

ARCH CAPITAL GROUP LTD.  
Form 10-Q  
November 09, 2006

**UNITED STATES  
SECURITIES AND EXCHANGE COMMISSION**

WASHINGTON, D.C. 20549

**FORM 10-Q**

(Mark One)

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

**For the quarterly period ended September 30, 2006**

Or

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)

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**Bermuda**

(State or other jurisdiction of incorporation or organization)

**Not Applicable**

(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  No

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  Accelerated Filer  Non-Accelerated Filer

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

Yes  No

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 November 1, 2006
Common Shares, \$0.01 par value	74,119,097

*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 September 30, 2006, and the related consolidated statements of income for each of the three-month and nine-month periods ended September 30, 2006 and 2005, and the consolidated statements of changes in shareholders' equity, comprehensive income and cash flows for the nine-month periods ended September 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 (United States), the objective of which is the expression of an opinion regarding the financial statements taken as a whole. Accordingly, we do not express such an opinion.

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

We 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

November 8, 2006

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

	(Unaudited) September 30, 2006	December 31, 2005
<b>Assets</b>		
Investments:		
Fixed maturities available for sale, at fair value (amortized cost: 2006, \$6,689,055; 2005, \$5,310,712)	\$ 6,727,113	\$ 5,280,987
Short-term investments available for sale, at fair value (amortized cost: 2006, \$883,673; 2005, \$679,530)	887,187	681,887
Short-term investment of funds received under securities lending agreements, at fair value	844,430	893,379
Other investments, at fair value (cost: 2006, \$275,442; 2005, \$59,839)	290,305	70,233
<b>Total investments</b>	<b>8,749,035</b>	<b>6,926,486</b>
Cash	188,139	222,477
Accrued investment income	70,163	62,196
Fixed maturities and short-term investments pledged under securities lending agreements, at fair value	815,268	863,866
Premiums receivable	901,001	672,902
Funds held by reinsureds	93,980	167,739
Unpaid losses and loss adjustment expenses recoverable	1,562,459	1,389,768
Paid losses and loss adjustment expenses recoverable	116,966	80,948
Prepaid reinsurance premiums	514,490	322,435
Deferred income tax assets, net	76,765	71,139
Deferred acquisition costs, net	313,806	317,357
Receivable for securities sold	91,375	220
Other assets	460,429	390,903
<b>Total Assets</b>	<b>\$ 13,953,876</b>	<b>\$ 11,488,436</b>
<b>Liabilities</b>		
Reserve for losses and loss adjustment expenses	\$ 6,309,624	\$ 5,452,826
Unearned premiums	1,995,755	1,699,691
Reinsurance balances payable	312,881	150,451
Senior notes	300,000	300,000
Deposit accounting liabilities	44,590	43,104
Securities lending collateral	844,430	893,379
Payable for securities purchased	288,815	12,020
Other liabilities	511,532	456,438
<b>Total Liabilities</b>	<b>10,607,627</b>	<b>9,007,909</b>
<b>Commitments and Contingencies</b>		
<b>Shareholders Equity</b>		
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, 74,006,652; 2005, 73,334,870)	740	733
Additional paid-in capital	1,928,914	1,595,440
Deferred compensation under share award plan		(9,646)
Retained earnings	1,354,629	901,348
Accumulated other comprehensive income (loss), net of deferred income tax	61,836	(7,348)
<b>Total Shareholders Equity</b>	<b>3,346,249</b>	<b>2,480,527</b>
<b>Total Liabilities and Shareholders Equity</b>	<b>\$ 13,953,876</b>	<b>\$ 11,488,436</b>

See Notes to Consolidated Financial Statements



**ARCH CAPITAL GROUP LTD. AND SUBSIDIARIES**  
**CONSOLIDATED STATEMENTS OF INCOME**  
(U.S. dollars in thousands, except share data)

	(Unaudited) Three Months Ended September 30, 2006		(Unaudited) Nine Months Ended September 30, 2006	
	2006	2005	2006	2005
<b>Revenues</b>				
Net premiums written	\$ 747,225	\$ 787,304	\$ 2,415,502	\$ 2,310,833
(Increase) decrease in unearned premiums	10,348	(39,529 )	(98,878 )	(126,098 )
Net premiums earned	757,573	747,775	2,316,624	2,184,735
Net investment income	101,622	59,270	272,451	162,846
Net realized losses	(11,115 )	(10,291 )	(46,700 )	(7,725 )
Fee income	2,269	2,239	7,542	9,376
<b>Total revenues</b>	<b>850,349</b>	<b>798,993</b>	<b>2,549,917</b>	<b>2,349,232</b>
<b>Expenses</b>				
Losses and loss adjustment expenses	445,748	672,224	1,376,181	1,541,678
Acquisition expenses	117,529	142,803	395,782	417,474
Other operating expenses	82,791	72,601	250,135	221,761
Interest expense	5,361	5,632	16,567	16,897
Net foreign exchange (gains) losses	4,251	(7,334 )	15,650	(20,769 )
<b>Total expenses</b>	<b>655,680</b>	<b>885,926</b>	<b>2,054,315</b>	<b>2,177,041</b>
<b>Income (loss) before income taxes</b>	<b>194,669</b>	<b>(86,933 )</b>	<b>495,602</b>	<b>172,191</b>
Income tax expense (benefit)	2,371	(642 )	28,127	16,598
<b>Net income (loss)</b>	<b>192,298</b>	<b>(86,291 )</b>	<b>467,475</b>	<b>155,593</b>
Preferred dividends	6,488		14,194	
<b>Net income (loss) available to common shareholders</b>	<b>\$ 185,810</b>	<b>\$ (86,291 )</b>	<b>\$ 453,281</b>	<b>\$ 155,593</b>
<b>Net income (loss) per common share</b>				
Basic	\$ 2.54	\$ (2.48 )	\$ 6.20	\$ 4.50
Diluted	\$ 2.44	\$ (2.48 )	\$ 5.96	\$ 2.09
<b>Weighted average common shares and common share equivalents outstanding</b>				
Basic (1)	73,244,138	34,750,770	73,111,759	34,561,131
Diluted (1)	76,283,910	34,750,770	76,108,510	74,458,013

(1) For the 2005 third quarter and nine months ended September 30, 2005, basic weighted average common shares and common share equivalents outstanding excluded 37,327,502 and 37,328,788 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. In addition, due to the net loss recorded for the 2005 third quarter, diluted weighted average common shares and common share equivalents outstanding for the 2005 third quarter do not include 40.0 million shares of dilutive securities since the inclusion of such securities would have had an anti-dilutive effect on the loss per share under GAAP.

