	$ 1,787	$ 507

The aggregate amortization expense for intangible assets was approximately $224,000, $171,000 and $144,000 for the years ended December 31, 2011, 2010 and 2009, respectively.

The estimated amortization expense for each of the next five years is as follows: 2012 $224,000, 2013 $224,000, 2014 $224,000, 2015 $184,000 and 2016 $144,000.

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THE SAVANNAH BANCORP, INC. AND SUBSIDIARIES

Notes to Consolidated Financial Statements (Continued)

Note 8 Goodwill and Other Intangible Assets (Continued)

Changes in the carrying amounts of goodwill at December 31, 2011 and 2010 are as follows:

	2011	2010
	($ in thousands)	
Balance, beginning of year	$ 2,506	$ 1,434
Goodwill acquired		1,072
Balance, end of year	$ 2,506	$ 2,506

All of the goodwill is related to the 2007 acquisition of Minis. The goodwill acquired in 2010 was a final contingent earn-out payment.

Note 9 Deposits

The aggregate amount of time deposits in denominations of $100,000 or more at December 31, 2011 and 2010 is $193,134,000 and $235,406,000, respectively. At December 31, 2011, brokered time deposits mature as follows: 2012 $24,274,000; 2013 $10,968,000; and 2014 $16,266,000. Additionally, $32,022,000 of non-maturity institutional money market accounts are considered brokered deposits because the deposits are from customers of brokerage firms up to a maximum of $250,000 per depositor.

The scheduled maturities of time deposits at December 31, 2011 are as follows:

	Total ($ in thousands)
2012	$ 220,622
2013	40,141
2014	32,377
2015	16,356
2016 and thereafter	7,431
Total	$ 316,927

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THE SAVANNAH BANCORP, INC. AND SUBSIDIARIES

Notes to Consolidated Financial Statements (Continued)

Note 10 Short-Term Borrowings

Short-term borrowings at December 31, 2011 and 2010 consist of federal funds purchased, securities sold under agreements to repurchase, and FRB short-term advances:

	Federal Funds Purchased	Securities Sold Under Repurchase Agreements	FRB Short-Term Advances
		($ in thousands)	
2011			
Balance at December 31	$ 492	$ 13,892	$
Maximum indebtedness at any month end	8,421	15,557	
Daily average indebtedness outstanding	843	13,940	
Average rate paid for the year	0.33%	0.41%	0.00%
Average rate paid on period-end borrowings	0.20%	0.25%	0.00%
2010			
Balance at December 31	$ 295	$ 14,780	$
Maximum indebtedness at any month end	1,320	17,225	6,000
Daily average indebtedness outstanding	805	14,847	1,009
Average rate paid for the year	0.26%	0.50%	0.55%
Average rate paid on period-end borrowings	0.20%	0.50%	0.00%

The maximum amount of short-term borrowings outstanding at the end of any month was $20,647,000 and $20,414,000 during 2011 and 2010, respectively. At December 31, 2011, federal funds borrowing arrangements aggregating $46,500,000 were available to the Subsidiary Banks from correspondent banking institutions. There are no commitment fees and no requirements for compensating balances. These unused lines principally serve as temporary liquidity back-up lines and are subject to availability of funds and other specific limitations of the correspondent banks.

Savannah is a member and shareholder of the FRB of Atlanta. The Subsidiary Banks have been approved to access the FRB discount window to borrow on a secured basis at 50-100 basis points over the Federal Funds Target Rate. The amount of credit available is subject to the amounts and types of collateral available when borrowings are requested. The Subsidiary Banks were approved by the FRB under the borrower-in-custody of collateral ("BIC") arrangement. This temporary liquidity arrangement allows collateral to be maintained at the Subsidiary Banks rather than being delivered to the FRB or a third party custodian. At December 31, 2011, the Company had secured borrowing capacity of $93.6 million with the FRB and no balance outstanding.

Note 11 Other Borrowings

Other borrowings consist of a note payable due to related parties (directors) with a balance of $8,581,000 as of December 31, 2011. The proceeds were used to fund SAVB Holdings. The loan is secured by a guarantee of the Company and a blanket assignment of all the assets of SAVB Holdings. Principal payments are due monthly based on repayments, sales, charge-offs or other activity in the assets held by SAVB Holdings. The agreement contains the following financial covenants: (i) the Company's dividend payout ratio will not exceed 50 percent of after tax net income on a quarterly basis, (ii) the Subsidiary Banks shall each maintain a "well-capitalized" status as determined by their

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THE SAVANNAH BANCORP, INC. AND SUBSIDIARIES

Notes to Consolidated Financial Statements (Continued)

Note 11 Other Borrowings (Continued)

primary regulator, (iii) on the last day of each calendar quarter, SAVB Holdings shall maintain a loan-to-value ratio of at least 1.00:1.00 and (iv) on the last day of each calendar quarter, the amount of nonperforming assets of the Company shall not exceed 4.75 percent of the total assets of the Company. Additionally, the note states that if the amount of nonperforming assets of the Company exceeds 5.25 percent of total assets, then the interest rate payable on the note would increase an additional 200 basis points. At December 31, 2011, the Company's ratio of nonperforming assets to total assets was 5.60 percent which exceeded both of the limits stated in the note's covenants. The interest rate payable on the note increased 50 basis points to 8.00 percent for exceeding the limit of 4.75 percent of nonperforming assets to total assets. The interest rate payable should have increased an additional 200 basis points to 10.00 percent for exceeding the nonperforming assets limit of 5.25 percent; however, the Company obtained a waiver from the lenders on this covenant and the interest rate payable remained at 8.00 percent as of December 31, 2011. The remaining indebtedness is due and payable by September 30, 2012.

Note 12 Federal Home Loan Advances

Short-term Advances The Company had short-term advances from the FHLB of $3,500,000 at December 31, 2011 and $4,000,000 at December 31, 2010. The weighted-average interest rates on the short-term advances were 2.16 and 1.08 percent at December 31, 2011 and 2010, respectively. The short-term advance at December 31, 2011 is a term fixed rate advance that matures on April 30, 2012 and pays interest monthly.

Convertible Advances The Company had convertible fixed rate advances of $10,000,000 at December 31, 2011 and 2010. The weighted-average interest rate on convertible advances was 2.26 percent at December 31, 2011 and 2010. The advances mature in 2018 and are now convertible each quarter at the option of the FHLB to an advance with an interest rate equal to the current three-month LIBOR.

Long-term Advances Long-term advances from the FHLB totaled $3,153,000 and $3,658,000 at December 31, 2011 and 2010, respectively. The weighted-average interest rates on the long-term advances were 0.71 and 2.09 percent at December 31, 2011 and 2010, respectively. Aggregate maturities for the long-term advances at December 31, 2011 are $3,000,000 in 2013 and $153,000 in 2016 and thereafter. Interest is generally payable monthly and scheduled principal reductions are made quarterly, semi-annually or at maturity. The long-term advances include prepayment penalties for each advance.

FHLB Advance Borrowing Capacity The Subsidiary Banks are shareholders of the FHLB and have access to secured borrowings from the FHLB under Blanket Floating Lien Agreements. Under these agreements, the Subsidiary Banks have pledged certain 1-4 family first mortgage loans, commercial real estate loans, home equity lines of credit and second mortgage residential loans. The Subsidiary Banks' individual borrowing limits range from 20 to 25 percent of assets. In aggregate, at December 31, 2011, the Subsidiary Banks had secured borrowing capacity of approximately $123 million of which $16.7 million was advanced and $16.0 million was used as collateral for FHLB Letters of Credit. These credit arrangements serve as a core funding source as well as liquidity backup for the Subsidiary Banks. Additional advances are subject to review and approval by the FHLB.

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THE SAVANNAH BANCORP, INC. AND SUBSIDIARIES

Notes to Consolidated Financial Statements (Continued)

Note 13 Subordinated Debt to Nonconsolidated Subsidiaries

During the third quarters 2003 and 2004, the Company formed SAVB Capital Trust I and SAVB Capital Trust II (the "Trusts"), nonconsolidated subsidiaries whose sole purpose was to issue $6,000,000 and $4,000,000, respectively, in Trust Preferred Securities through investment pools sponsored by two national brokerage firms. The Trust Preferred Securities have maturities of 30 years and are both redeemable at the Company's option on any quarterly interest payment date. At December 31, 2011, the interest rates on the securities were 3.25 and 2.75 percent, respectively, with quarterly resets at the three-month LIBOR plus 2.85 and 2.20 percent, respectively. The Company's liabilities to the nonconsolidated Trusts are recorded as liabilities of $6.186 million and $4.124 million and investments (included in other assets) of $186,000 and $124,000, respectively, in the consolidated balance sheet. Subject to certain limitations, the securities qualify as Tier 1 capital for regulatory capital purposes under FRB regulations.

Note 14 Income Taxes

Income tax expense (benefit) is composed of the following for each of the years ended December 31:

	2011	2010	2009
	($ in thousands)		
Current federal	$ (618)	$ (1,092)	$ 1,861
Current state		(279)	42
Total current	(618)	(1,371)	1,903
Deferred federal	(957)	(1,528)	(1,417)
Deferred state	(320)	(231)	(331)
Total deferred	(1,277)	(1,759)	(1,748)
Income tax expense (benefit)	$ (1,895)	$ (3,130)	$ 155

A reconciliation between income tax expense (benefit) and the amounts computed by applying the U.S. federal tax rate of 34 percent to income (loss) before income taxes is as follows:

	2011	2010	2009
	($ in thousands)		
Tax provision at 34%	$ (1,383)	$ (2,421)	$ 369
State tax, net of federal tax benefit	(188)	(300)	46
Benefit of tax-exempt income, net	(177)	(197)	(141)
Other	(147)	(212)	(119)
Income tax expense (benefit)	$ (1,895)	$ (3,130)	$ 155

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THE SAVANNAH BANCORP, INC. AND SUBSIDIARIES

Notes to Consolidated Financial Statements (Continued)

Note 14 Income Taxes (Continued)

Deferred income tax assets and liabilities are comprised of the following at December 31:

	2011	2010
	($ in thousands)	
Deferred tax assets:		
Allowance for loan losses	$ 8,209	$ 7,676
Write-down of foreclosed assets	1,223	306
Tax-deductible goodwill	1,203	1,317
Tax credit carry forwards	887	
Deferred compensation expense	531	469
Stock-based compensation expense	149	140
Unamortized loan fees	76	49
Other	241	129
Total deferred tax assets	12,519	10,086
Deferred tax liabilities:		
Unrealized gains on securities	718	425
Depreciation	639	624
Deferred costs on loans and deposits	68	72
Other	20	25
Total deferred tax liabilities	1,445	1,146
Net deferred tax assets	$ 11,074	$ 8,940

The net deferred tax assets are included in the consolidated balance sheets in other assets. A portion of the deferred tax asset balance relates to federal and state tax credits which will be available to reduce the Company's income tax liability in future years. The federal and state tax credits at December 31, 2011 total $376,000 and $511,000, respectively, and have various expirations beginning in 2014 through the year 2031. The Company files a consolidated Federal tax return and a consolidated Georgia return for the Georgia-based parent and subsidiaries.

Note 15 Stock Option and Employee Benefit Plans

As discussed in Note 1, the Company has two stock option plans. All authorized shares have been awarded from the 1995 Plan. There are 144,151 authorized option shares remaining under the 2005 Omnibus Plan at December 31, 2011. The options granted in the chart below generally vest 20 percent each year over five years and are exercisable over ten years except for 55,115 option shares granted to directors which vest within one year. Some of the executive officer option shares also include minimum performance triggers as a condition of vesting.

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THE SAVANNAH BANCORP, INC. AND SUBSIDIARIES

Notes to Consolidated Financial Statements (Continued)

Note 15 Stock Option and Employee Benefit Plans (Continued)

Changes in stock options outstanding for the years ended December 31, 2011, 2010 and 2009 are as follows.

	2011		2010		2009	
	Shares	Weighted Average Exercise Price	Shares	Weighted Average Exercise Price	Shares	Weighted Average Exercise Price
Outstanding at beginning of year	174,328	$ 17.24	194,814	$ 17.09	192,022	$ 18.28
Granted	13,350	5.26	7,915	11.25	19,291	8.74
Exercised						
Forfeited	(37,710)	16.89	(28,401)	14.55	(16,499)	21.12
Outstanding at end of year	149,968	$ 17.14	174,328	$ 17.24	194,814	$ 17.09
Exercisable at end of year	133,618	$ 17.16	163,355	$ 16.87	175,625	$ 16.75

At December 31, 2011, there is no aggregate intrinsic value for the outstanding or exercisable stock options.

Options outstanding at December 31, 2011 are as follows:

	Outstanding			Exercisable	
Outstanding Common Options	Remaining Contractual Number	Weighted Average Life	Weighted Average Price	Number	Weighted Average Price
Range of exercise prices					
$5.25 $12.00	39,223	8.42	$ 9.48	25,873	$ 9.51
$12.01 $15.00	15,466	0.54	13.02	15,466	13.02
$15.01 $20.00	51,012	2.73	16.69	51,012	16.69
$20.01 $25.00	27,457	3.15	22.34	27,457	22.34
$25.00 $28.56	16,810	4.80	26.71	13,810	27.59
Total outstanding	149,968	4.30	$ 17.14	133,618	$ 17.16

Restricted Stock In 2007 and 2006, the Board granted 20,185 shares of restricted stock under the 2005 Omnibus Plan which awards certain officers common shares of the Company. The cost of these shares is being amortized against earnings using the vesting schedule over the three and ten year vesting periods. Restricted stock shares in the amount of 7,391 did not vest due to forfeiture. Unrecognized compensation cost for restricted stock awards was $81,000 at December 31, 2011.

The Company sponsors a 401(k) employee savings and profit sharing plan in which substantially all full-time employees are eligible to participate. The plan allows eligible employees to save a portion of their salary on a pre-tax basis. Contributions by the Company to the plan are discretionary. Contributions and administrative expenses related to the plan aggregated $10,000, $10,000 and $290,000 for the years ended December 31, 2011, 2010 and 2009, respectively. The Company did not make a contribution to the plan in 2011 or 2010 and the only costs were for administrative expenses.

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THE SAVANNAH BANCORP, INC. AND SUBSIDIARIES

Notes to Consolidated Financial Statements (Continued)

Note 16 Capital Ratios and Dividend Restrictions

The Subsidiary Banks' primary regulators have adopted capital requirements that specify the minimum capital level for which no prompt corrective action is required. In addition, the FDIC has adopted FDIC insurance assessment rates based on certain "well-capitalized" risk-based and equity capital ratios. Failure to meet minimum capital requirements can result in the initiation of certain actions by the regulators that, if undertaken, could have a material effect on the Company's and the Subsidiary Banks' financial statements. As of December 31, 2011, the Company and the Subsidiary Banks were categorized as well-capitalized under the regulatory framework for prompt corrective action in the most recent notification from the FDIC. Bryan has agreed with its primary regulator to maintain a Tier 1 Leverage Ratio of not less than 8.00 percent and was in conformity with the requirement at December 31, 2011. Savannah has agreed with its primary regulator to maintain a Tier 1 Leverage Ratio of not less than 8.00 percent and a Total Risk-based Capital Ratio of not less than 12.00 percent and is currently in conformity with the agreement.