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) Nine Months Ended September 30,	
	2006	2005
<b>Series A Convertible Preference Shares</b>		
Balance at beginning of year	\$	\$ 373
Converted to common shares		(0 )
Balance at end of period		373
<b>Non-Cumulative Preferred Shares</b>		
Series A preferred shares issued	80	
Series B preferred shares issued	50	
Balance at end of period	130	
<b>Common Shares</b>		
Balance at beginning of year	733	349
Common shares issued, net	7	6
Balance at end of period	740	355
<b>Additional Paid-in Capital</b>		
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	193,377	
Series B non-cumulative preferred shares issued	120,881	
Common shares issued	410	2,893
Exercise of stock options	17,585	13,415
Common shares retired	(1,279 )	(1,398 )
Amortization of share-based compensation	11,621	
Other	525	642
Balance at end of period	1,928,914	1,575,843
<b>Deferred Compensation Under Share Award Plan</b>		
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		(1,488 )
Deferred compensation expense recognized		5,742
Balance at end of period		(5,625 )
<b>Retained Earnings</b>		
Balance at beginning of year	901,348	644,862
Dividends declared on preferred shares	(14,194 )	
Net income	467,475	155,593
Balance at end of period	1,354,629	800,455
<b>Accumulated Other Comprehensive Income (Loss)</b>		
Balance at beginning of year	(7,348 )	45,910
Change in unrealized appreciation (decline) in value of investments, net of deferred income tax	72,408	(64,571 )
Foreign currency translation adjustments, net of deferred income tax	(3,224 )	(1,209 )
Balance at end of period	61,836	(19,870 )
<b>Total Shareholders Equity</b>	<b>\$ 3,346,249</b>	<b>\$ 2,351,531</b>

See Notes to Consolidated Financial Statements



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

	(Unaudited) Nine Months Ended September 30,	
	2006	2005
<b>Comprehensive Income</b>		
Net income	\$ 467,475	\$ 155,593
Other comprehensive income (loss), net of deferred income tax		
Unrealized appreciation (decline) in value of investments:		
Unrealized holding gains (losses) arising during period	22,675	(74,758 )
Reclassification of net realized losses, net of income taxes, included in net income	49,733	10,187
Foreign currency translation adjustments	(3,224 )	(1,209 )
<b>Other comprehensive income (loss)</b>	69,184	(65,780 )
<b>Comprehensive Income</b>	\$ 536,659	\$ 89,813

See Notes to Consolidated Financial Statements

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

	(Unaudited) Nine Months Ended September 30,	
	2006	2005
<b>Operating Activities</b>		
Net income	\$ 467,475	\$ 155,593
Adjustments to reconcile net income to net cash provided by operating activities:		
Net realized losses	46,788	9,601
Share-based compensation	11,621	6,486
Changes in:		
Reserve for losses and loss adjustment expenses, net of unpaid losses and loss adjustment expenses recoverable	684,107	983,360
Unearned premiums, net of prepaid reinsurance premiums	104,009	124,174
Premiums receivable	(228,099 )	(157,554 )
Deferred acquisition costs, net	3,551	(35,758 )
Funds held by reinsureds	73,759	11,038
Reinsurance balances payable	162,430	27,226
Paid losses and loss adjustment expenses recoverable	(36,018 )	(3,377 )
Deferred income tax assets, net	(6,419 )	6,649
Other liabilities	40,646	11,679
Other items, net	(73,864 )	(33,623 )
<b>Net Cash Provided By Operating Activities</b>	<b>1,249,986</b>	<b>1,105,494</b>
<b>Investing Activities</b>		
Purchases of fixed maturity investments	(11,905,546 )	(6,212,818 )
Proceeds from sales of fixed maturity investments	10,328,588	5,178,452
Proceeds from redemptions and maturities of fixed maturity investments	371,202	282,552
Purchases of other investments	(215,052 )	
Proceeds from sale of other investments	6,329	12,701
Net purchases of short-term investments	(182,394 )	(317,043 )
Change in short-term investment of funds received under securities lending agreements, at fair value	48,949	(954,684 )
Purchases of furniture, equipment and other	(9,032 )	(10,548 )
<b>Net Cash Used For Investing Activities</b>	<b>(1,556,956 )</b>	<b>(2,021,388 )</b>
<b>Financing Activities</b>		
Proceeds from common shares issued, net of repurchases	12,165	10,081
Proceeds from preferred shares issued, net of issuance costs	314,388	
Change in securities lending collateral	(48,949 )	954,684
Excess tax benefits from share-based compensation	3,706	
Preferred dividends paid	(10,892 )	
<b>Net Cash Provided By Financing Activities</b>	<b>270,418</b>	<b>964,765</b>
Effects of exchange rate changes on foreign currency cash	2,214	(164 )
Increase (decrease) in cash	(34,338 )	48,707
Cash beginning of year	222,477	113,052
<b>Cash end of period</b>	<b>\$ 188,139</b>	<b>\$ 161,759</b>
Income taxes paid, net	\$ 35,446	\$ 37,099
Interest paid	\$ 11,067	\$ 11,141