On March 1, 2012, Bryan entered into a Consent Order ("Order") with the FDIC and the Georgia Department of Banking and Finance ("GDBF") requiring Bryan to implement a number of actions to address identified deficiencies. The Order also includes a capital article that requires Bryan to maintain a Tier 1 Leverage Ratio of not less than 8.00 percent and a Total Risk-based Capital Ratio of not less than 10.00 percent. As a result of this capital article, Bryan is automatically classified as an "adequately capitalized" for regulatory purposes and is prohibited from certain practices by the regulatory authorities and subject to certain restrictions.

Banking regulation restrict the amount of cash dividends that the Subsidiary Banks may pay without obtaining regulatory approval , subject to maintaining adequate capital ratios. Based upon these regulatory restrictions and the agreements made with the Subsidiary Banks' primary regulators, there are no cash dividends available to the Company from the Subsidiary Banks at December 31, 2011. As of December 31, 2011, the Company has agreed with its primary regulator to obtain approval prior to paying or declaring any dividends.

Management believes that the Company and the Subsidiary Banks meet all capital adequacy requirements to which they are subject as of December 31, 2011. The following tables show the capital amounts and ratios for the Company and the Subsidiary Banks at December 31, 2011 and 2010:

	Company		Savannah		Bryan	
	2011	2010	2011	2010	2011	2010
	($ in thousands)					
Qualifying Capital						
Tier 1 capital	$ 81,697	$ 87,623	$ 62,451	$ 64,193	$ 19,416	$ 21,294
Total capital	90,845	97,589	69,191	71,450	21,691	23,826
Leverage Ratios						
Tier 1 capital to average assets	8.37%	8.12%	8.63%	7.97%	8.01%	8.20%
Risk-based Ratios						
Tier 1 capital to risk-weighted assets	11.36%	11.13%	11.74%	11.18%	10.82%	10.67%
Total capital to risk-weighted assets	12.63%	12.40%	13.01%	12.44%	12.09%	11.93%

Required Regulatory Capital Ratios:	**Minimum**	**Well-Capitalized**
Tier 1 capital to average assets	4.00%	5.00%
Tier 1 capital to risk-weighted assets	4.00%	6.00%
Total capital to risk-weighted assets	8.00%	10.00%

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THE SAVANNAH BANCORP, INC. AND SUBSIDIARIES

Notes to Consolidated Financial Statements (Continued)

Note 17 Leases and Commitments

Future minimum payments under non-cancelable land and office space operating leases with remaining terms in excess of one year are presented as follows: 2012 $881,000; 2013 $795,000; 2014 $724,000; 2015 $736,000; 2016 and thereafter is $2,427,000. The land and office space leases contain customary escalation clauses. Two of the branch office leases are with a related party (director). The Company or the Subsidiary Banks are responsible for taxes, insurance and maintenance during the lease term under certain leases. Future minimum payments due under the Company's long-term data processing contract are as follows: 2012 $1,224,000; 2013 $1,248,000; 2014 $1,273,000; and 2015 $1,191,000. The contract contains customary escalation and buyout clauses.

The net rental expense for all office space operating leases amounted to $1,161,000 in 2011, $1,272,000 in 2010 and $636,000 in 2009. The leases on the office space have five to twenty-year renewal options and typically require increased rental payments under consumer price index escalation clauses.

Note 18 Other Operating Expense

The components of other operating expense for the years ended December 31, 2011, 2010 and 2009 are as follows:

($ in thousands)	2011	2010	2009
Professional and directors fees	$ 904	$ 873	$ 1,114
Regulatory assessments and audit fees	612	545	592
Postage and courier	303	297	310
Taxes and licenses	274	273	244
Loan origination costs	247	231	259
Advertising and sales promotion	237	377	233
Insurance	210	147	95
Stationery and supplies	181	198	253
Telephone	160	172	175
Correspondent bank charges	123	39	50
Dues and subscriptions	98	111	115
Other expense	525	574	422
Total other operating expense	$ 3,874	$ 3,837	$ 3,862

Note 19 On-Balance Sheet Derivative Instruments and Hedging Activities

Risk Management Objective of Using Derivatives

The Company is exposed to certain risks arising from both its business operations and economic conditions. The Company principally manages its exposures to a wide variety of business and operational risks through management of its core business activities. The Company manages economic risks, including interest rate, liquidity, and credit risk, primarily by managing the amount, sources, and duration of its assets and liabilities and through the use of derivative financial instruments. Specifically, the Company enters into derivative financial instruments to manage exposures that arise from business activities that result in the receipt or payment of future known and uncertain cash amounts, the value of which are determined by interest rates. The Company's derivative financial instruments are used to

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THE SAVANNAH BANCORP, INC. AND SUBSIDIARIES

Notes to Consolidated Financial Statements (Continued)

Note 19 On-Balance Sheet Derivative Instruments and Hedging Activities (Continued)

manage differences in the amount, timing, and duration of the Company's known or expected cash receipts principally related to certain variable rate loan assets.

Fair Values of Derivative Instruments on the Balance Sheet

The table below presents the fair value of the Company's derivative financial instruments at December 31:

	2011		2010	
	Fair Value		Fair Value	
($ in thousands)	Asset	Liability	Asset	Liability
Derivatives designated as hedging instruments:				
Interest rate products	$	$	$	$
Derivatives not designated as hedging instruments:				
Interest rate products	301	301	136	135
Total	$ 301	$ 301	$ 136	$ 135

Cash Flow Hedges of Interest Rate Risk

The Company's objectives in using interest rate derivatives are to add stability to interest income and expense and to manage its exposure to interest rate movements. To accomplish this objective, the Company has historically used interest rate swaps, collars, and floors as part of its interest rate risk management strategy. Interest rate swaps designated as cash flow hedges involve the receipt of variable amounts from a counterparty in exchange for the Company making fixed payments over the life of the agreements without exchange of the underlying notional amount. Interest rate collars designated as cash flow hedges involve the receipt of variable-rate amounts from a counterparty if interest rates fall below the strike rate on the purchased floor and the payment of variable-rate amounts if interest rates rise above the cap rate on the sold floor. Interest rate floors designated as cash flow hedges involve the receipt of variable-rate amounts from a counterparty if interest rates fall below the strike rate on the contract in exchange for an up-front premium. As of December 31, 2011 and 2010 the Company had no outstanding derivatives that were designated as cash flow hedging relationships. No hedge ineffectiveness was recognized during the years ended December 31, 2011, 2010 and 2009.

Amounts reported in accumulated other comprehensive income related to derivatives were reclassified to interest income as interest payments are received on the Company's variable rate assets. During the year ended December 31, 2010, the Company accelerated the reclassification of amounts in other comprehensive income to earnings as a result of a portion of the hedged forecasted transactions related to the Company's interest rate swaps, collars and interest rate floor becoming probable not to occur. The accelerated amount for the year ended December 31, 2010 was a gain of $14,000. There was no amount accelerated for the year ended December 31, 2011.

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THE SAVANNAH BANCORP, INC. AND SUBSIDIARIES

Notes to Consolidated Financial Statements (Continued)

Note 19 On-Balance Sheet Derivative Instruments and Hedging Activities (Continued)

Effect of Derivative Instruments on the Income Statement

The table below presents the effect of the Company's derivative financial instruments on the income statement for the years ended December 31:

($ in thousands)	2011	2010	2009		2011	2010	2009
Cash Flow Hedging Relationships	Gain Recognized in OCI on Derivative (Effective Portion)			Location of Gain Reclassified from Accumulated OCI into Income (Effective Portion)	Gain Reclassified from Accumulated OCI into Income (Effective Portion)		
Interest Rate Products	$	$	$	Interest income	$	$ 450	$ 1,205
				Noninterest income		14	794
Total	$	$	$		$	$ 464	$ 1,999

Non-designated Hedges

As of December 31, 2011 none of the Company's outstanding derivatives are designated in qualifying hedging relationships. Derivatives not designated as hedges are not speculative and result from a service the Company provides to certain customers. The Company executes interest rate swaps with commercial banking customers to facilitate their respective risk management strategies. Those interest rate swaps are simultaneously hedged by executing offsetting interest rate swaps that the Company executes with a third party, such that the Company minimizes its net risk exposure resulting from such transactions. As the interest rate swaps associated with this program do not meet the strict hedge accounting requirements, changes in the fair value of both the customer swaps and the offsetting swaps are recognized directly in earnings. As of December 31, 2011, the Company had two interest rate swaps with an aggregate notional amount of $4,810,000 related to this program. The net effect of recording the derivatives at fair value through earnings was immaterial to the Company's financial condition and results of operations as of the twelve months ended December 31, 2011, 2010 and 2009.

Credit-risk-related Contingent Features

The Company has an agreement with one of its derivative counterparties that contains a provision where if the Company defaults on any of its indebtedness, including default where repayment of the indebtedness has not been accelerated by the lender, then the Company could also be declared in default on its derivative obligations.

As of December 31, 2011 the fair value of derivatives in a net liability position, which includes accrued interest but excludes any adjustment for nonperformance risk, related to these agreements was $301,000. As of December 31, 2011, the Company has minimum collateral posting thresholds with certain of its derivative counterparties and has posted collateral of $373,000 against its obligations under these agreements. If the Company had breached any of these provisions at December 31, 2011, it would have been required to settle its obligations under the agreements at the termination value.

Note 20 Financial Instruments with Off-Balance Sheet Risk

The Company is a party to financial instruments with off-balance sheet risk in the normal course of business in order to meet the financing needs of its customers. These financial instruments include

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THE SAVANNAH BANCORP, INC. AND SUBSIDIARIES

Notes to Consolidated Financial Statements (Continued)

Note 20 Financial Instruments with Off-Balance Sheet Risk (Continued)

commitments to extend credit and standby letters of credit. These instruments involve, to varying degrees, elements of credit and interest rate risk in excess of the amount recognized in the balance sheets. The majority of all commitments to extend credit and standby letters of credit are variable rate instruments. The Company's exposure to credit losses is represented by the contractual amounts of those instruments. The Company uses the same credit policies in making commitments and conditional obligations as it does for on-balance sheet instruments.

Commitments to extend credit are agreements to lend to a customer as long as there is no violation of any condition established in the contract. Commitments generally have fixed expiration dates or other termination clauses and may require payment of a fee. At December 31, 2011 and 2010 unfunded commitments to extend credit and unfunded lines of credit were $71,741,000 and $81,183,000, respectively, of which some were subject to interest rate lock commitments. Since many of the commitments are expected to expire without being drawn upon, the total commitment amounts do not necessarily represent future cash requirements. The amount of collateral obtained by the Company upon extension of credit, if deemed necessary, is based on management's credit evaluation of the customer. Collateral may include cash, securities, accounts receivable, inventory, equipment, and real estate.

Letters of credit are conditional commitments issued by the Company to guarantee the performance of a customer to a third party. The letters of credit are primarily issued to support public and private borrowing arrangements. At December 31, 2011 and 2010, commitments under letters of credit aggregated approximately $3,386,000 and $2,667,000, respectively.

Note 21 Fair Value of Financial Instruments

Determination of Fair Value

The Company uses fair value measurements to record fair value adjustments to certain assets and liabilities and to determine fair value disclosures. In accordance with the accounting standards for fair value measurements and disclosure, the fair value of a financial instrument is the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date. Fair value is best determined based upon quoted market prices. However, in many instances, there are no quoted market prices for the Company's various financial instruments. In cases where quoted market prices are not available, fair values are based on estimates using present value or other valuation techniques. Those techniques are significantly affected by the assumptions used, including the discount rate and estimates of future cash flows. Accordingly, the fair value estimates may not be realized in an immediate settlement of the instrument.

The fair value guidance provides a consistent definition of fair value, which focuses on exit price in an orderly transaction (that is, not a forced liquidation or distressed sale) between market participants at the measurement date under current market conditions. If there has been a significant decrease in the volume and level of activity for the asset or liability, a change in valuation technique or the use of multiple valuation techniques may be appropriate. In such instances, determining the price at which willing market participants would transact at the measurement date under current market conditions depends on the facts and circumstances and requires the use of significant judgment. The fair value is a reasonable point within the range that is most representative of fair value under current market conditions.

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THE SAVANNAH BANCORP, INC. AND SUBSIDIARIES

Notes to Consolidated Financial Statements (Continued)

Note 21 Fair Value of Financial Instruments (Continued)

In accordance with this guidance, the Company groups its financial assets and financial liabilities generally measured at fair value in three levels, based on the markets in which the assets and liabilities are traded and the reliability of the assumptions used to determine fair value:

Level 1: Quoted prices (unadjusted) for identical assets or liabilities in active markets that the entity has the ability to access as of the measurement date.

Level 2: Significant other observable inputs other than Level 1 prices, such as quoted prices for similar assets or liabilities, quoted prices in markets that are not active, and other inputs that are observable or can be corroborated by observable market data.

Level 3: Significant unobservable inputs that are supported by little or no market activity for the asset or liability. Level 3 assets and liabilities include financial instruments whose value is determined using pricing models, discounted cash flow methodologies, or similar techniques, as well as instruments for which determination of fair value requires significant management judgment or estimation.

Recurring Fair Value Changes

Following is a description of the valuation methodologies used for instruments measured at fair value on a recurring basis and recognized in the accompanying balance sheets, as well as the general classification of such instruments pursuant to the valuation hierarchy.

Investment securities: The fair values of securities available for sale are determined by obtaining quoted prices on nationally recognized securities exchanges or matrix pricing, which is a mathematical technique used widely in the industry to value debt securities without relying exclusively on quoted prices for the specific securities but rather by relying on the securities' relationship to other benchmark quoted securities.

Derivative instruments: Our derivative instruments consist of loan level swaps. As such, significant fair value inputs can generally be verified and do not typically involve significant judgments by management.

Assets and liabilities measured at fair value on a recurring basis are summarized below as of December 31:

		Fair Value Measurements at December 31, 2011 Using		
($ in thousands)	**Carrying Value**	**Quoted Prices in Active Markets for Identical Assets (Level 1)**	**Significant Other Observable Inputs (Level 2)**	**Significant Unobservable Inputs (Level 3)**
Investment securities	$ 83,653	$	$ 80,115	$ 3,538
Derivative asset positions	301		301	
Derivative liability positions	301		301	

		Fair Value Measurements at December 31, 2010 Using		
($ in thousands)	**Carrying Value**	**Level 1**	**Level 2**	**Level 3**
Investment securities	$ 138,099	$	$ 134,223	$ 3,876
Derivative asset positions	136		136	
Derivative liability positions	135		135	

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THE SAVANNAH BANCORP, INC. AND SUBSIDIARIES

Notes to Consolidated Financial Statements (Continued)

Note 21 Fair Value of Financial Instruments (Continued)

The level 3 securities include FHLB and FRB stock. The change in 2011 was solely due to a partial redemption of FHLB stock.

Nonrecurring Fair Value Changes

Certain assets and liabilities are measured at fair value on a nonrecurring basis. These instruments are not measured at fair value on an ongoing basis, but subject to fair value in certain circumstances, such as when there is evidence of impairment that may require write-downs. The write-downs for the Company's more significant assets or liabilities measured on a nonrecurring basis are based on the lower of amortized or estimated fair value.