**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 \$1.6 million, or \$0.02 per basic and diluted share, related to stock option awards for the 2006 third quarter, net of tax benefits of \$0.4 million. For the nine months ended September 30, 2006, the Company recorded after-tax share-based compensation expense of \$4.4 million, or \$0.06 per basic and diluted share, net of tax benefits of \$1.1 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 third quarter and nine months ended September 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 September 30, 2005	(Unaudited) Nine Months Ended September 30, 2005
Net income (loss), as reported	\$ (86,291 )	\$ 155,593
Total share-based employee compensation expense under fair value method, net of income taxes	(1,342 )	(3,538 )
Pro forma net income	\$ (87,633 )	\$ 152,055
Earnings per share basic:		
As reported	\$ (2.48 )	\$ 4.50
Pro forma	\$ (2.52 )	\$ 4.40
Earnings per share diluted:		
As reported	\$ (2.48 )	\$ 2.09
Pro forma	\$ (2.52 )	\$ 2.04

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 third quarter and nine

months ended September 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 third quarter and nine months ended September 30, 2005, the Company based its volatility estimate under the same method as the 2006 third quarter and nine months ended September 30, 2006, using the period from September 20, 2002 through the last day of the applicable period.

	<b>(Unaudited)</b>			
	<b>Three Months Ended</b>		<b>September 30,</b>	
	<b>2006</b>		<b>2005</b>	
Dividend yield	0.0	%	0.0	%
Expected volatility	20.4	%	21.0	%
Risk free interest rate	4.9	%	4.08	%
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 nine months ended September 30, 2006 is presented below:

	<b>(Unaudited)</b>	
	<b>Nine Months Ended</b>	
	<b>September 30, 2006</b>	
	<b>Number of</b>	<b>Weighted Average</b>
	<b>Options</b>	<b>Exercise Price</b>
Outstanding, beginning of year	5,637,108	\$ 26.30
Granted	883,750	\$ 56.39
Exercised	(557,330 )	\$ 24.12
Forfeited or expired	(22,599 )	\$ 48.88
Outstanding, end of period	5,940,929	\$ 30.89
Exercisable, end of period	4,856,415	\$ 25.39

The weighted average remaining contractual life of the Company's outstanding and exercisable stock options at September 30, 2006 was 6.2 years and 5.5 years, respectively. The aggregate intrinsic value of the Company's outstanding and exercisable stock options at September 30, 2006 was \$190.8 million and \$182.6 million, respectively. The Company received proceeds of approximately \$13.4 million from the exercise of stock options during the nine months ended September 30, 2006.

The weighted average grant-date fair value of options during the nine months ended September 30, 2006 was \$18.17 per option based on the Black-Scholes option pricing model. The aggregate intrinsic value of options exercised during the nine months ended September 30, 2006 was approximately \$17.6 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 September 30, 2006, there was approximately \$14.8 million of



unrecognized compensation cost related to nonvested stock options. Such cost is expected to be recognized over a weighted average period of 2.29 years.

At September 30, 2006, approximately 1,538,000 and 14,000 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 third quarter as required by the provisions of SFAS No. 123(R), compared to \$2.0 million, net of a tax benefit of \$0.4 million, for the 2005 third quarter. The Company recorded \$5.3 million of share-based compensation expense, net of a tax benefit of \$0.8 million, related to restricted share and unit awards for the nine months ended September 30, 2006, compared to \$5.3 million, net of a tax benefit of \$1.2 million, for the nine months ended September 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.

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

	(Unaudited) Nine Months Ended September 30, 2006	
	Nonvested Shares	Weighted Average Grant Date Fair Value
Unvested balance, beginning of year	666,504	\$ 33.14
Granted	130,316	\$ 56.76
Vested	(107,803 )	\$ 39.05
Forfeited	(2,945 )	\$ 52.46
Unvested balance, end of period	686,072	\$ 36.62

As of September 30, 2006, 93,469 restricted units were outstanding with an aggregate intrinsic value of \$5.9 million. The aggregate intrinsic value of 8,776 restricted units converted during the nine months ended September 30, 2006 was \$0.5 million. As of September 30, 2006, there were \$10.9 million and \$0.5 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 1.01 years and 1.36 years, respectively. The total weighted average fair value of restricted shares that vested during the nine months ended September 30, 2006 was \$6.4 million, or \$59.24 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 September 30, 2006, the Company had declared an aggregate of \$3.3 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 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.

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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 September 30, 2006			
	Insurance	Reinsurance	Total	
Gross premiums written (1)	\$ 750,609	\$ 366,833	\$ 1,105,165	
Net premiums written (1)	470,619	276,606	747,225	
Net premiums earned (1)	\$ 424,657	\$ 332,916	\$ 757,573	
Fee income	1,293	976	2,269	
Losses and loss adjustment expenses	(261,553 )	(184,195 )	(445,748 )	
Acquisition expenses, net	(43,162 )	(74,367 )	(117,529 )	
Other operating expenses	(63,350 )	(12,987 )	(76,337 )	
Underwriting income	\$ 57,885	\$ 62,343	120,228	
Net investment income			101,622	
Net realized losses			(11,115 )	
Other expenses			(6,454 )	
Interest expense			(5,361 )	
Net foreign exchange losses			(4,251 )	
Income before income taxes			194,669	
Income tax expense			(2,371 )	
<b>Net income</b>			192,298	
Preferred dividends			(6,488 )	
<b>Net income available to common shareholders</b>			\$ 185,810	
<b>Underwriting Ratios</b>				
Loss ratio	61.6	% 55.3	% 58.8	%
Acquisition expense ratio (2)	10.0	% 22.3	% 15.4	%
Other operating expense ratio	14.9	% 3.9	% 10.1	%
Combined ratio	86.5	% 81.5	% 84.3	%