Impaired loans and OREO: Impaired loans and OREO are evaluated and valued at the time the loan or OREO is identified as impaired, at the lower of cost or market value. Market value is measured based on the value of the collateral securing these loans and is classified at a Level 3 in the fair value hierarchy. Collateral for impaired loans may be real estate and/or business assets, including equipment, inventory and/or accounts receivable. Its fair value is generally determined based on real estate appraisals or other independent evaluations by qualified professionals. Impaired loans and OREO are reviewed and evaluated on at least a quarterly basis for additional impairment and adjusted accordingly, based on the same factors identified above. Impaired loans measured on a nonrecurring basis do not include pools of impaired loans.

Assets and liabilities with an impairment charge during the current year and measured at fair value on a nonrecurring basis are summarized below as of December 31:

	Carrying Values at December 31, 2011				
($ in thousands)	Total	Level 1	Level 2	Level 3	Total gain (loss)
Impaired loans	$ 11,541	$	$	$ 11,541	$ (6,091)
OREO	7,323			7,323	(1,880)

	Carrying Values at December 31, 2010				
($ in thousands)	Total	Level 1	Level 2	Level 3	Total gain (loss)
Impaired loans	$ 7,236	$	$	$ 7,236	$ (5,073)
OREO	5,423			5,423	(1,424)

Fair Value Disclosures

Accounting standards require the disclosure of the estimated fair value of financial instruments including those financial instruments for which the Company did not elect the fair value option. The fair value represents management's best estimates based on a range of methodologies and assumptions.

Cash and federal funds sold, interest-bearing deposits in banks, accrued interest receivable, all non-maturity deposits, short-term borrowings, other borrowings, subordinated debt and accrued interest payable have carrying amounts which approximate fair value primarily because of the short repricing opportunities of these instruments.

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THE SAVANNAH BANCORP, INC. AND SUBSIDIARIES

Notes to Consolidated Financial Statements (Continued)

Note 21 Fair Value of Financial Instruments (Continued)

Following is a description of the methods and assumptions used by the Company to estimate the fair value of its financial instruments:

Investment securities: Fair value is based upon quoted market prices, if available. If a quoted market price is not available, fair value is estimated using quoted market prices for similar securities. Restricted equity securities are carried at cost because no market value is available.

Loans: The fair value is estimated for portfolios of loans with similar financial characteristics. Loans are segregated by type, such as commercial, mortgage, and consumer loans. The fair value of the loan portfolio is calculated by discounting contractual cash flows using estimated market discount rates which reflect the credit and interest rate risk inherent in the loan. The estimated fair value of the Subsidiary Banks' off-balance sheet commitments is nominal since the committed rates approximate current rates offered for commitments with similar rate and maturity characteristics and since the estimated credit risk associated with such commitments is not significant.

Derivative instruments: The fair value of derivative instruments, consisting of interest rate contracts, is equal to the estimated amount that the Company would receive or pay to terminate the derivative instruments at the reporting date, taking into account current interest rates and the credit-worthiness of the counterparties.

Deposit liabilities: The fair value of time deposits is estimated using the discounted value of contractual cash flows based on current rates offered for deposits of similar remaining maturities.

FHLB advances: The fair value is estimated using the discounted value of contractual cash flows based on current rates offered for debt of similar remaining maturities and/or termination values provided by the FHLB.

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THE SAVANNAH BANCORP, INC. AND SUBSIDIARIES

Notes to Consolidated Financial Statements (Continued)

Note 21 Fair Value of Financial Instruments (Continued)

The carrying amounts and estimated fair values of the Company's financial instruments are as follows as of December 31:

	2011		2010	
($ in thousands)	Carrying Value	Estimated Fair Value	Carrying Value	Estimated Fair Value
Financial assets:				
Cash and federal funds sold	$ 13,760	$ 13,760	$ 18,100	$ 18,100
Interest-bearing deposits	81,717	81,717	40,836	40,836
Securities available for sale	83,653	83,653	138,099	138,099
Loans, net of allowance for loan losses	737,761	727,714	806,212	800,785
Accrued interest receivable	3,103	3,103	3,789	3,789
Derivative asset positions	301	301	136	136
Financial liabilities:				
Deposits	846,929	851,700	923,745	929,271
Short-term borrowings	14,384	14,384	15,075	15,075
Other borrowings	8,581	8,581	10,536	10,536
FHLB advances	16,653	17,393	17,658	18,214
Subordinated debt to nonconsolidated subsidiaries	10,310	10,310	10,310	10,310
Accrued interest payable	687	687	1,108	1,108
Derivative liability positions	301	301	135	135

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THE SAVANNAH BANCORP, INC. AND SUBSIDIARIES

Notes to Consolidated Financial Statements (Continued)

Note 22 The Savannah Bancorp, Inc. (Parent Company Only) Financial Information ($ in thousands)

The following are condensed balance sheets of the Parent Company at December 31, 2011 and 2010:

	2011	2010
Assets		
Cash on deposit	**$ 15**	$ 60
Interest-bearing deposits	**917**	1,542
Investment in subsidiaries	**90,822**	92,031
Premises and equipment	**509**	554
Investment in nonconsolidated subsidiary	**940**	905
Other assets	**3,017**	2,625
Total assets	**$ 96,220**	$ 97,717
Liabilities		
Subordinated debt	**$ 10,310**	$ 10,310
Other liabilities	**1,780**	1,604
Total liabilities	**12,090**	11,914
Shareholders' equity		
Common stock	**7,201**	7,201
Additional paid-in capital	**48,656**	48,634
Retained earnings	**27,103**	29,275
Treasury stock	**(1)**	(1)
Accumulated other comprehensive income, net	**1,171**	694
Total shareholders' equity	**84,130**	85,803
Total liabilities and equity	**$ 96,220**	$ 97,717

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THE SAVANNAH BANCORP, INC. AND SUBSIDIARIES

Notes to Consolidated Financial Statements (Continued)

Note 22 The Savannah Bancorp, Inc. (Parent Company Only) Financial Information ($ in thousands) (Continued)

The operating results of the Parent Company are shown below for the three years ended December 31:

	2011	2010	2009
Dividends from subsidiaries	**$ 1,750**	$ 950	$ 4,200
Interest income	**9**	31	4
Interest expense	**303**	306	362
Net interest and dividend income	**1,456**	675	3,842
Other income	**83**	289	29
Processing/management fees	**4,804**	4,996	5,267
Total income	**6,343**	5,960	9,138
Corporate expenses	**590**	535	733
Processing/management costs	**4,933**	5,111	5,342
Other expenses	**5,523**	5,646	6,075
Income before income taxes and distributions in excess of earnings of subsidiaries	**820**	314	3,063
Income tax benefit	**340**	175	395
Income before distributions in excess of earnings of subsidiaries	**1,160**	489	3,458
Distributions in excess of earnings of subsidiaries	**(3,332)**	(4,478)	(2,529)
Net income (loss)	**$ (2,172)**	$ (3,989)	$ 929

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THE SAVANNAH BANCORP, INC. AND SUBSIDIARIES

Notes to Consolidated Financial Statements (Continued)

Note 22 The Savannah Bancorp, Inc. (Parent Company Only) Financial Information ($ in thousands) (Continued)

The cash flows of the Parent Company are shown below for the three years ended December 31:

	2011	2010	2009
Operating activities			
Net income (loss)	**$ (2,172)**	$ (3,989)	$ 929
Adjustments to reconcile net income (loss) to cash provided by operating activities:			
Distributions in excess of earnings of subsidiaries	**3,332**	4,478	2,529
Depreciation	**277**	343	449
Gain on sale of partnership interest		(255)	
Non cash stock-based compensation expense	**20**	79	144
Change in other assets and liabilities, net	**(252)**	(601)	(477)
Net cash provided by operating activities	**1,205**	55	3,574
Investing activities			
Proceeds from sale of partnership interest		694	
Purchase of equipment and software	**(232)**	(65)	(108)
Capital contribution to consolidated subsidiaries	**(1,645)**	(10,475)	(3,390)
Net cash used in investing activities	**(1,877)**	(9,846)	(3,498)
Financing activities			
Dividends paid		(119)	(1,098)
Issuance of common stock and exercise of options	**2**	11,247	
Issuance of treasury stock		3	
Net cash provided by (used in) financing activities	**2**	11,131	(1,098)
Increase (decrease) in cash and cash equivalents	**(670)**	1,340	(1,022)
Cash, beginning of year	**1,602**	262	1,284
Cash, end of year	**$ 932**	$ 1,602	$ 262

The Parent Company financial statements include the following intercompany items: interest-bearing deposits on the balance sheets; dividend income, interest income and processing/management fees on the statements of income. The investment in the nonconsolidated subsidiary on the balance sheet represents a 50 percent interest in a limited partnership which owns the headquarters building at 25 Bull Street, Savannah, GA.

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THE SAVANNAH BANCORP, INC. AND SUBSIDIARIES

Consolidated Balance Sheets

($ in thousands, except share data)

	September 30, 2012 (Unaudited)	December 31, 2011	September 30, 2011 (Unaudited)
Assets			
Cash and due from banks	**$ 11,906**	$ 13,225	$ 14,468
Federal funds sold	**670**	535	345
Interest-bearing deposits in banks	**90,400**	81,717	52,210
Cash and cash equivalents	**102,976**	95,477	67,023
Securities available for sale, at fair value (amortized cost of $77,263, $81,764 and $87,014)	**79,646**	83,653	89,145
Loans, net of allowance for loan losses of $18,110, $21,917 and $22,854	**667,085**	737,761	765,696
Premises and equipment, net	**13,842**	14,286	14,515
Other real estate owned	**11,820**	20,332	17,135
Bank-owned life insurance	**6,664**	6,510	6,459
Goodwill and other intangible assets, net	**3,394**	3,562	3,618
Deferred tax assets, net		11,074	10,265
Other assets	**10,840**	12,580	14,864
Total assets	**$ 896,267**	$ 985,235	$ 988,720
Liabilities			
Deposits:			
Noninterest-bearing	**$ 122,283**	$ 106,939	$ 96,294
Interest-bearing demand	**143,152**	147,716	136,555
Savings	**23,099**	20,062	20,508
Money market	**235,984**	255,285	268,933
Time deposits	**253,609**	316,927	323,783
Total deposits	**778,127**	846,929	846,073
Short-term borrowings	**14,206**	14,384	16,029
Other borrowings	**7,169**	8,581	9,160
Federal Home Loan Bank advances	**13,149**	16,653	16,654
Subordinated debt to nonconsolidated subsidiaries	**10,310**	10,310	10,310
Other liabilities	**5,435**	4,248	4,185
Total liabilities	**828,396**	901,105	902,411
Shareholders' equity			
Preferred stock, par value $1 per share:			
authorized 10,000,000 shares, none issued			
Common stock, par value $1 per share:			
shares authorized 20,000,000; issued 7,201,346	**7,201**	7,201	7,201
Additional paid-in capital	**48,681**	48,656	48,651
Retained earnings	**10,512**	27,103	29,137
Treasury stock, at cost, 2,109, 2,210 and 2,210 shares	**(1)**	(1)	(1)
Accumulated other comprehensive income, net	**1,478**	1,171	1,321
Total shareholders' equity	**67,871**	84,130	86,309

Total liabilities and shareholders' equity	**$**	**896,267**	$	985,235	$	988,720

The accompanying notes are an integral part of these consolidated financial statements.

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THE SAVANNAH BANCORP, INC. AND SUBSIDIARIES

Consolidated Statements of Operations

($ in thousands, except per share data)

(Unaudited)

	For the Three Months Ended September 30,		For the Nine Months Ended September 30,	
	2012	**2011**	**2012**	**2011**
Interest and dividend income				
Loans, including fees	**$ 9,009**	$ 10,535	**$ 28,341**	$ 31,852
Investment securities:				
Taxable	**430**	626	**1,337**	2,166
Tax-exempt	**58**	60	**178**	197
Dividends	**26**	14	**67**	48
Deposits with banks	**61**	25	**168**	84
Federal funds sold		1	**1**	3
Total interest and dividend income	**9,584**	11,261	**30,092**	34,350
Interest expense				
Deposits	**1,190**	1,877	**4,024**	6,342
Short-term and other borrowings	**159**	208	**509**	628
Federal Home Loan Bank advances	**67**	87	**224**	262
Subordinated debt	**80**	75	**242**	225
Total interest expense	**1,496**	2,247	**4,999**	7,457
Net interest income	**8,088**	9,014	**25,093**	26,893
Provision for loan losses	**3,800**	2,865	**11,080**	13,525
Net interest income after provision for loan losses	**4,288**	6,149	**14,013**	13,368
Noninterest income				
Trust and asset management fees	**707**	663	**2,054**	2,008
Service charges on deposit accounts	**330**	371	**1,026**	1,089
Mortgage related income, net	**76**	72	**178**	154
Gain on sale of securities	**(2)**	308	**21**	763
Other operating income	**437**	403	**1,331**	1,135
Total noninterest income	**1,548**	1,817	**4,610**	5,149
Noninterest expense				
Salaries and employee benefits	**2,844**	2,886	**8,769**	8,638
Occupancy and equipment	**919**	925	**2,650**	2,789
Information technology	**494**	428	**1,448**	1,246
FDIC deposit insurance	**356**	325	**1,103**	1,141
Loan collection and OREO costs	**313**	324	**962**	879
Amortization of intangibles	**56**	56	**168**	168
Loss on sales and write-downs of foreclosed assets	**1,488**	577	**3,578**	1,925
Other operating expense	**2,492**	897	**4,371**	2,854

Total noninterest expense	**8,962**	6,418	**23,049**	19,640
Income (loss) before income taxes	**(3,126)**	1,548	**(4,426)**	(1,123)
Income tax expense (benefit)	**12,850**	320	**12,165**	(985)
Net income (loss)	**$ (15,976)**	$ 1,228	**$ (16,591)**	$ (138)
Net income (loss) per share:				
Basic	**$ (2.22)**	$ 0.17	**$ (2.30)**	$ (0.02)
Diluted	**$ (2.22)**	$ 0.17	**$ (2.30)**	$ (0.02)

The accompanying notes are an integral part of these consolidated financial statements.

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THE SAVANNAH BANCORP, INC. AND SUBSIDIARIES

Consolidated Statements of Other Comprehensive Income (Loss)

($ in thousands, except per share data)

(Unaudited)

	For the Three Months Ended September 30,		For the Nine Months Ended September 30,	
	2012	**2011**	**2012**	**2011**
Net income (loss)	**$ (15,976)**	$ 1,228	**$ (16,591)**	$ (138)
Other comprehensive income (loss):				
Change in unrealized holding gains on securities available for sale arising during the period, net of tax of $74, $81, $195 and $675	**122**	132	**320**	1,100
Reclassification adjustment for net (gains) losses on securities available for sale included in net income (loss), net of tax of $(1), $117, $8 and $290	**1**	(191)	**(13)**	(473)
Other comprehensive income (loss)	**$ (15,853)**	$ 1,169	**$ (16,284)**	$ 489

The accompanying notes are an integral part of these consolidated financial statements.

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THE SAVANNAH BANCORP, INC. AND SUBSIDIARIES

Consolidated Statements of Changes in Shareholders' Equity

($ in thousands, except share data)

(Unaudited)

	For the Nine Months Ended September 30, 2012	2011
Common shares issued		
Shares, beginning of period	**7,201,346**	7,201,346
Common stock issued		
Shares, end of period	**7,201,346**	7,201,346
Treasury shares owned		
Shares, beginning of period	**2,210**	2,483
Treasury stock issued	**(101)**	(273)
Shares, end of period	**2,109**	2,210
Common stock		
Balance, beginning of period	**$ 7,201**	$ 7,201
Common stock issued		
Balance, end of period	**7,201**	7,201
Additional paid-in capital		
Balance, beginning of period	**48,656**	48,634
Common stock issued, net of issuance cost		2
Stock-based compensation, net	**25**	15
Balance, end of period	**48,681**	48,651
Retained earnings		
Balance, beginning of period	**27,103**	29,275
Net loss	**(16,591)**	(138)
Balance, end of period	**10,512**	29,137
Treasury stock		
Balance, beginning of period	**(1)**	(1)
Treasury stock issued		
Balance, end of period	**(1)**	(1)
Accumulated other comprehensive income, net		
Balance, beginning of period	**1,171**	694
Change in unrealized gains/losses on securities available for sale, net of reclassification adjustment	**307**	627

Balance, end of period		**1,478**		1,321
Total shareholders' equity	**$**	**67,871**	$	86,309

The accompanying notes are an integral part of these consolidated financial statements.

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THE SAVANNAH BANCORP, INC. AND SUBSIDIARIES

Consolidated Statements of Cash Flows

($ in thousands)

(Unaudited)

	For the Nine Months Ended September 30, 2012	2011
Operating activities		
Net loss	**$ (16,591)**	$ (138)
Adjustments to reconcile net loss to cash provided by operating activities:		
Provision for loan losses	**11,080**	13,525
Net amortization of securities	**905**	743
Depreciation and amortization	**974**	1,022
Non cash stock-based compensation expense	**25**	15
Decrease (increase) in deferred income taxes, net	**11,792**	(1,710)
Gain on sale of securities, net	**(21)**	(763)
Loss on sales and write-downs of foreclosed assets	**3,578**	1,925
Increase in CSV of bank-owned life insurance policies	**(154)**	(150)
Decrease in prepaid FDIC deposit insurance assessment	**913**	1,040
Decrease in income taxes receivable	**242**	335
Change in other assets and other liabilities, net	**866**	536
Net cash provided by operating activities	**13,609**	16,380
Investing activities		
Activity in available for sale securities:		
Purchases	**(23,701)**	(2,767)
Sales	**12,401**	38,200
Maturities and principal collections	**14,917**	14,553
Loan originations and principal collections, net	**56,896**	16,743
Proceeds from sales of foreclosed assets	**7,635**	4,387
Additions to premises and equipment	**(362)**	(313)
Net cash provided by investing activities	**67,786**	70,803
Financing activities		
Net increase in noninterest-bearing deposits	**15,344**	569
Net decrease in interest-bearing deposits	**(84,146)**	(78,241)
Net (decrease) increase in short-term borrowings	**(178)**	954
Net decrease in other borrowings	**(1,412)**	(1,376)
Net decrease in FHLB advances	**(3,504)**	(1,004)
Issuance of common stock, net of issuance costs		2
Net cash used in financing activities	**(73,896)**	(79,096)
Increase in cash and cash equivalents	**7,499**	8,087
Cash and cash equivalents, beginning of period	**95,477**	58,936
Cash and cash equivalents, end of period	**$ 102,976**	$ 67,023

The accompanying notes are an integral part of these consolidated financial statements.

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THE SAVANNAH BANCORP, INC. AND SUBSIDIARIES

Condensed Notes to Consolidated Financial Statements

For the Three and Nine Months Ended September 30, 2012 and 2011

(Unaudited)

Note 1 Basis of Presentation

The accompanying unaudited condensed consolidated financial statements of The Savannah Bancorp, Inc. (the "Company" or "SAVB") have been prepared in accordance with accounting principles generally accepted in the United States of America ("GAAP") for interim financial information and with the instructions to Securities and Exchange Commission ("SEC") Form 10-Q and Regulation S-X. Accordingly, they do not include all of the information and footnotes required by GAAP for complete financial statements. In the opinion of management, all adjustments (consisting of normal recurring accruals) considered necessary for a fair presentation have been included. Operating results for the three and nine month periods ended September 30, 2012, are not necessarily indicative of the results that may be expected for the year ending December 31, 2012. For further information, refer to the consolidated financial statements and footnotes thereto included in the Company's annual report on Form 10-K for the year ended December 31, 2011. Certain prior period balances and formats have been reclassified to conform to the current period presentation.

In preparing the consolidated financial statements in accordance with GAAP, management is required to make estimates and assumptions that affect the reported amounts of assets and liabilities and the disclosure of contingent assets and liabilities as of the date of the respective balance sheets and the reported amounts of revenues and expenses for the periods presented. Actual results could differ significantly from those estimates.

Recent Accounting Pronouncements

Accounting Standards Update ("ASU") No. 2011-04, "*Fair Value Measurement (Topic 820): Amendments to Achieve Common Fair Value Measurement and Disclosure Requirements in U.S. GAAP and IFRSs"* ("ASU 2011-04") amends the Fair Value Measurement topic of the Accounting Standards Codification by clarifying the application of existing fair value measurement and disclosure requirements and by changing particular principles or requirements for measuring fair value or for disclosing information about fair value measurements. The amendments were effective for the Company beginning January 1, 2012. The adoption of ASU 2011-04 did not have a material impact on the Company's financial position, results of operations or cash flows. See Note 6 for the required disclosures.

ASU No. 2011-08, "*Intangibles Goodwill and Other (Topic 350) Testing Goodwill for Impairment"* ("ASU 2011-08"), amends Topic 350 to permit entities to first assess qualitative factors to determine whether it is more likely than not that the fair value of a reporting unit is less than its carrying amount as a basis for determining whether it is necessary to perform the two-step goodwill impairment test described in Topic 350. The more-likely-than-not threshold is defined as having a likelihood of more than 50 percent. If, after assessing the totality of events or circumstances, an entity determines it is not more likely than not that the fair value of a reporting unit is less than its carrying amount, then performing the two-step impairment test is unnecessary. However, if an entity concludes otherwise, then it is required to perform the first step of the two-step impairment test by calculating the fair value of the reporting unit and comparing the fair value with the carrying amount of the reporting unit. If the carrying amount of the reporting unit exceeds its fair value, then the entity is required to perform the second step of the goodwill impairment test to measure the amount of impairment loss, if any.

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THE SAVANNAH BANCORP, INC. AND SUBSIDIARIES

Condensed Notes to Consolidated Financial Statements (Continued)

For the Three and Nine Months Ended September 30, 2012 and 2011

(Unaudited)

Note 1 Basis of Presentation (Continued)

ASU 2011-08 was effective for annual and interim impairment tests beginning after December 15, 2011, and did not have a significant impact on the Company's financial statements.

ASU No. 2011-11, *"Balance Sheet (Topic 210) Disclosures about Offsetting Assets and Liabilities"* ("ASU 2011-11") amends Topic 210 to require an entity to disclose both gross and net information about financial instruments, such as sales and repurchase agreements and reverse sale and repurchase agreements and securities borrowing/lending arrangements, and derivative instruments that are eligible for offset in the statement of financial position and/or subject to a master netting arrangement or similar agreement. ASU 2011-11 is effective for annual and interim periods beginning on January 1, 2013, and is not expected to have a significant impact on the Company's financial statements.

Note 2 Restrictions on Cash and Demand Balances Due from Banks and Interest-Bearing Bank Balances

The Savannah Bank, N.A. and Bryan Bank & Trust (collectively referred to as the "Subsidiary Banks") are required by the Federal Reserve Bank ("FRB") to maintain minimum cash reserves based on reserve requirements calculated on their deposit balances. Cash reserves of $601,000, $571,000 and $458,000 are required as of September 30, 2012, December 31, 2011 and September 30, 2011, respectively. At times, the Company pledges interest-bearing cash balances at the Federal Home Loan Bank of Atlanta ("FHLB") in addition to investment securities to secure public fund deposits and securities sold under repurchase agreements. The Company did not have any cash pledged at the FHLB at September 30, 2012, December 31, 2011 or September 30, 2011.

Note 3 Earnings (Loss) Per Share

Basic earnings (loss) per share represents net income (loss) divided by the weighted average number of common shares outstanding during the period. Diluted earnings (loss) per share reflect additional common shares that would have been outstanding if dilutive potential common shares had been issued, as well as any adjustment to income that would result from the assumed issuance. Potential dilutive common shares that may be issued by the Company relate solely to outstanding stock options, and are determined using the treasury stock method. For the three months and nine months ended September 30, 2012 and 2011 the Company did not have any dilutive shares.

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THE SAVANNAH BANCORP, INC. AND SUBSIDIARIES

Condensed Notes to Consolidated Financial Statements (Continued)

For the Three and Nine Months Ended September 30, 2012 and 2011

(Unaudited)

Note 3 Earnings (Loss) Per Share (Continued)

Earnings (loss) per common share have been computed based on the following:

(Amounts in thousands)	For the Three Months Ended September 30, 2012	2011	For the Nine Months Ended September 30, 2012	2011
Average number of common shares outstanding basic	7,199	7,199	7,199	7,199
Effect of dilutive options				
Average number of common shares outstanding diluted	7,199	7,199	7,199	7,199

Stock option shares in the amount of 134,502 and 138,306 at September 30, 2012 and 2011, respectively, were excluded from the diluted earnings per share calculation due to their anti-dilutive effect.

Note 4 Securities Available for Sale

The aggregate amortized cost and fair value of securities available for sale are as follows:

($ in thousands)	September 30, 2012 Amortized Cost	Unrealized Gains	Unrealized Losses	Fair Value
Investment securities:				
U.S. government-sponsored enterprises ("GSE")	$ 3,084	$ 6	$ (4)	$ 3,086
Mortgage-backed securities GSE	56,874	1,910	(45)	58,739
State and municipal securities	14,436	528	(12)	14,952
Restricted equity securities	2,869			2,869
Total investment securities	$ 77,263	$ 2,444	$ (61)	$ 79,646

($ in thousands)	December 31, 2011 Amortized Cost	Unrealized Gains	Unrealized Losses	Fair Value
Investment securities:				
U.S. government-sponsored enterprises	$ 1,433	$ 13	$	$ 1,446
Mortgage-backed securities GSE	66,464	1,583	(35)	68,012
State and municipal securities	10,329	339	(11)	10,657
Restricted equity securities	3,538			3,538
Total investment securities	$ 81,764	$ 1,935	$ (46)	$ 83,653

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THE SAVANNAH BANCORP, INC. AND SUBSIDIARIES

Condensed Notes to Consolidated Financial Statements (Continued)

For the Three and Nine Months Ended September 30, 2012 and 2011

(Unaudited)

Note 4 Securities Available for Sale (Continued)

The distribution of securities by contractual maturity at September 30, 2012 is shown below. Actual maturities may differ from contractual maturities because issuers have the right to call or prepay obligations with or without call or prepayment penalties.

($ in thousands)	Amortized Cost	Fair Value
Securities available for sale:		
Due in one year or less	$	$
Due after one year through five years	2,124	2,161
Due after five years through ten years	6,670	7,054
Due after ten years	8,726	8,823
Mortgage-backed securities GSE	56,874	58,739
Restricted equity securities	2,869	2,869
Total investment securities	$ 77,263	$ 79,646

The restricted equity securities consist solely of FHLB and FRB stock. These securities are carried at cost since they do not have readily determinable fair values due to their restricted nature.

The following table shows the gross unrealized losses and fair value of the Company's investments with unrealized losses that are not deemed to be other-than-temporarily impaired, aggregated by investment category and length of time that individual securities have been in a continuous unrealized loss position at September 30, 2012 and December 31, 2011. Available for sale securities that have been in a continuous unrealized loss position are as follows:

	September 30, 2012					
	Less Than 12 Months		12 Months or More		Total	
($ in thousands)	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses
U.S. government-sponsored enterprises	$ 1,996	$ (4)	$	$	$ 1,996	$ (4)
Mortgage-backed securities GSE	5,817	(45)			5,817	(45)
State and municipal securities	1,160	(12)			1,160	(12)
Total temporarily impaired securities	$ 8,973	$ (61)	$	$	$ 8,973	$ (61)

	December 31, 2011					
	Less Than 12 Months		12 Months or More		Total	
($ in thousands)	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses
Mortgage-backed securities GSE	$ 5,585	$ (35)	$	$	$ 5,585	$ (35)
State and municipal securities	800	(11)			800	(11)
Total temporarily impaired securities	$ 6,385	$ (46)	$	$	$ 6,385	$ (46)

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THE SAVANNAH BANCORP, INC. AND SUBSIDIARIES

Condensed Notes to Consolidated Financial Statements (Continued)

For the Three and Nine Months Ended September 30, 2012 and 2011

(Unaudited)

Note 4 Securities Available for Sale (Continued)

The unrealized losses at September 30, 2012 on the Company's investment in GSE agency and mortgage-backed securities were caused by interest rate increases. The Company purchased those investments at a premium relative to their face amount, and the contractual cash flows of those investments are guaranteed by an agency of the U.S. Government. Accordingly, it is expected that the securities would not be settled at a price less than the amortized cost bases of the Company's investments. The Company also has three municipal securities with unrealized losses for less than twelve months. Management has reviewed these bonds and believes that the decrease in value is due to interest rate fluctuations and not credit quality. All three of the municipal bonds are rated AA or higher. Because the decline in market value is attributable to changes in interest rates and not credit quality, and because the Company does not intend to sell the investments and it is not more likely than not that the Company will be required to sell the investments before recovery of their amortized cost bases, which may be maturity, the Company does not consider those investments to be other-than-temporarily impaired at September 30, 2012.

Note 5 Loans

The composition of the loan portfolio at September 30, 2012 and December 31, 2011 is presented below:

($ in thousands)	**September 30, 2012**	**Percent of Total**	**December 31, 2011**	**Percent of Total**
Commercial real estate				
Construction and development	$ 15,918	2.3%	$ 22,675	3.0%
Owner-occupied	105,103	15.3	110,900	14.6
Non owner-occupied	212,853	31.1	221,128	29.1
Residential real estate mortgage	282,621	41.3	324,365	42.7
Commercial	58,834	8.6	68,304	9.0
Installment and other consumer	9,866	1.4	12,306	1.6
Gross loans	685,195	100.0%	759,678	100.0%
Allowance for loan losses	(18,110)		(21,917)	
Net loans	$ 667,085		$ 737,761	

For purposes of the disclosures required pursuant to accounting standards, the loan portfolio was disaggregated into segments and then further disaggregated into classes for certain disclosures. A portfolio segment is defined as the level at which an entity develops and documents a systematic method for determining its allowance for loan losses. There are four loan portfolio segments that include commercial real estate, residential real estate-mortgage, commercial and installment and other consumer. Commercial real estate has three classes including construction and development, owner-occupied and non owner-occupied. The construction and development class includes residential and commercial construction and development loans. Land and lot development loans are included in the non owner-occupied commercial real estate class or residential real estate segment depending on the property type.