(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 \$0.2 million and \$12.0 million, respectively, of gross and net premiums written and \$0.3 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 September 30, 2005			
	Insurance	Reinsurance	Total	
Gross premiums written (1)	\$ 617,499	\$ 445,628	\$ 1,048,042	
Net premiums written (1)	377,536	409,768	787,304	
Net premiums earned (1)	\$ 339,962	\$ 407,813	\$ 747,775	
Fee income	2,165	74	2,239	
Losses and loss adjustment expenses	(300,771 )	(371,453 )	(672,224 )	
Acquisition expenses, net	(34,976 )	(107,827 )	(142,803 )	
Other operating expenses	(53,644 )	(12,420 )	(66,064 )	
Underwriting income (loss)	\$ (47,264 )	\$ (83,813 )	(131,077 )	
Net investment income			59,270	
Net realized losses			(10,291 )	
Other expenses			(6,537 )	
Interest expense			(5,632 )	
Net foreign exchange gains			7,334	
Income (loss) before income taxes			(86,933 )	
Income tax benefit			642	
<b>Net income (loss)</b>			(86,291 )	
Preferred dividends				
<b>Net income (loss) available to common shareholders</b>			\$ (86,291 )	
<b>Underwriting Ratios</b>				
Loss ratio	88.5	% 91.1	% 89.9	%
Acquisition expense ratio (2)	10.0	% 26.4	% 19.0	%
Other operating expense ratio	15.8	% 3.0	% 8.8	%
Combined ratio	114.3	% 120.5	% 117.7	%

(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 \$14.3 million, respectively, of gross and net premiums written and \$1.1 million and \$12.4 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) Nine Months Ended September 30, 2006			
	Insurance	Reinsurance	Total	
Gross premiums written (1)	\$ 2,013,910	\$ 1,430,742	\$ 3,409,253	
Net premiums written (1)	1,277,175	1,138,327	2,415,502	
Net premiums earned (1)	\$ 1,190,788	\$ 1,125,836	\$ 2,316,624	
Fee income	3,950	3,592	7,542	
Losses and loss adjustment expenses	(760,727 )	(615,454 )	(1,376,181 )	
Acquisition expenses, net	(122,322 )	(273,460 )	(395,782 )	
Other operating expenses	(189,115 )	(40,418 )	(229,533 )	
Underwriting income	\$ 122,574	\$ 200,096	322,670	
Net investment income			272,451	
Net realized losses			(46,700 )	
Other expenses			(20,602 )	
Interest expense			(16,567 )	
Net foreign exchange losses			(15,650 )	
Income before income taxes			495,602	
Income tax expense			(28,127 )	
<b>Net income</b>			467,475	
Preferred dividends			(14,194 )	
<b>Net income available to common shareholders</b>			\$ 453,281	
<b>Underwriting Ratios</b>				
Loss ratio	63.9	% 54.7	% 59.4	%
Acquisition expense ratio (2)	10.1	% 24.3	% 17.0	%
Other operating expense ratio	15.9	% 3.6	% 9.9	%
Combined ratio	89.9	% 82.6	% 86.3	%

(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 \$1.0 million and \$34.4 million, respectively, of gross and net premiums written and \$1.7 million and \$37.4 million, respectively, of net premiums earned assumed through intersegment transactions.

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

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(U.S. dollars in thousands)	(Unaudited) Nine Months Ended September 30, 2005			
	Insurance	Reinsurance	Total	
Gross premiums written (1)	\$ 1,701,663	\$ 1,311,226	\$ 2,969,487	
Net premiums written (1)	1,073,316	1,237,517	2,310,833	
Net premiums earned (1)	\$ 1,015,084	\$ 1,169,651	\$ 2,184,735	
Fee income	4,657	4,719	9,376	
Losses and loss adjustment expenses	(737,604 )	(804,074 )	(1,541,678 )	
Acquisition expenses, net	(96,752 )	(320,722 )	(417,474 )	
Other operating expenses	(168,474 )	(35,241 )	(203,715 )	
Underwriting income	\$ 16,911	\$ 14,333	31,244	
Net investment income			162,846	
Net realized losses			(7,725 )	
Other expenses			(18,046 )	
Interest expense			(16,897 )	
Net foreign exchange gains			20,769	
Income before income taxes			172,191	
Income tax expense			(16,598 )	
<b>Net income</b>			<b>155,593</b>	
Preferred dividends				
<b>Net income available to common shareholders</b>			<b>\$ 155,593</b>	
<b>Underwriting Ratios</b>				
Loss ratio	72.7	% 68.7	% 70.6	%
Acquisition expense ratio (2)	9.3	% 27.4	% 19.0	%
Other operating expense ratio	16.6	% 3.0	% 9.3	%
Combined ratio	98.6	% 99.1	% 98.9	%

(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 \$2.3 million and \$41.1 million, respectively, of gross and net premiums written and \$3.5 million and \$43.5 million, respectively, of net premiums earned assumed through intersegment transactions.

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

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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 September 30, 2006		2005	
	Amount	% of Total	Amount	% of Total
<b>Net premiums written (1)</b>				
Property, marine and aviation	\$ 107,395	22.8	\$ 46,407	12.3
Professional liability	88,948	18.9	64,216	17.0
Construction and surety Programs	74,870	15.9	59,353	15.7
Executive assurance	64,558	13.7	56,335	14.9
Casualty	51,769	11.0	49,257	13.0
Healthcare	51,659	11.0	70,924	18.8
Other	17,051	3.6	19,507	5.2
Total	14,369	3.1	11,537	3.1
Total	\$ 470,619	100.0	\$ 377,536	100.0
<b>Net premiums earned (1)</b>				
Property, marine and aviation	\$ 89,294	21.0	\$ 32,484	9.6
Professional liability	71,165	16.7	53,212	15.6
Construction and surety Programs	65,696	15.5	56,965	16.8
Executive assurance	58,066	13.7	54,392	16.0
Casualty	49,641	11.7	37,791	11.1
Healthcare	61,903	14.6	76,200	22.4
Other	17,595	4.1	18,099	5.3
Total	11,297	2.7	10,819	3.2
Total	\$ 424,657	100.0	\$ 339,962	100.0
<b>Net premiums written by client location (1)</b>				
United States	\$ 364,726	77.5	\$ 324,525	86.0
Europe	69,012	14.7	22,680	6.0
Other	36,881	7.8	30,331	8.0
Total	\$ 470,619	100.0	\$ 377,536	100.0

(1) Insurance segment results include premiums written and earned assumed through intersegment transactions of \$0.2 million and \$0.3 million, respectively, for the 2006 third quarter and \$0.8 million and \$1.1 million, respectively, for the 2005 third quarter. Insurance segment results exclude premiums written and earned ceded through intersegment transactions of \$12.0 million and \$12.3 million, respectively, for the 2006 third quarter and \$14.3 million and \$12.4 million, respectively, for the 2005 third quarter.

INSURANCE SEGMENT (U.S. dollars in thousands)	(Unaudited) Nine Months Ended September 30, 2006		2005	
	Amount	% of Total	Amount	% of Total
<b>Net premiums written (1)</b>				
Property, marine and aviation	\$ 250,753	19.6	\$ 156,589	14.6
Construction and surety	222,216	17.4	170,155	15.9
Professional liability	214,957	16.8	167,874	15.6
Programs	181,604	14.2	168,126	15.7
Casualty	169,052	13.2	207,225	19.3
Executive assurance	151,201	11.9	117,777	11.0
Healthcare	49,365	3.9	48,569	4.5
Other	38,027	3.0	37,001	3.4
Total	\$ 1,277,175	100.0	\$ 1,073,316	100.0
<b>Net premiums earned (1)</b>				
Property, marine and aviation	\$ 207,045	17.4	\$ 131,567	13.0
Construction and surety	200,366	16.8	164,077	16.2
Professional liability	190,849	16.0	150,509	14.8
Programs	172,933	14.5	162,857	16.0
Casualty	185,832	15.6	219,153	21.6
Executive assurance	149,424	12.6	97,084	9.5
Healthcare	52,141	4.4	51,438	5.1
Other	32,198	2.7	38,399	3.8
Total	\$ 1,190,788	100.0	\$ 1,015,084	100.0
<b>Net premiums written by client location (1)</b>				
United States	\$ 1,032,924	80.9	\$ 934,181	87.0
Europe	156,525	12.2	78,981	7.4
Other	87,726	6.9	60,154	5.6
Total	\$ 1,277,175	100.0	\$ 1,073,316	100.0

(1) Insurance segment results include premiums written and earned assumed through intersegment transactions of \$1.0 million and \$1.7 million, respectively, for the nine months ended September 30, 2006 and \$2.3 million and \$3.5 million, respectively, for the nine months ended September 30, 2005. Insurance segment results exclude premiums written and earned ceded through intersegment transactions of \$34.4 million and \$37.4 million, respectively, for the nine months ended September 30, 2006 and \$41.1 million and \$43.5 million, respectively, for the nine months ended September 30, 2005.

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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 September 30, 2006		2005	
	Amount	% of Total	Amount	% of Total
<b>Net premiums written (1)</b>				
Casualty (2)	\$ 131,719	47.6	\$ 194,871	47.5
Property excluding property catastrophe	56,984	20.6	92,853	22.7
Other specialty	36,798	13.3	56,441	13.8
Property catastrophe	31,052	11.2	22,008	5.4
Marine and aviation	21,774	7.9	24,264	5.9
Other	(1,721 )	(0.6 )	19,331	4.7
Total	\$ 276,606	100.0	\$ 409,768	100.0
<b>Net premiums earned (1)</b>				
Casualty (2)	\$ 151,820	45.6	\$ 193,891	47.6
Property excluding property catastrophe	71,192	21.4	72,865	17.9
Other specialty	48,865	14.7	71,529	17.5
Property catastrophe	38,378	11.5	20,387	5.0
Marine and aviation	22,929	6.9	31,089	7.6
Other	(268 )	(0.1 )	18,052	4.4
Total	\$ 332,916	100.0	\$ 407,813	100.0
<b>Net premiums written (1)</b>				
Pro rata	\$ 220,552	79.7	\$ 323,133	78.9
Excess of loss	56,054	20.3	86,635	21.1
Total	\$ 276,606	100.0	\$ 409,768	100.0
<b>Net premiums earned (1)</b>				
Pro rata	\$ 243,473	73.1	\$ 304,425	74.6
Excess of loss	89,443	26.9	103,388	25.4
Total	\$ 332,916	100.0	\$ 407,813	100.0
<b>Net premiums written by client location (1)</b>				
United States	\$ 145,647	52.7	\$ 245,755	60.0
Europe	67,064	24.2	95,241	23.2
Bermuda	38,285	13.8	38,507	9.4
Canada	6,867	2.5	17,549	4.3
Asia and Pacific	3,913	1.4	5,134	1.2
Other	14,830	5.4	7,582	1.9
Total	\$ 276,606	100.0	\$ 409,768	100.0

- (1) Reinsurance segment results include premiums written and earned assumed through intersegment transactions of \$12.0 million and \$12.3 million, respectively, for the 2006 third quarter and \$14.3 million and \$12.4 million, respectively, for the 2005 third quarter. Reinsurance segment results exclude premiums written and earned ceded through intersegment transactions of \$0.2 million and \$0.3 million, respectively, for the 2006 third quarter and \$0.8 million and \$1.1 million, respectively, for the 2005 third quarter.
- (2) Includes professional liability and executive assurance business.