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THE SAVANNAH BANCORP, INC. AND SUBSIDIARIES

Condensed Notes to Consolidated Financial Statements (Continued)

For the Three and Nine Months Ended September 30, 2012 and 2011

(Unaudited)

Note 5 Loans (Continued)

The following table details the change in the allowance for loan losses from July 1, 2012 to September 30, 2012 on the basis of the Company's impairment methodology by loan segment:

($ in thousands)	Commercial Real Estate	Residential Real Estate	Commercial	Consumer	Unallocated	Total
Allowance for loan losses						
Beginning balance	$ 7,599	$ 13,872	$ 1,045	$ 214	$ 46	$ 22,776
Charge-offs	(1,646)	(6,539)	(416)	(18)		(8,619)
Recoveries	17	81	38	17		153
Provision	590	2,752	470	11	(23)	3,800
Ending balance	$ 6,560	$ 10,166	$ 1,137	$ 224	$ 23	$ 18,110

The following table details the change in the allowance for loan losses from January 1, 2012 to September 30, 2012 on the basis of the Company's impairment methodology by loan segment:

($ in thousands)	Commercial Real Estate	Residential Real Estate	Commercial	Consumer	Unallocated	Total
Allowance for loan losses						
Beginning balance	$ 6,162	$ 14,195	$ 1,271	$ 193	$ 96	$ 21,917
Charge-offs	(2,298)	(11,977)	(1,017)	(221)		(15,513)
Recoveries	53	371	157	45		626
Provision	2,643	7,577	726	207	(73)	11,080
Ending balance	$ 6,560	$ 10,166	$ 1,137	$ 224	$ 23	$ 18,110

The following table details the change in the allowance for loan losses from July 1, 2011 to September 30, 2011 by loan segment:

($ in thousands)	Commercial Real Estate	Residential Real Estate	Commercial	Consumer	Unallocated	Total
Allowance for loan losses						
Beginning balance	$ 7,053	$ 14,592	$ 1,382	$ 209	$ 287	$ 23,523
Charge-offs	(1,038)	(2,752)	(24)	(11)		(3,825)
Recoveries		276	5	10		291
Provision	560	2,377	(51)	184	(205)	2,865
Ending balance	$ 6,575	$ 14,493	$ 1,312	$ 392	$ 82	$ 22,854

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THE SAVANNAH BANCORP, INC. AND SUBSIDIARIES

Condensed Notes to Consolidated Financial Statements (Continued)

For the Three and Nine Months Ended September 30, 2012 and 2011

(Unaudited)

Note 5 Loans (Continued)

The following table details the change in the allowance for loan losses from January 1, 2011 to September 30, 2011 by loan segment:

($ in thousands)	Commercial Real Estate	Residential Real Estate	Commercial	Consumer	Unallocated	Total
Allowance for loan losses						
Beginning balance	$ 4,722	$ 13,582	$ 1,528	$ 518	$	$ 20,350
Charge-offs	(2,127)	(8,579)	(670)	(71)		(11,447)
Recoveries	20	363	22	21		426
Provision	3,960	9,127	432	(76)	82	13,525
Ending balance	$ 6,575	$ 14,493	$ 1,312	$ 392	$ 82	$ 22,854

The following table details the allowance for loan losses at September 30, 2012 on the basis of the Company's impairment methodology by loan segment:

($ in thousands)	Commercial Real Estate	Residential Real Estate	Commercial	Consumer	Unallocated	Total
Allowance for loan losses						
Ending balance	$ 6,560	$ 10,166	$ 1,137	$ 224	$ 23	$ 18,110
Ending balance: individually evaluated for impairment	$ 1,597	$ 1,975	$ 276	$ 16	$	$ 3,864
Ending balance: collectively evaluated for impairment	$ 4,963	$ 8,191	$ 861	$ 208	$ 23	$ 14,246
Loans						
Ending balance	$ 333,874	$ 282,621	$ 58,834	$ 9,866	$	$ 685,195
Ending balance: individually evaluated for impairment	$ 11,204	$ 21,376	$ 276	$ 16	$	$ 32,872
Ending balance: collectively evaluated for impairment	$ 322,670	$ 261,245	$ 58,558	$ 9,850	$	$ 652,323

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THE SAVANNAH BANCORP, INC. AND SUBSIDIARIES

Condensed Notes to Consolidated Financial Statements (Continued)

For the Three and Nine Months Ended September 30, 2012 and 2011

(Unaudited)

Note 5 Loans (Continued)

The following table details the allowance for loan losses at December 31, 2011 on the basis of the Company's impairment methodology by loan segment:

($ in thousands)	Commercial Real Estate	Residential Real Estate	Commercial	Consumer	Unallocated	Total
Allowance for loan losses						
Ending balance	$ 6,162	$ 14,195	$ 1,271	$ 193	$ 96	$ 21,917
Ending balance: individually evaluated for impairment	$ 1,108	$ 5,813	$ 145	$	$	$ 7,066
Ending balance: collectively evaluated for impairment	$ 5,054	$ 8,382	$ 1,126	$ 193	$ 96	$ 14,851
Loans						
Ending balance	$ 354,703	$ 324,365	$ 68,304	$ 12,306	$	$ 759,678
Ending balance: individually evaluated for impairment	$ 10,936	$ 24,941	$ 522	$	$	$ 36,399
Ending balance: collectively evaluated for impairment	$ 343,767	$ 299,424	$ 67,782	$ 12,306	$	$ 723,279

A loan is considered impaired, in accordance with the impairment accounting guidance, when based on current information and events, it is probable that the Company will be unable to collect all amounts due from the borrower in accordance with the contractual term of the loan. Impaired loans include loans modified in troubled debt restructurings ("TDRs") where concessions have been granted to borrowers experiencing financial difficulties. These concessions could include a reduction in the interest rate on the loan, payment extensions, forgiveness of principal, forbearance or other actions intended to maximize collection.

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THE SAVANNAH BANCORP, INC. AND SUBSIDIARIES

Condensed Notes to Consolidated Financial Statements (Continued)

For the Three and Nine Months Ended September 30, 2012 and 2011

(Unaudited)

Note 5 Loans (Continued)

The following is a summary of information pertaining to impaired loans as of and for the period ended September 30, 2012:

($ in thousands)	Recorded Investment	Unpaid Principal Balance	Related Allowance
Impaired loans without a valuation allowance			
Commercial real estate			
Construction and development	$ 458	$ 2,929	$
Owner-occupied	1,371	1,667	
Non owner-occupied	3,267	3,689	
Residential real estate mortgage	15,398	30,076	
Commercial			
Installment and other consumer			
Total impaired loans without a valuation allowance	20,494	38,361	
Impaired loans with a valuation allowance			
Commercial real estate			
Construction and development	35	35	35
Owner-occupied	1,269	1,300	301
Non owner-occupied	8,738	8,823	1,597
Residential real estate mortgage	12,950	13,890	2,602
Commercial	389	452	287
Installment and other consumer	120	123	29
Total impaired loans with a valuation allowance	23,501	24,623	4,851
Total impaired loans	$ 43,995	$ 62,984	$ 4,851
Average investment in impaired loans for the quarter	$ 43,246		
Income recognized on impaired loans for the quarter	$ 175		
Average investment in impaired loans for the nine months	$ 45,041		
Income recognized on impaired loans for the nine months	$ 461		

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THE SAVANNAH BANCORP, INC. AND SUBSIDIARIES

Condensed Notes to Consolidated Financial Statements (Continued)

For the Three and Nine Months Ended September 30, 2012 and 2011

(Unaudited)

Note 5 Loans (Continued)

The following is a summary of information pertaining to impaired loans as of and for the year ended December 31, 2011:

($ in thousands)	Recorded Investment	Unpaid Principal Balance	Related Allowance
Impaired loans without a valuation allowance			
Commercial real estate			
Construction and development	$	$	$
Owner-occupied	710	758	
Non owner-occupied	5,998	6,507	
Residential real estate mortgage	12,940	19,556	
Commercial	294	351	
Total impaired loans without a valuation allowance	19,492	27,172	
Impaired loans with a valuation allowance			
Commercial real estate			
Construction and development	2,325	3,325	751
Owner-occupied	2,946	3,034	425
Non owner-occupied	3,239	3,742	481
Residential real estate mortgage	22,889	24,958	6,776
Commercial	721	778	215
Installment and other consumer	99	103	13
Total impaired loans with a valuation allowance	32,219	35,940	8,661
Total impaired loans	$ 51,711	$ 63,112	$ 8,661
Average investment in impaired loans for the year	$ 55,324		
Income recognized on impaired loans for the year	$ 818		

For the three and nine months ended September 30, 2011, the Company had an average investment of $60,717,000 and $58,123,000, respectively, in impaired loans and recognized interest income of $191,000 and $648,000, respectively, on impaired loans.

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THE SAVANNAH BANCORP, INC. AND SUBSIDIARIES

Condensed Notes to Consolidated Financial Statements (Continued)

For the Three and Nine Months Ended September 30, 2012 and 2011

(Unaudited)

Note 5 Loans (Continued)

The following table presents the aging of the recorded investment in past due loans as of September 30, 2012 by class of loans:

($ in thousands)	30-59 days past due	60-89 days past due	Accruing greater than 90 days past due	Nonaccrual	Total past due and nonaccrual
Commercial real estate					
Construction and development	$	$ 35	$	$ 458	$ 493
Owner-occupied	238			1,988	2,226
Non owner-occupied	1,366	2,707	145	7,649	11,867
Residential real estate mortgage	5,317	2,220	217	17,510	25,264
Commercial	67		6	356	429
Installment and other consumer	81	29		21	131
Total	$ 7,069	$ 4,991	$ 368	$ 27,982	$ 40,410

The following table presents the aging of the recorded investment in past due loans as of December 31, 2011 by class of loans:

($ in thousands)	30-59 days past due	60-89 days past due	Accruing greater than 90 days past due	Nonaccrual	Total past due and nonaccrual
Commercial real estate					
Construction and development	$	$	$	$ 2,325	$ 2,325
Owner-occupied	77	931		1,232	2,240
Non owner-occupied	1,217	260		7,054	8,531
Residential real estate mortgage	10,322	2,107	213	23,376	36,018
Commercial	23	162		652	837
Installment and other consumer	20	13		29	62
Total	$ 11,659	$ 3,473	$ 213	$ 34,668	$ 50,013

Internal risk-rating grades are assigned to each loan by lending or credit administration, based on an analysis of the financial and collateral strength and other credit attributes underlying each loan. Management analyzes the resulting ratings, as well as other external statistics and factors, such as delinquency, to track the migration performance of the portfolio balances. Loan grades range between 1 and 8, with 1 being loans with the least credit risk. Loans that migrate toward the "Pass" grade (those with a risk rating between 1 and 4) or within the "Pass" grade generally have a lower risk of loss

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THE SAVANNAH BANCORP, INC. AND SUBSIDIARIES

Condensed Notes to Consolidated Financial Statements (Continued)

For the Three and Nine Months Ended September 30, 2012 and 2011

(Unaudited)

Note 5 Loans (Continued)

and therefore a lower risk factor. The "Special Mention" grade (those with a risk rating of 5) is utilized on a temporary basis for "Pass" grade loans where a significant risk-modifying action is anticipated in the near term. Substantially all of the "Special Mention" loans are performing. Loans that migrate toward the "Substandard" or higher grade (those with a risk rating between 6 and 8) generally have a higher risk of loss and therefore a higher risk factor applied to those related loan balances.

The following tables present the Company's loan portfolio by risk-rating grades:

	September 30, 2012					
($ in thousands)	Pass (1-4)	Special Mention (5)	Sub-standard (6)	Doubtful (7)	Loss (8)	Total
Commercial real estate						
Construction and development	$ 15,348	$	$ 570	$	$	$ 15,918
Owner-occupied	97,038	4,063	4,002			105,103
Non owner-occupied	192,943	7,358	12,552			212,853
Residential real estate mortgage	229,048	19,473	34,100			282,621
Commercial	56,794	538	1,502			58,834
Installment and other consumer	9,531	53	282			9,866
Total	$ 600,702	$ 31,485	$ 53,008	$	$	$ 685,195

	December 31, 2011					
($ in thousands)	Pass (1-4)	Special Mention (5)	Sub-standard (6)	Doubtful (7)	Loss (8)	Total
Commercial real estate						
Construction and development	$ 19,749	$ 147	$ 2,779	$	$	$ 22,675
Owner-occupied	101,004	3,444	6,452			110,900
Non owner-occupied	201,960	4,833	14,335			221,128
Residential real estate mortgage	260,301	19,190	44,874			324,365
Commercial	64,406	622	3,276			68,304
Installment and other consumer	11,760	67	479			12,306
Total	$ 659,180	$ 28,303	$ 72,195	$	$	$ 759,678

TDRs of $9.6 million and $16.1 million were performing to their agreed terms at September 30, 2012 and December 31, 2011, respectively. There was approximately $790,000 and $2.0 million, respectively, in specific reserves established for these loans at September 30, 2012 and December 31,

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THE SAVANNAH BANCORP, INC. AND SUBSIDIARIES

Condensed Notes to Consolidated Financial Statements (Continued)

For the Three and Nine Months Ended September 30, 2012 and 2011

(Unaudited)

Note 5 Loans (Continued)

2011. The total amount of TDRs that subsequently defaulted at September 30, 2012 and December 31, 2011 was $6.6 million and $11.2 million, respectively. There was $662,000 and $4.2 million, respectively, in specific reserves established for these loans at September 30, 2012 and December 31, 2011. The Company has committed to lend additional amounts totaling up to $79,000 as of September 30, 2012 to customers with outstanding loans that are classified as TDRs.

During the three and nine month periods ended September 30, 2012, the terms of certain loans were modified as TDRs. The modification of the terms of such loans included one or a combination of the following: a reduction of the stated interest rate of the loan; an extension of the maturity date at a stated rate of interest lower than the current market rate for new debt with similar risk; or a permanent reduction of the recorded investment in the loan. The following tables presents additional information on TDRs including the number of loan contracts restructured and the pre- and post-modification recorded investment for the three and nine months ended September 30, 2012. There was a specific reserve for $131,000 established for one of the loans that was restructured during the three months ended September 30, 2012. None of the other loans restructured during 2012 have any specific reserves established for them.

	Three Months Ended September 30, 2012		
($ in thousands)	Number of Contracts	Pre-Modification Outstanding Recorded Investment	Post-Modification Outstanding Recorded Investment
Troubled debt restructurings			
Commercial real estate			
Construction and development	0	$	$
Residential real estate mortgage	2	951	720
Commercial	0		
Installment and other consumer	1	19	19
Total	3	$ 970	$ 739

	Nine Months Ended September 30, 2012		
($ in thousands)	Number of Contracts	Pre-Modification Outstanding Recorded Investment	Post-Modification Outstanding Recorded Investment
Troubled debt restructurings			
Commercial real estate			
Construction and development	0	$	$
Residential real estate mortgage	5	1,178	959
Commercial	1	11	11
Installment and other consumer	1	19	19
Total	7	$ 1,208	$ 989

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THE SAVANNAH BANCORP, INC. AND SUBSIDIARIES

Condensed Notes to Consolidated Financial Statements (Continued)

For the Three and Nine Months Ended September 30, 2012 and 2011

(Unaudited)

Note 5 Loans (Continued)

There was one loan that was restructured over the past twelve months that did not repay all amounts due on their restructured terms within the three and nine months ended September 30, 2012. The Company restructured a commercial loan in 2011 with a balance of $337,000 and accepted a discounted payoff in the first quarter of 2012. The Company received funds of approximately $250,000 and charged-off the remaining balance of approximately $87,000.

Note 6 Fair Value of Financial Instruments

Determination of Fair Value

The Company uses fair value measurements to record fair value adjustments to certain assets and liabilities and to determine fair value disclosures. In accordance with the accounting standards for fair value measurements and disclosure, the fair value of a financial instrument is the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date. Fair value is best determined based upon quoted market prices. However, in many instances, there are no quoted market prices for the Company's various financial instruments. In cases where quoted market prices are not available, fair values are based on estimates using present value or other valuation techniques. Those techniques are significantly affected by the assumptions used, including the discount rate and estimates of future cash flows. Accordingly, the fair value estimates may not be realized in an immediate settlement of the instrument.

The fair value guidance provides a consistent definition of fair value, which focuses on exit price in an orderly transaction (that is, not a forced liquidation or distressed sale) between market participants at the measurement date under current market conditions. If there has been a significant decrease in the volume and level of activity for the asset or liability, a change in valuation technique or the use of multiple valuation techniques may be appropriate. In such instances, determining the price at which willing market participants would transact at the measurement date under current market conditions depends on the facts and circumstances and requires the use of significant judgment. The fair value is a reasonable point within the range that is most representative of fair value under current market conditions.

In accordance with this guidance, the Company groups its financial assets and financial liabilities generally measured at fair value in three levels, based on the markets in which the assets and liabilities are traded and the reliability of the assumptions used to determine fair value:

Level 1: Quoted prices (unadjusted) for identical assets or liabilities in active markets that the entity has the ability to access as of the measurement date.

Level 2: Significant other observable inputs other than Level 1 prices, such as quoted prices for similar assets or liabilities, quoted prices in markets that are not active, and other inputs that are observable or can be corroborated by observable market data. Generally, this includes U.S. Government and sponsored entity mortgage-backed securities, corporate debt securities and derivative contracts.

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THE SAVANNAH BANCORP, INC. AND SUBSIDIARIES

Condensed Notes to Consolidated Financial Statements (Continued)

For the Three and Nine Months Ended September 30, 2012 and 2011

(Unaudited)

Note 6 Fair Value of Financial Instruments (Continued)

Level 3: Significant unobservable inputs that are supported by little or no market activity for the asset or liability. Level 3 assets and liabilities include financial instruments whose value is determined using pricing models, discounted cash flow methodologies, or similar techniques, as well as instruments for which determination of fair value requires significant management judgment or estimation.

Recurring Fair Value Changes

Following is a description of the valuation methodologies used for instruments measured at fair value on a recurring basis and recognized in the accompanying balance sheet, as well as the general classification of such instruments pursuant to the valuation hierarchy.

Investment securities: The fair values of securities available for sale are determined by obtaining quoted prices on nationally recognized securities exchanges or matrix pricing, which is a mathematical technique used widely in the industry to value debt securities without relying exclusively on quoted prices for the specific securities but rather by relying on the securities' relationship to other benchmark quoted securities. All of the Company's investment securities are classified as Level 2, except for its restricted equity securities that are considered to be Level 3.

Derivative instruments: The derivative instruments consist of loan level swaps. As such, significant fair value inputs can generally be verified and do not typically involve significant judgments by management.

Assets and liabilities measured at fair value on a recurring basis are summarized below:

		Fair Value Measurements at September 30, 2012 Using		
($ in thousands)	Carrying Value	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
Investment securities	$ 79,646	$	$ 76,777	$ 2,869
Derivative asset positions	334		334	
Derivative liability positions	334		334	

	Carrying	Fair Value Measurements at December 31, 2011 Using		
($ in thousands)	Value	Level 1	Level 2	Level 3
Investment securities	$ 83,653	$	$ 80,115	$ 3,538
Derivative asset positions	301		301	
Derivative liability positions	301		301	

The Level 3 securities consist of FHLB and FRB stock. The change in the period was solely due to a partial redemption of FHLB stock.

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THE SAVANNAH BANCORP, INC. AND SUBSIDIARIES

Condensed Notes to Consolidated Financial Statements (Continued)

For the Three and Nine Months Ended September 30, 2012 and 2011

(Unaudited)

Note 6 Fair Value of Financial Instruments (Continued)

Nonrecurring Fair Value Changes

Certain assets and liabilities are measured at fair value on a nonrecurring basis. These instruments are not measured at fair value on an ongoing basis, but are subject to fair value in certain circumstances, such as when there is evidence of impairment that may require write-downs. The write-downs for the Company's more significant assets or liabilities measured on a nonrecurring basis are based on the lower of amortized cost or estimated fair value.

Impaired loans and other real estate owned ("OREO"): Impaired loans and OREO are evaluated and valued at the time the loan or OREO is identified as impaired. Impaired loans are valued at the lower of cost or market value and OREO is recorded at market value. Market value is measured based on the value of the collateral securing these loans or OREO and is classified at a Level 3 in the fair value hierarchy. Collateral for impaired loans may be real estate and/or business assets, including equipment, inventory and/or accounts receivable. The fair value of an impaired loan is generally determined based on real estate appraisals or other independent evaluations by qualified professionals. Impaired loans and OREO are reviewed and evaluated on at least a quarterly basis for additional impairment and adjusted accordingly based on the same factors identified above. Impaired loans measured on a nonrecurring basis do not include pools of impaired loans.

Assets and liabilities with an impairment charge during the current period and measured at fair value on a nonrecurring basis are summarized below:

	Carrying Values at September 30, 2012				
($ in thousands)	**Total**	**Level 1**	**Level 2**	**Level 3**	**Total loss**
Impaired loans	$ 11,977	$	$	$ 11,977	$ (9,403)
OREO	4,132			4,132	(1,477)

	Carrying Values at December 31, 2011				
($ in thousands)	**Total**	**Level 1**	**Level 2**	**Level 3**	**Total loss**
Impaired loans	$ 11,541	$	$	$ 11,541	$ (6,091)
OREO	7,323			7,323	(1,880)

Fair Value Disclosures

Accounting standards require the disclosure of the estimated fair value of financial instruments including those financial instruments for which the Company did not elect the fair value option. The fair value represents management's best estimates based on a range of methodologies and assumptions.

Cash and federal funds sold, interest-bearing deposits in banks, accrued interest receivable, all non-maturity deposits, short-term borrowings, other borrowings, subordinated debt and accrued interest payable have carrying amounts which approximate fair value primarily because of the short repricing opportunities of these instruments.

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THE SAVANNAH BANCORP, INC. AND SUBSIDIARIES

Condensed Notes to Consolidated Financial Statements (Continued)

For the Three and Nine Months Ended September 30, 2012 and 2011

(Unaudited)

Note 6 Fair Value of Financial Instruments (Continued)

Following is a description of the methods and assumptions used by the Company to estimate the fair value of its other financial instruments:

Investment securities: Fair value is based upon quoted market prices, if available. If a quoted market price is not available, fair value is estimated using quoted market prices for similar securities. Restricted equity securities are carried at cost because no market value is available.

Loans: The fair value is estimated for portfolios of loans with similar financial characteristics. Loans are segregated by type, such as commercial, mortgage, and consumer loans. The fair value of the loan portfolio is calculated by discounting contractual cash flows using estimated market discount rates which reflect the credit and interest rate risk inherent in the loan. The estimated fair value of the Subsidiary Banks' off-balance sheet commitments is nominal since the committed rates approximate current rates offered for commitments with similar rate and maturity characteristics and since the estimated credit risk associated with such commitments is not significant.

Derivative instruments: The fair value of derivative instruments, consisting of interest rate contracts, is equal to the estimated amount that the Company would receive or pay to terminate the derivative instruments at the reporting date, taking into account current interest rates and the credit-worthiness of the counterparties.

Deposit liabilities: The fair value of time deposits is estimated using the discounted value of contractual cash flows based on current rates offered for deposits of similar remaining maturities.

FHLB advances: The fair value is estimated using the discounted value of contractual cash flows based on current rates offered for advances of similar remaining maturities and/or termination values provided by the FHLB.

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THE SAVANNAH BANCORP, INC. AND SUBSIDIARIES

Condensed Notes to Consolidated Financial Statements (Continued)

For the Three and Nine Months Ended September 30, 2012 and 2011

(Unaudited)

Note 6 Fair Value of Financial Instruments (Continued)

The carrying amounts and estimated fair values of the Company's financial instruments are as follows:

September 30, 2012					
			Fair Value Measurement		
($ in thousands)	Carrying Value	Estimated Fair Value	Level 1	Level 2	Level 3
Financial assets:					
Cash and federal funds sold	$ 12,576	$ 12,576	$ 12,576	$	$
Interest-bearing deposits	90,400	90,400	90,400		
Securities available for sale	79,646	79,646		76,777	2,869
Loans, net of allowance for loan losses	667,085	654,440			654,440
Accrued interest receivable	2,640	2,640	2,640		
Derivative asset positions	334	334		334	
Financial liabilities:					
Deposits	778,127	781,823		524,518	257,305
Short-term borrowings	14,206	14,206		14,206	
Other borrowings	7,169	7,169		7,169	
FHLB advances	13,149	13,949		13,949	
Subordinated debt to nonconsolidated subsidiaries	10,310	10,310		10,310	
Accrued interest payable	486	486	486		
Derivative liability positions	334	334		334	

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THE SAVANNAH BANCORP, INC. AND SUBSIDIARIES

Condensed Notes to Consolidated Financial Statements (Continued)

For the Three and Nine Months Ended September 30, 2012 and 2011

(Unaudited)

Note 6 Fair Value of Financial Instruments (Continued)

($ in thousands)	December 31, 2011 Carrying Value	Estimated Fair Value
Financial assets:		
Cash and federal funds sold	$ 13,760	$ 13,760
Interest-bearing deposits	81,717	81,717
Securities available for sale	83,653	83,653
Loans, net of allowance for loan losses	737,761	727,714
Accrued interest receivable	3,103	3,103
Derivative asset positions	301	301
Financial liabilities:		
Deposits	846,929	851,700
Short-term borrowings	14,384	14,384
Other borrowings	8,581	8,581
FHLB advances	16,653	17,393
Subordinated debt to nonconsolidated subsidiaries	10,310	10,310
Accrued interest payable	687	687
Derivative liability positions	301	301

Note 7 Reconciliation of Non-GAAP Financial Measures

Below is the reconciliation from GAAP income (loss) before income taxes to the pre-tax core earnings measure that is discussed in Management's Discussion and Analysis on pages 29-31.

($ in thousands)	For the Three Months Ended September 30, 2012	2011	For the Nine Months Ended September 30, 2012	2011
Pre-tax core earnings				
Income (loss) before income taxes	$ (3,126)	$ 1,548	$ (4,426)	$ (1,123)
Add: Provision for loan losses	3,800	2,865	11,080	13,525
Add: Losses on foreclosed assets	1,488	577	3,578	1,925
Add: Expenses related to the merger and other strategic initiatives	1,474		1,474	
Add: (Gain) loss on sale of securities	2	(308)	(21)	(763)
Pre-tax core earnings	$ 3,638	$ 4,682	$ 11,685	$ 13,564

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THE SAVANNAH BANCORP, INC. AND SUBSIDIARIES

Condensed Notes to Consolidated Financial Statements (Continued)

For the Three and Nine Months Ended September 30, 2012 and 2011

(Unaudited)

Note 7 Reconciliation of Non-GAAP Financial Measures (Continued)

Below is the reconciliation from the GAAP measure of book value per share to tangible book value per share. This ratio is disclosed in the third quarter financial highlights on page 23.

	September 30,	
	2012	2011
Tangible book value per share		
Book value per share	$ 9.43	$ 11.99
Less: Effect to adjust for intangible assets	0.47	0.50
Tangible book value per share	$ 8.96	$ 11.49

Below is the reconciliation from the GAAP measure of equity to assets to tangible equity to tangible assets. This ratio is disclosed in the capital resources section on page 33.

	September 30,	
	2012	2011
Tangible equity to tangible assets		
Equity to assets	7.57%	8.73%
Less: Effect to adjust for intangible assets	0.35%	0.34%
Tangible equity to tangible assets	7.22%	8.39%

Note 8 Proposed Merger with SCBT Financial Corporation

On August 8, 2012, the Company and SCBT Financial Corporation ("SCBT Financial") jointly announced the entry into a definitive merger agreement, dated as of August 7, 2012, under which SCBT Financial will acquire the Company.

Under the terms of the agreement, the Company's shareholders will receive 0.2503 shares of SCBT Financial common stock for each share of SAVB common stock. The stock issuance is valued at approximately $67.1 million in the aggregate, based on 7,199,237 shares of SAVB common stock outstanding and on SCBT Financial's August 7, 2012 closing stock price of $37.21.

The merger agreement has been unanimously approved by the board of directors of each company. The transaction is expected to close in the fourth quarter of 2012 and is subject to customary conditions, including approval by both SCBT Financial and SAVB shareholders. At closing, the Company will be merged into SCBT Financial.

Note 9 Deferred Tax Assets

As a result of entering into the merger agreement with SCBT Financial, and thus contractually agreeing to forego certain other strategic initiatives that the Company had previously intended to pursue, the positive evidence considered in support of the Company's use of forecasted future earnings as a source of realizing deferred tax assets became insufficient to overcome the negative evidence associated with its pre-tax cumulative loss position. In assessing the need for a valuation allowance, the

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THE SAVANNAH BANCORP, INC. AND SUBSIDIARIES

Condensed Notes to Consolidated Financial Statements (Continued)

For the Three and Nine Months Ended September 30, 2012 and 2011

(Unaudited)

Note 9 Deferred Tax Assets (Continued)

Company considered all available evidence about the realization of deferred tax assets, both positive and negative, that could be objectively verified. Accordingly, the Company recorded a valuation allowance against its deferred tax assets through income tax expense in the amount of approximately $13.8 million during the quarter ending September 30, 2012. This impairment did not have a material effect on the regulatory capital ratios of the Company or its subsidiaries, in that a significant portion of this deferred tax asset was already disallowed for regulatory capital purposes.

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Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations

Forward-Looking Statements

The Company may, from time to time, make written or oral "forward-looking statements" within the meaning of federal securities laws, including statements contained in the Company's filings with the Securities and Exchange Commission ("SEC") (including this quarterly report on Form 10-Q) and in its reports to shareholders and in other communications by the Company.