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REINSURANCE SEGMENT (U.S. dollars in thousands)	(Unaudited) Nine Months Ended September 30, 2006		2005	
	Amount	% of Total	Amount	% of Total
<b>Net premiums written (1)</b>				
Casualty (2)	\$ 470,823	41.4	\$ 566,386	45.8
Property excluding property catastrophe	252,551	22.2	262,389	21.2
Other specialty	194,555	17.1	222,458	18.0
Property catastrophe	135,174	11.9	75,932	6.1
Marine and aviation	83,752	7.3	72,382	5.8
Other	1,472	0.1	37,970	3.1
Total	\$ 1,138,327	100.0	\$ 1,237,517	100.0
<b>Net premiums earned (1)</b>				
Casualty (2)	\$ 506,491	45.0	\$ 583,551	49.9
Property excluding property catastrophe	232,480	20.6	217,848	18.6
Other specialty	177,754	15.8	190,828	16.3
Property catastrophe	136,965	12.2	66,916	5.7
Marine and aviation	70,280	6.2	73,699	6.3
Other	1,866	0.2	36,809	3.2
Total	\$ 1,125,836	100.0	\$ 1,169,651	100.0
<b>Net premiums written (1)</b>				
Pro rata	\$ 781,525	68.7	\$ 948,622	76.7
Excess of loss	356,802	31.3	288,895	23.3
Total	\$ 1,138,327	100.0	\$ 1,237,517	100.0
<b>Net premiums earned (1)</b>				
Pro rata	\$ 860,199	76.4	\$ 876,563	74.9
Excess of loss	265,637	23.6	293,088	25.1
Total	\$ 1,125,836	100.0	\$ 1,169,651	100.0
<b>Net premiums written by client location (1)</b>				
United States	\$ 651,639	57.2	\$ 690,284	55.8
Europe	305,990	26.9	360,706	29.1
Bermuda	105,967	9.3	82,885	6.7
Canada	25,072	2.2	59,607	4.8
Asia and Pacific	17,721	1.6	20,533	1.7
Other	31,938	2.8	23,502	1.9
Total	\$ 1,138,327	100.0	\$ 1,237,517	100.0

(1) Reinsurance segment results include premiums written and earned assumed through intersegment transactions of \$34.4 million and \$37.4 million, respectively, for the nine months ended September 30, 2006 and \$41.1 million and \$43.5 million, respectively, for the nine months ended September 30, 2005. Reinsurance segment results exclude premiums written and earned ceded through intersegment transactions of \$1.0 million and \$1.7 million, respectively, for the nine months ended September 30, 2006 and \$2.3 million and \$3.5 million, respectively, for the nine months ended September 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 September 30, 2006		(Unaudited) Nine Months Ended September 30, 2006	
	2006	2005	2006	2005
<b>Premiums Written</b>				
Direct	\$ 735,791	\$ 602,087	\$ 1,972,740	\$ 1,659,769
Assumed	369,374	445,955	1,436,513	1,309,718
Ceded	(357,940 )	(260,738 )	(993,751 )	(658,654 )
Net	\$ 747,225	\$ 787,304	\$ 2,415,502	\$ 2,310,833
<b>Premiums Earned</b>				
Direct	\$ 648,014	\$ 564,013	\$ 1,832,893	\$ 1,589,604
Assumed	412,408	446,807	1,308,954	1,239,307
Ceded	(302,849 )	(263,045 )	(825,223 )	(644,176 )
Net	\$ 757,573	\$ 747,775	\$ 2,316,624	\$ 2,184,735
<b>Losses and Loss Adjustment Expenses</b>				
Direct	\$ 354,199	\$ 684,029	\$ 1,222,245	\$ 1,310,827
Assumed	208,292	486,417	704,057	935,891
Ceded	(116,743 )	(498,222 )	(550,121 )	(705,040 )
Net	\$ 445,748	\$ 672,224	\$ 1,376,181	\$ 1,541,678

The Company monitors the financial condition of its reinsurers and attempts to place coverages only with substantial, financially sound carriers. At September 30, 2006 and December 31, 2005, approximately 93.6% 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 September 30, 2006 and December 31, 2005, the largest reinsurance recoverables from any one carrier were less than 5.4% 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 \$0.3 million and \$0.1 million, respectively, for the 2006 third quarter and 2005 third quarter, and \$2.9 million and \$0.2 million, respectively, for the nine months ended September 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 \$0.5 million and \$1.0 million, respectively, for the 2006 third quarter and 2005 third quarter, and \$1.8 million and \$4.8 million, respectively, for the nine months ended September 30, 2006 and 2005. On a notional basis, the amount of premiums from those contracts that contain an element of underwriting risk was de minimis for the 2006 third quarter, compared to \$7.4 million for the 2005 third quarter, and \$11.3 million for the nine months ended September 30, 2006, compared to \$17.0 million for the 2005 period.

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) September 30, 2006	December 31, 2005
Fixed maturities available for sale, at fair value	\$ 6,727,113	\$ 5,280,987
Fixed maturities pledged under securities lending agreements, at fair value (1)	815,268	862,766
Total fixed maturities	7,542,381	6,143,753
Short-term investments available for sale, at fair value	887,187	681,887
Short-term investments pledged under securities lending agreements, at fair value (1)		1,100
Other investments, at fair value	290,305	70,233
Total invested assets (1)	\$ 8,719,873	\$ 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 \$844.4 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 \$815.3 million and \$863.9 million, respectively, of fixed maturities and short-term investments pledged under securities lending agreements, at fair value at September 30, 2006 and December 31, 2005.



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

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

(U.S. dollars in thousands)	Estimated Fair Value	Gross Unrealized Gains	Gross Unrealized Losses	Amortized Cost
<b>September 30, 2006 (unaudited):</b>				
U.S. government and government agencies	\$ 2,161,753	\$ 21,465	\$ (7,238 )	\$ 2,147,526
Corporate bonds	1,349,520	7,402	(5,489 )	1,347,607
Mortgage backed securities	1,077,520	9,729	(316 )	1,068,107
Commercial mortgage backed securities	849,654	7,005	(705 )	843,354
Municipal bonds	831,945	7,498	(2,377 )	826,824
Asset backed securities	702,225	1,843	(596 )	700,978
Non-U.S. government securities	569,764	8,314	(3,455 )	564,905
Total	\$ 7,542,381	\$ 63,256	\$ (20,176 )	\$ 7,499,301
<b>December 31, 2005:</b>				
U.S. government and government agencies	\$ 2,106,866	\$ 18,152	\$ (10,001 )	\$ 2,098,715
Corporate bonds	1,595,559	2,663	(10,345 )	1,603,241
Municipal bonds	623,822	5,039	(4,006 )	622,789
Asset backed securities	591,401	194	(3,348 )	594,555
Commercial mortgage backed securities	469,984	292	(5,292 )	474,984
Non-U.S. government securities	379,328	3,756	(20,483 )	396,055
Mortgage backed securities	376,793	653	(1,576 )	377,716
Total	\$ 6,143,753	\$ 30,749	\$ (55,051 )	\$ 6,168,055

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

(U.S. dollars in thousands) Rating (1)	(Unaudited) September 30, 2006 Estimated Fair Value	% of Total	December 31, 2005 Estimated Fair Value	% of Total
AAA	\$ 6,295,539	83.5	\$ 4,692,579	76.4
AA	539,798	7.2	654,129	10.6
A	444,408	5.9	538,570	8.8
BBB	128,710	1.7	146,325	2.4
BB	31,448	0.4	24,472	0.4
B	61,665	0.8	53,178	0.9
Lower than B	8,328	0.1	7,388	0.1
Not rated	32,485	0.4	27,112	0.4
Total	\$ 7,542,381	100.0	\$ 6,143,753	100.0

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

**Securities Lending Agreements**

The Company participates in a securities lending program under which certain of its fixed income portfolio securities are loaned to third parties, primarily major brokerage firms, for short periods of time through a lending agent. Such securities have been reclassified as Fixed maturities and short-term investments pledged under securities lending agreements, at fair value. The Company maintains control over the securities it lends, retains the earnings and cash flows associated with the loaned securities and receives a fee from the borrower for the temporary use of the securities. Collateral received, primarily in the form of cash, is required at a rate of 102% of the market value of the loaned securities (or 104% 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 September 30, 2006, the fair value and amortized cost of fixed maturities and short-term investments pledged under securities lending agreements were \$815.3 million and \$810.2 million, respectively, while collateral received totaled \$844.4 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. The Company 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 \$73.7 million at September 30, 2006. In connection with the use of equity futures, the Company also began using exchange-traded Treasury note futures in the 2006 first quarter. The notional value of the net short position for Treasury note futures was \$16.9 million at September 30, 2006. The Company recorded net realized gains of \$5.6 million and \$4.4 million, respectively, for the 2006 third quarter and nine months ended September 30, 2006 related to changes in the fair value of all futures contracts. At September 30, 2006, the carrying value and fair value of all futures contracts was de minimis.

**Other Investments**

The following table details the Company's other investments:

(U.S. dollars in thousands)	(Unaudited) September 30, 2006		December 31, 2005	
	Estimated Fair Value	Cost	Estimated Fair Value	Cost
Alternative investment funds	\$ 200,035	\$ 200,411	\$ 28,719	\$ 28,746
Equity securities	68,838	60,815	27,900	25,899
Privately held securities	21,432	14,216	13,614	5,194
Total	\$ 290,305	\$ 275,442	\$ 70,233	\$ 59,839

Other investments include (i) alternative investment funds that invest in investment grade and non-investment grade fixed income securities; (ii) equity securities consisting of the Company's investments in certain stock index funds and other preferred stocks; and (iii) privately held securities. The Company's investment commitments related to its other investments totaled approximately \$5.2 million and \$8.4 million, respectively, at September 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) September 30, 2006	December 31, 2005
Deposits with U.S. regulatory authorities	\$ 215,178	\$ 173,313
Deposits with non-U.S. regulatory authorities	20,759	17,029
Assets used for collateral or guarantees	661,673	745,084
Trust funds	96,065	69,468
Total restricted assets	\$ 993,675	\$ 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 September 30, 2006 and December 31, 2005, such amounts approximated \$3.42 billion and \$2.77 billion, respectively.

**Net Investment Income**

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

(U.S. dollars in thousands)	(Unaudited) Three Months Ended September 30, 2006		(Unaudited) Nine Months Ended September 30, 2006	
	2006	2005	2006	2005
Fixed maturities	\$ 87,759	\$ 58,902	\$ 234,346	\$ 164,472
Short-term investments	12,283	1,640	34,230	3,115
Other	4,384	1,421	12,235	2,161
Gross investment income	104,426	61,963	280,811	169,748
Investment expenses	(2,804 )	(2,693 )	(8,360 )	(6,902 )
Net investment income	\$ 101,622	\$ 59,270	\$ 272,451	\$ 162,846

**Net Realized Gains (Losses)**

Net realized gains (losses) were as follows:

(U.S. dollars in thousands)	(Unaudited) Three Months Ended September 30,		(Unaudited) Nine Months Ended September 30,	
	2006	2005	2006	2005
Net realized gains (losses):				
Fixed maturities	\$ (17,488 )	\$ (13,086 )	\$ (55,133 )	\$ (10,613 )
Other investments	299	2,463	3,441	1,012
Other	6,074	332	4,992	1,876
Total	\$ (11,115 )	\$ (10,291 )	\$ (46,700 )	\$ (7,725 )

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 third quarter and nine months ended September 30, 2006, net realized losses on the Company's fixed maturities of \$17.5 million and \$55.1 million, respectively, included a provision of \$13.6 million and \$30.1 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. In periods subsequent to the recognition of an other-than-temporary impairment on fixed maturities, the Company accounts for such securities as if they had been purchased on the measurement date of the other-than-temporary impairment and the provision for the other-than-temporary impairment (reflected as a discount or reduced premium based on the new cost basis) is amortized into net investment income over the remaining life of the fixed maturities, or until such securities are sold. The declines in market value on such securities were primarily due to the current interest rate environment. For the 2005 third quarter and nine months ended September 30, 2005, the Company did not consider any declines in the market value of investments to be other-than-temporary.