These forward-looking statements may include, among others, statements about our beliefs, plans, objectives, goals, expectations, estimates and intentions that are subject to significant risks and uncertainties and which may change based on various factors, many of which are beyond our control. The words "may," "could," "should," "would," "will," "believe," "anticipate," "estimate," "expect," "intend," "indicate," "plan" and similar words are intended to identify expressions of the future. These forward-looking statements involve risks and uncertainties, such as statements of the Company's plans, objectives, expectations, estimates and intentions that are subject to change based on various important factors (some of which are beyond the Company's control). The following factors, among others, could cause the Company's financial performance to differ materially from the plans, objectives, expectations, estimates and intentions expressed in such forward-looking statements: the strength of the United States economy in general and the strength of the local economies in which the Company conducts operations; the effects of, and changes in, trade, monetary and fiscal policies and laws, including interest rate policies of the Board of Governors of the Federal Reserve System; inflation, interest rates, market and monetary fluctuations; competitors' products and services; technological changes; cyber security risks; changes in consumer spending and saving habits; deterioration in credit quality; continuing declines in the values of residential and commercial real estate or continuing weakness in the residential and commercial real estate environment generally; risk that our allowance for loan losses may prove to be inadequate or may be negatively affected by credit risk exposures; the concentration in our nonperforming assets by loan type, in certain geographic regions and with affiliated borrowing groups; future availability and cost of capital on favorable terms, if at all; changes in the cost and availability of funding from historical and alternative sources of liquidity; the potential for additional regulatory restrictions on our operations; changes to our reputation; future departures of key personnel; the cost and other affects of material contingencies, including litigation contingencies; changes to the availability of a deferred tax asset; the possibility that the proposed merger (the "Merger") with SCBT Financial Corporation ("SCBT Financial") does not close when expected or at all because required regulatory, shareholder or other approvals and other conditions to closing are not received or satisfied on a timely basis, or at all; the terms of the proposed Merger may need to be unfavorably modified to satisfy such approvals or conditions; the anticipated benefits from the proposed Merger are not realized in the time frame anticipated or at all as a result of changes in general economic and market conditions, interest and exchange rates, monetary policy, laws and regulations (including changes to capital requirements) and their enforcement, and the degree of competition in the geographic and business areas in which the companies operate; the potential inability to promptly and effectively integrate the businesses of the Company and SCBT Financial; reputational risks and the reaction of the companies' customers to the proposed Merger; diversion of management time on Merger-related issues; the success of the Company at managing the risks involved in the foregoing; and other factors and other information contained in this Report and in other reports and filings that we make with the SEC, including, without limitation, the items described in Item 1A of the Company's Annual Report on Form 10-K for the year ended December 31, 2011.

The Company cautions that the foregoing list of important risk factors is not exhaustive. The Company does not undertake to update any forward-looking statement, whether written or oral, that may be made from time to time by or on behalf of the Company, except as required by law.

Overview

For a comprehensive presentation of the Company's financial condition at September 30, 2012 and December 31, 2011 and results of operations for the three and nine month periods ended September 30, 2012 and 2011, the following analysis should be reviewed with other information including the Company's December 31, 2011 Annual Report on Form 10-K and the Company's Condensed Consolidated Financial Statements and the Notes thereto included in this report.

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THE SAVANNAH BANCORP, INC. AND SUBSIDIARIES
Third Quarter Financial Highlights
($ in thousands, except share data)
(Unaudited)

	2012	2011	% Change
Balance Sheet Data at September 30			
Total assets	**$ 896,267**	$ 988,720	*(9.4)*
Interest-earning assets(a)	**825,547**	886,430	*(6.9)*
Loans	**685,195**	788,550	*(13)*
Other real estate owned	**11,820**	17,135	*(31)*
Deposits	**778,127**	846,073	*(8.0)*
Interest-bearing liabilities	**700,678**	801,932	*(13)*
Shareholders' equity	**67,871**	86,309	*(21)*
Loan to deposit ratio	**88.06%**	93.20%	*(5.5)*
Equity to assets	**7.57%**	8.73%	*(13)*
Tier 1 capital to risk-weighted assets	**11.36%**	11.35%	*0.1*
Total capital to risk-weighted assets	**12.62%**	12.62%	*0.0*
Outstanding shares	**7,199**	7,199	*0.0*
Book value per share	**$ 9.43**	$ 11.99	*(21)*
Tangible book value per share	**$ 8.96**	$ 11.49	*(22)*
Market value per share	**$ 10.00**	$ 6.00	*67*
Loan Quality Data			
Nonaccruing loans	**$ 27,982**	$ 41,689	*(33)*
Loans past due 90 days accruing	**368**	851	*(57)*
Net charge-offs	**14,887**	11,021	*35*
Allowance for loan losses	**18,110**	22,854	*(21)*
Allowance for loan losses to total loans	**2.64%**	2.90%	*(9.0)*
Nonperforming assets to total assets	**4.48%**	6.04%	*(26)*
Performance Data for the Third Quarter			
Net income (loss)	**$ (15,976)**	$ 1,228	*NM*
Return on average assets	**(6.80)%**	0.49%	*NM*
Return on average equity	**(76.64)%**	5.64%	*NM*
Net interest margin	**3.78%**	4.01%	*(6.0)*
Efficiency ratio	**93.01%**	59.26%	*57*
Per share data:			
Net income (loss) basic	**$ (2.22)**	$ 0.17	*NM*
Net income (loss) diluted	**$ (2.22)**	$ 0.17	*NM*
Average shares (000s):			
Basic	**7,199**	7,199	*0.0*
Diluted	**7,199**	7,199	*0.0*
Performance Data for the First Nine Months			
Net loss	**$ (16,591)**	$ (138)	*NM*
Return on average assets	**(2.32)%**	(0.02)%	*NM*
Return on average equity	**(26.32)%**	(0.21)%	*NM*
Net interest margin	**3.88%**	3.88%	*0.0*
Efficiency ratio	**77.60%**	61.29%	*27*
Per share data:			
Net loss basic	**$ (2.30)**	$ (0.02)	*NM*
Net loss diluted	**$ (2.30)**	$ (0.02)	*NM*
Average shares (000s):			
Basic	**7,199**	7,199	*0.0*
Diluted	**7,199**	7,199	*0.0*

(a) Interest-earnings assets do not include the unrealized gain/loss on available for sale investment securities.

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Annex G

CONDENSED CONSOLIDATED FINANCIAL INFORMATION OF FIRST FINANCIAL HOLDINGS, INC. AND SCBT FINANCIAL CORPORATION
(Pursuant to S.C. Code Section 33-11-103)

Section 33-11-103 of the Code of Laws of South Carolina, 1976, as amended, requires that the notice of the meeting of shareholders at which a plan of merger will be voted upon be accompanied by balance sheets for each corporation participating in the merger as of the close of the preceding two fiscal years as well as income statements for each participating corporation for each of the preceding three fiscal years. The condensed consolidated balance sheets as of December 31, 2012 and 2011 and September 30, 2011 and condensed consolidated income statements for the year ended December 31, 2012, the quarter ended December 31, 2011, and the years ended September 30, 2011 and 2010 comply with the requirements of Section 33-11-103 with respect to First Financial Holdings, Inc. The condensed consolidated balance sheets at December 31, 2012 and 2011 and condensed consolidated income statements for the years ended December 31, 2012, 2011 and 2010 for SCBT Financial Corporation satisfy the requirements of Section 33-11-103 with respect to SCBT Financial Corporation.

This Annex G should be read in conjunction with the audited consolidated financial statements of First Financial Holdings, Inc. and SCBT Financial Corporation, respectively, and the notes to such audited consolidated financial statements contained in reports that First Financial Holdings, Inc. and SCBT Financial Corporation have previously filed with the Securities and Exchange Commission, including as set forth in this joint proxy statement/prospectus under "Where You Can Find More Information" and incorporated by reference into this joint proxy statement / prospectus.

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First Financial Holdings, Inc. and Subsidiaries

Consolidated Balance Sheets

(in thousands, except share data)	December 31, 2012	As of December 31, 2011	September 30, 2011
ASSETS			
Cash and due from banks	$ 60,290	$ 61,400	$ 54,307
Interest-bearing deposits with banks	57,161	15,275	31,630
Total cash and cash equivalents	117,451	76,675	85,937
Investment securities			
Securities available for sale, at fair value	253,798	404,550	412,108
Securities held to maturity at amortized cost, approximate fair value $17,867, $23,242 and $24,162, respectively	15,555	20,486	21,671
Nonmarketable securities	20,914	32,694	35,782
Total investment securities	290,267	457,730	469,561
Loans			
Residential	1,031,533	1,032,134	967,063
Commercial	681,119	618,070	634,650
Consumer	782,672	735,253	753,621
Total loans	2,495,324	2,385,457	2,355,334
Less: Allowance for loan losses	44,179	53,524	54,333
Net loans	2,451,145	2,331,933	2,301,001
Loans held for sale	55,201	48,303	94,872
FDIC indemnification asset, net	80,268	51,021	50,465
Premises and equipment, net	85,378	82,907	83,423
Bank owned life insurance	50,624		
Other intangible assets, net	8,025	2,401	2,491
Other assets	77,199	95,994	118,560
Total assets	$ 3,215,558	$ 3,146,964	$ 3,206,310
LIABILITIES			
Deposits			
Noninterest-bearing checking	$ 388,259	$ 279,310	$ 278,944
Interest-bearing checking	511,647	429,907	440,584
Savings and money market	743,970	522,496	505,059
Retail time deposits	845,391	791,544	824,875
Wholesale time deposits	106,066	215,941	253,395
Total deposits	2,595,333	2,239,198	2,302,857
Advances from FHLB	233,000	561,000	558,000
Long-term debt	47,204	47,204	47,204
Other liabilities	40,380	22,384	29,743
Total liabilities	2,915,917	2,869,786	2,937,804

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First Financial Holdings, Inc. and Subsidiaries

Consolidated Balance Sheets (Continued)

(in thousands, except share data)	December 31, 2012	As of December 31, 2011	September 30, 2011
SHAREHOLDERS' EQUITY			
Preferred stock, Series A, $.01 par value, authorized 3,000,000 shares, issued and outstanding 65,000 shares at December 31, 2012, December 31, 2011 and September 30, 2011 (Redemption value $65,000).	$ 1	$ 1	$ 1
Common stock, $.01 par value, authorized 34,000,000 shares, issued 21,465,163 shares at December 31, 2012, December 31, 2011 and September 30, 2011.	215	215	215
Additional paid-in capital	196,819	196,002	195,790
Treasury stock at cost, 4,938,411 shares at December 31, 2012, December 31, 2011 and September 30, 2011.	(103,563)	(103,563)	(103,563)
Retained earnings	208,853	187,367	173,587
Accumulated other comprehensive (loss) income	(2,684)	(2,844)	2,476
Total shareholders' equity	299,641	277,178	268,506
Total liabilities and shareholders' equity	$ 3,215,558	$ 3,146,964	$ 3,206,310

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First Financial Holdings, Inc. and Subsidiaries
Consolidated Statements of Operations (Continued)

(in thousands)	Year Ended December 31, 2012	Quarter Ended December 31, 2011	Years Ended September 30, 2011	Years Ended September 30, 2010
INTEREST INCOME				
Interest and fees on loans	$ 144,150	$ 33,460	$ 139,535	$ 152,522
Interest and dividends on investment securities				
Taxable	11,285	3,589	17,591	23,369
Tax-exempt	1,410	270	1,123	1,166
Other	420	293	2,035	3,812
Total interest income	157,265	37,612	160,284	180,869
INTEREST EXPENSE				
Interest on deposits	15,067	4,554	25,731	32,784
Interest on borrowed money	13,947	4,159	16,538	21,538
Total interest expense	29,014	8,713	42,269	54,322
NET INTEREST INCOME	128,251	28,899	118,015	126,547
Provision for loan losses	20,136	7,445	109,901	125,194
Net interest income after provision for loan losses	108,115	21,454	8,114	1,353
NONINTEREST INCOME				
Service charges and fees on deposit accounts	30,532	7,099	26,837	25,574
Mortgage and other loan income	17,855	2,681	8,560	11,436
Trust and plan administration income	4,495	1,192	4,738	4,414
Brokerage fees	3,004	532	2,425	2,281
Other income	3,284	650	2,495	5,095
Other-than-temporary impairment losses on investment securities	(503)	(180)	(879)	(2,853)
Gain on acquisition	13,889			
Gain on sale or call of investment securities	3,877		1,419	
Gain on sold loan pool, net		20,796	1,900	
Total noninterest income	76,433	32,770	47,495	45,947
NONINTEREST EXPENSE				
Salaries and employee benefits	61,995	14,511	62,981	58,496
Occupancy costs	9,747	2,144	8,900	8,746
Furniture and equipment	7,867	1,870	7,044	7,739
Other real estate expenses, net	1,712	1,541	4,909	6,751
FDIC insurance and regulatory fees	3,094	830	4,090	4,672
Professional services	7,158	1,042	5,707	4,151
Advertising and marketing	3,296	789	3,219	3,073
Other loan expense	6,537	1,043	3,915	2,049
Intangible amortization	1,482	90	325	328
FDIC indemnification impairment	3,986			
Other expense	20,946	5,026	15,182	16,572
FHLB prepayment termination charge	8,525			
Goodwill impairment			630	
Total noninterest expense	136,345	28,886	116,902	112,577

ncome (loss) from continuing operations before taxes	48,203	25,338	(61,293)	(65,277)
ncome tax expense (benefit) from continuing operations	19,390	9,766	(23,672)	(25,969)

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First Financial Holdings, Inc. and Subsidiaries
Consolidated Statements of Operations (Continued)

(in thousands)	Year Ended December 31, 2012	Quarter Ended December 31, 2011	Years Ended September 30, 2011	Years Ended September 30, 2010
NET INCOME (LOSS) FROM CONTINUING OPERATIONS	$ 28,813	$ 15,572	$ (37,621)	$ (39,308)
(Loss) income from discontinued operations, net of tax			(3,565)	2,519
NET INCOME (LOSS)	28,813	15,572	(41,186)	(36,789)
Preferred stock dividends	3,250	813	3,250	3,252
Accretion on preferred stock discount	637	153	591	556
NET INCOME (LOSS) AVAILABLE TO COMMON SHAREHOLDERS	$ 24,926	$ 14,606	$ (45,027)	$ (40,597)
Net income (loss) per common share from continuing operations				
Basic	$ 1.51	$ 0.88	$ (2.51)	$ (2.61)
Diluted	1.51	0.88	(2.51)	(2.61)
Net (loss) income per common share from discontinued operations				
Basic	$	$	$ (0.21)	$ 0.15
Diluted			(0.21)	0.15
Net income (loss) per common share				
Basic	$ 1.51	$ 0.88	$ (2.72)	$ (2.46)
Diluted	1.51	0.88	(2.72)	(2.46)
Average common shares outstanding				
Basic	16,527	16,527	16,527	16,511
Diluted	16,529	16,527	16,527	16,511

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SCBT Financial Corporation and Subsidiary

Consolidated Balance Sheets

(Dollars in thousands, except par value)

	December 31, 2012	December 31, 2011
ASSETS		
Cash and cash equivalents:		
Cash and due from banks	$ 185,708	$ 129,729
Interest-bearing deposits with banks	16,018	1,822
Federal funds sold and securities purchased under agreements to resell	179,004	39,874
Total cash and cash equivalents	380,730	171,425
Investment securities:		
Securities held to maturity (fair value of $16,553 and $17,864, respectively)	15,440	16,569
Securities available for sale, at fair value	534,883	289,195
Other investments	9,768	18,292
Total investment securities	560,091	324,056
Loans held for sale	65,279	45,809
Loans:		
Acquired (covered of $282,728, and $394,495, respectively; non-covered of $792,014, and $7,706, respectively)	1,074,742	402,201
Less allowance for acquired loan losses	(32,132)	(31,620)
Non-acquired	2,571,003	2,470,565
Less allowance for non-acquired loan losses	(44,378)	(49,367)
Loans, net	3,569,235	2,791,779
FDIC receivable for loss share agreements	146,171	262,651
Premises and equipment, net	115,583	94,250
Goodwill	100,602	62,888
Other real estate owned (covered of $34,257 and $65,849, respectively; non-covered of $32,248 and $18,022, respectively)	66,505	83,871
Bank owned life insurance	42,737	22,111
Deferred tax assets	33,901	
Core deposit and other intangibles	25,199	11,538
Other assets	30,413	26,179
Total assets	$ 5,136,446	$ 3,896,557

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SCBT Financial Corporation and Subsidiary

Consolidated Balance Sheets

(Dollars in thousands, except par value)

	December 31,	
	2012	**2011**
LIABILITIES AND SHAREHOLDERS' EQUITY		
Deposits:		
Noninterest-bearing	$ 981,963	$ 658,454
Interest-bearing	3,316,397	2,596,018
Total deposits	4,298,360	3,254,472
Federal funds purchased and securities sold under agreements to repurchase	238,621	180,436
Other borrowings	54,897	46,683
Deferred tax liabilities		2,680
Other liabilities	37,019	30,506
Total liabilities	4,628,897	3,514,777
Shareholders' equity:		
Preferred stock $.01 par value; authorized 10,000,000 shares; no shares issued and outstanding		
Common stock $2.50 par value; authorized 40,000,000 shares; 16,937,464 and 14,039,422 shares issued and outstanding	42,344	35,099
Surplus	328,843	233,232
Retained earnings	135,986	116,198
Accumulated other comprehensive income (loss)	376	(2,749)
Total shareholders' equity	507,549	381,780
Total liabilities and shareholders' equity	$ 5,136,446	$ 3,896,557

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SCBT Financial Corporation and Subsidiary
Consolidated Statements of Income
(Dollars in thousands, except per share data)

	Years Ended December 31,		
	2012	2011	2010
Interest income:			
Loans, including fees	$ 174,807	$ 162,205	$ 143,493
Investment securities:			
Taxable	7,577	7,641	9,985
Tax-exempt	3,947	854	853
Federal funds sold and securities purchased under agreements to resell	1,157	1,018	1,023
Total interest income	187,488	171,718	155,354
Interest expense:			
Deposits	8,424	17,557	28,526
Federal funds purchased and securities sold under agreements to repurchase	451	527	630
Other borrowings	2,219	2,182	3,581
Total interest expense	11,094	20,266	32,737
Net interest income	176,394	151,452	122,617
Provision for loan losses	13,619	30,236	54,282
Net interest income after provision for loan losses	162,775	121,216	68,335
Noninterest income:			
Service charges on deposit accounts	23,815	22,654	21,342
Bankcard services income	14,173	11,721	8,987
Mortgage banking income	12,622	6,271	6,564
Trust and investment services income	6,360	5,464	4,251
Securities gains, net	189	323	292
Total other-than-temporary impairment losses		(115)	(1,281)
Portion of impairment losses recognized in other comprehensive income			(5,489)
Net impairment losses recognized in earnings		(115)	(6,770)
Gains on acquisitions		16,529	98,081
Accretion (amortization) of FDIC indemnification asset	(20,773)	(10,135)	2,443
Other	4,897	2,407	2,545
Total noninterest income	41,283	55,119	137,735
Noninterest expense:			
Salaries and employee benefits	76,308	68,937	60,795
OREO expense and loan related	12,003	14,051	5,074
Information services expense	11,092	10,512	9,144
Merger expense	10,214	3,198	5,504
Net occupancy expense	9,817	9,674	8,544
Furniture and equipment expense	9,115	8,476	7,530
Bankcard expense	4,062	3,241	2,812
FDIC assessment and other regulatory charges	3,875	4,573	5,283
Advertising and marketing	2,735	2,729	3,618
Professional fees	2,681	1,776	2,276
Amortization of intangibles	2,172	1,991	1,650
Federal Home Loan Bank advances prepayment fee			3,189
Other	14,824	13,820	9,823
Total noninterest expense	158,898	142,978	125,242
Earnings:			

ncome before provision for income taxes	45,160	33,357	80,828
Provision for income taxes	15,128	10,762	28,946
Net income	$ 30,032	$ 22,595	$ 51,882
Earnings per common share:			
Basic	$ 2.04	$ 1.65	$ 4.11
Diluted	$ 2.03	$ 1.63	$ 4.08
Dividends per common share	$ 0.69	$ 0.68	$ 0.68
Weighted average common shares outstanding:			
Basic	14,698	13,677	12,618
Diluted	14,796	13,751	12,720

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PART II

INFORMATION NOT REQUIRED IN PROSPECTUS

Item 20. ***Indemnification of Directors and Officers.***

Section 33-2-102 of the South Carolina Business Corporation Act of 1988, as amended, (the "BCA") permits a South Carolina corporation to include in its articles of incorporation a provision eliminating or limiting the personal liability of its directors and officers to the corporation and its shareholders for monetary damages for breach of fiduciary duty as a director, except: (1) for any breach of the director's duty of loyalty to the corporation or its shareholders; (2) for acts or omissions not in good faith or which involve gross negligence, intentional misconduct, or a knowing violation of law; (3) as imposed for any unlawful distributions as set forth in Section 33-8-330 of the BCA or (4) for any transaction from which the director derived an improper personal benefit. SCBT's articles of incorporation contain such a provision, thereby limiting the liability of its directors and officers to the maximum extent permitted by South Carolina law.

Section 33-8-510 of the BCA permits a South Carolina corporation to indemnify a director or officer who is made a party to any proceeding by reason of service in that capacity against liability incurred in the proceeding if he or she: (1) conducted himself or herself in good faith, (2) reasonably believed that his or her conduct was in the corporation's best interest or, if he or she was not acting in his or her official capacity, that such conduct was not opposed to the corporation's best interest and (3) in the case of a criminal proceeding, had no reasonable cause to believe his or her conduct was unlawful. The BCA provides that where a director or officer is a defendant in a proceeding by or in the right of the corporation, the director or officer may not be indemnified if he or she is found liable to the corporation. The BCA also provides that a director or officer may not be indemnified in respect of any proceeding alleging improper personal benefit in which he or she was found liable on the grounds that personal benefit was improperly received. A director or officer found liable in a proceeding by or in the right of the corporation or in a proceeding alleging improper personal benefit may petition a court to nevertheless order indemnification of expenses if the court determines that the director or officer is fairly and reasonably entitled to indemnification in view of all the relevant circumstances.

Section 33-8-520 of the BCA provides that unless limited by the articles of incorporation of a South Carolina corporation, a director or officer who is wholly successful on the merits or otherwise in defense of any proceeding must be indemnified against reasonable expenses. Section 33-8-520 also provides that a South Carolina corporation may advance reasonable expenses to a director or an officer upon the corporation's receipt of (1) a written affirmation by the director or officer of his or her good faith belief that he or she has met the standard of conduct necessary for indemnification by the corporation and (2) a written undertaking by the director or officer or on his or her behalf to repay the amount paid or reimbursed by the corporation if it is ultimately determined that the standard of conduct was not met, so long as a determination is made by the corporation that indemnification is proper under Section 33-8-520.

SCBT's bylaws provide for the indemnification of any current and former directors to the fullest extent authorized by law. SCBT's bylaws further provide that SCBT may, to the extent authorized from time to time by SCBT's board of directors, grant rights of indemnification and to the advancement of expenses to any officer, employee or agent of the SCBT consistent with the other provisions of SCBT's bylaws concerning the indemnification of SCBT directors. SCBT's bylaws provide that SCBT may maintain insurance, at its expense, to protect itself and any director, officer, employee or agent of SCBT or another corporation, partnership, joint venture, trust or other enterprise against any expense, liability or loss, whether or not SCBT would have the power to indemnify such person against such expense, liability or loss under applicable law.

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The foregoing is only a general summary of certain aspects of South Carolina law and SCBT's articles of incorporation and bylaws dealing with indemnification of directors and officers, and does not purport to be complete. It is qualified in its entirety by reference to the detailed provisions of those Sections of the BCA referenced above and the articles of incorporation and bylaws of SCBT.

Item 21. ***Exhibits and Financial Statement Schedules***

Exhibit No.	Description
2.1	Agreement and Plan of Merger, dated as of February 19, 2013, by and between SCBT Financial Corporation and First Financial Holdings, Inc. (attached as Annex A to the joint proxy statement/prospectus contained in this Registration Statement)
3.1	Amended and Restated Articles of Incorporation of SCBT Financial Corporation (filed as Exhibit 3.1 to SCBT's Current Report on Form 8-K, filed December 31, 2008, and incorporated herein by reference)
3.2	Articles of Amendment to Articles of Incorporation of SCBT Financial Corporation (filed as Exhibit 3.1 to SCBT's Current Report on Form 8-K, filed on January 16, 2009, and incorporated herein by reference)
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23.3	Consent of Dixon Hughes Goodman LLP (with respect to SCBT Financial Corporation)
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24.1	Power of Attorney*

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99.2	Consent of Sandler O'Neill + Partners, L.P.
99.3	Form of proxy of First Financial Holdings, Inc.
99.4	Form of proxy of SCBT Financial Corporation

*

Previously filed

Item 22. ***Undertakings.***

The undersigned Registrant hereby undertakes:

(1) To file, during any period in which offers or sales are being made, a post-effective amendment to this registration statement: (i) to include any prospectus required by Section 10(a)(3) of the Securities Act of 1933, as amended (the "Securities Act"); (ii) to reflect in the prospectus any facts or events arising after the effective date of the registration statement (or the most recent post-effective amendment thereof) which, individually or in the aggregate, represent a fundamental change in the information set forth in the registration statement (notwithstanding the foregoing, any increase or decrease in volume of securities offered (if the total dollar value of securities offered would not exceed that which was registered) and any deviation from the low or high end of the estimated maximum offering range may be reflected in the form of prospectus filed with the SEC pursuant to Rule 424(b) if, in the aggregate, the changes in volume and price represent no more than a 20% change in the maximum aggregate offering price set forth in the "Calculation of Registration Fee" table in the effective registration statement); and (iii) to include any material information with respect to the plan of distribution not previously disclosed in the registration statement or any material change to such information in the registration statement.

(2) That, for the purpose of determining any liability under the Securities Act of 1933, each such post-effective amendment shall be deemed to be a new registration statement relating to the securities offered therein, and the offering of such securities at that time shall be deemed to be the initial *bona fide* offering thereof.

(3) To remove from registration by means of a post-effective amendment any of the securities being registered which remain unsold at the termination of the offering.

(4) That, for purposes of determining any liability under the Securities Act, each filing of the Registrant's annual report pursuant to Section 13(a) or 15(d) of the Securities Exchange Act of 1934, as amended (and, where applicable, each filing of an employee benefit plan's annual report pursuant to Section 15(d) of the Securities Exchange Act of 1934, as amended) that is incorporated by reference in this registration statement shall be deemed to be a new registration statement relating to the securities offered therein, and the offering of such securities at that time shall be deemed to be the initial *bona fide* offering thereof.

(5) That prior to any public reoffering of the securities registered hereunder through use of a prospectus which is a part of this registration statement, by any person or party who is deemed to be an underwriter within the meaning of Rule 145(c), the Registrant undertakes that such reoffering prospectus will contain the information called for by the applicable registration form with respect to reofferings by persons who may be deemed underwriters, in addition to the information called for by the other items of the applicable form.

(6) That each prospectus (i) that is filed pursuant to paragraph (5) above, or (ii) that purports to meet the requirements of Section 10(a)(3) of the Securities Act and is used in

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connection with an offering of securities subject to Rule 415, will be filed as a part of an amendment to this registration statement and will not be used until such amendment has become effective, and that for the purpose of determining liabilities under the Securities Act, each such post-effective amendment shall be deemed to be a new registration statement relating to the securities offered therein, and the offering of such securities at that time shall be deemed to be the initial *bona fide* offering thereof.

(7) To respond to requests for information that is incorporated by reference into the prospectus pursuant to Items 4, 10(b), 11 or 13 of this form, within one business day of receipt of such request, and to send the incorporated documents by first class mail or other equally prompt means. This includes information contained in documents filed subsequent to the effective date of the registration statement through the date of responding to the request.

(8) To supply by means of a post-effective amendment all information concerning a transaction, and the company being acquired involved therein, that was not the subject of and included in this registration statement when it became effective.

(9) Insofar as indemnification for liabilities arising under the Securities Act may be permitted to directors, officers and controlling persons of the registrant pursuant to the foregoing provisions, or otherwise, the registrant has been advised that in the opinion of the SEC such indemnification is against public policy as expressed in the Securities Act and is, therefore, unenforceable. In the event that a claim for indemnification against such liabilities (other than the payment by the registrant of expenses incurred or paid by a director, officer or controlling person of the registrant in the successful defense of any action, suit or proceeding) is asserted by such director, officer, or controlling person in connection with the securities being registered, the registrant will, unless in the opinion of its counsel the matter has been settled by controlling precedent, submit to a court of appropriate jurisdiction the question whether such indemnification by it is against public policy as expressed in the Securities Act and will be governed by the final adjudication of such issue.

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SIGNATURES

Pursuant to the requirements of the Securities Act of 1933, as amended, the Registrant has duly caused this Form S-4 Registration Statement to be signed on its behalf by the undersigned, thereunto duly authorized, in the city of Columbia, state of South Carolina, on May 29, 2013.

SCBT FINANCIAL CORPORATION

By: /s/ JOHN C. POLLOK

Name: John C. Pollok
Title: *Senior Executive Vice President, Chief Financial Officer, Chief Operating Officer and Director*

Pursuant to the requirements of the Securities Act of 1933, as amended, this Form S-4 Registration Statement has been signed by the following persons in the capacities indicated on May 29, 2013.

Signature	Title
* Robert R. Hill, Jr.	President and Chief Executive Officer and Director (Principal Executive Officer)
/s/ JOHN C. POLLOK John C. Pollok	Senior Executive Vice President, Chief Financial Officer, Chief Operating Officer and Director (Principal Financial Officer)
* Keith S. Rainwater	Senior Vice President and Director of External Reporting (Principal Accounting Officer)
* Robert R. Horger	Chairman of the Board of Directors
* Jimmy E. Addison	Director
* Luther J. Battiste, III	Director
* Robert H. Demere, Jr.	Director

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Signature	Title
* M. Oswald Fogle	Director
* Herbert G. Gray	Director
* Cynthia A. Hartley	Director
* Harry M. Mims, Jr.	Director
* Ralph W. Norman, Jr.	Director
* Alton C. Phillips	Director
* James W. Roquemore	Director
* Thomas E. Suggs	Director
* Kevin P. Walker	Director
* John W. Williamson, III	Director

*By: /s/ JOHN C. POLLOK

John C. Pollok
Attorney-in-Fact
May 29, 2013

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EXHIBIT INDEX

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