The balance of \$3.9 million and \$25.0 million, respectively, in net realized losses on the Company's fixed maturities in the 2006 third quarter and nine months ended September 30, 2006 resulted from the sale of securities, compared to net realized losses from the sale of fixed maturities of \$13.1 million and \$10.6 million, respectively, in the 2005 third quarter and nine months ended September 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 September 30, 2006		(Unaudited) Nine Months Ended September 30, 2006	
	2006	2005	2006	2005
<b>Basic earnings (loss) per common share:</b>				
Net income (loss)	\$ 192,298	\$ (86,291 )	\$ 467,475	\$ 155,593
Preferred dividends	(6,488 )		(14,194 )	
Net income (loss) available to common shareholders	185,810	(86,291 )	453,281	155,593
Divided by:				
Weighted average common shares outstanding (1)	73,244,138	34,750,770	73,111,759	34,561,131
Basic earnings (loss) per common share	\$ 2.54	\$ (2.48 )	\$ 6.20	\$ 4.50
<b>Diluted earnings (loss) per common share:</b>				
Net income (loss)	\$ 192,298	\$ (86,291 )	\$ 467,475	\$ 155,593
Preferred dividends	(6,488 )		(14,194 )	
Net income (loss) available to common shareholders	185,810	(86,291 )	453,281	155,593
Divided by:				
Weighted average common shares outstanding (1)	73,244,138	34,750,770	73,111,759	34,561,131
Effect of dilutive securities:				
Series A convertible preference shares				37,328,788
Warrants				54,011
Nonvested restricted shares	502,442		473,321	437,161
Stock options	2,537,330		2,523,430	2,076,922
Weighted average common shares and common share equivalents outstanding diluted	76,283,910	34,750,770	76,108,510	74,458,013
Diluted earnings (loss) per common share	\$ 2.44	\$ (2.48 )	\$ 5.96	\$ 2.09

(1) For the 2005 third quarter and nine months ended September 30, 2005, basic weighted average common shares and common share equivalents outstanding excluded 37,327,502 and 37,328,788 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. In addition, due to the net loss recorded for the 2005 third quarter, diluted weighted average common shares and common share equivalents outstanding for the 2005 third quarter do not include 40.0 million shares of dilutive securities since the inclusion of such securities would have had an anti-dilutive effect on the loss per share under GAAP.

Certain stock options were not included in the computation of diluted earnings per share where the exercise price of the stock options exceeded the average market price and would have been anti-dilutive or where, when applying the treasury stock method to in-the-money options, the sum of the proceeds, including unrecognized compensation, exceeded the average market price and would have been anti-dilutive. The number of excluded stock options were 1,015,375 and nil, respectively, for the 2006 and 2005 third quarters and 842,390 and 31,071, respectively, for the nine months ended September 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 1.2% for the 2006 third quarter, and 5.7% and 9.6%, respectively, for the nine months ended September 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 1.2% effective tax rate in the 2006 third quarter resulted from a reduction in the Company's effective tax rate on income before income taxes from 8.6% for the six months ended June 30, 2006 to 5.7% for the nine months ended September 30, 2006. The Company's valuation allowance related to its deferred income tax assets is \$1.4 million at September 30, 2006.

## 10. Transactions with Related Parties

In connection with the Company's information technology initiative in 2002, the Company entered into arrangements with two software companies, which provide document management systems and information and research tools to insurance underwriters, in which John Pasquesi, Vice Chairman of 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 \$0.1 million and \$0.4 million, respectively, for the 2006 third quarter and nine months ended September 30, 2006, compared to \$0.1 million and \$0.3 million, respectively, for the 2005 third quarter and nine months ended September 30, 2005.

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. The Company funded \$6.25 million on July 28, 2006 and \$3.75 million on August 16, 2006, with a remaining commitment of \$15.0 million. 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 25.5% of the Company s outstanding voting shares as of September 30, 2006. 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.

#### **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 reinsureds. 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 September 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. Interest expense on the Senior Notes was approximately \$5.5 million for the 2006 and 2005 third quarters, and \$16.6 million for the nine months ended September 30, 2006 and 2005.

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

On August 30, 2006, the Company entered into the Second Amended and Restated Credit Agreement ( Credit Agreement ) for a \$300 million unsecured revolving loan and letter of credit facility and a \$1.0 billion secured letter of credit facility, an increase of \$500 million from the previous credit agreement. 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 insurance and reinsurance subsidiaries.

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 \$1.95 billion plus 25% of future aggregate net income for each quarterly period (not including any future net losses) beginning after June 30, 2006 and 25% of future aggregate proceeds from the issuance of common or preferred equity 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 September 30, 2006. The Credit Agreement expires on August 30, 2011.

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 \$1.5 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 September 30, 2006. At such date, the Company had approximately \$545.3 million in outstanding letters of credit under the LOC Facilities, which were secured by investments totaling \$582.6 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 did 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, will be 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 third quarter and nine months ended September 30, 2006, \$77.8 million and \$237.9 million, respectively, of premiums written and \$52.0 million and \$95.6 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 \$4.6 million at September 30, 2006. The fair value of the Guarantee included as a liability in the Company's balance sheet was \$0.3 million at September 30, 2006 and December 31, 2005.

#### **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 September 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 were granted in an Opinion and Order dated September 20, 2006, in which the court dismissed all counts of the second amended complaint with prejudice. Although it is possible that plaintiffs may appeal this Order, management does not believe that any of the plaintiffs' claims are meritorious.

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

In February 2006, the FASB issued SFAS No. 155, Accounting for Certain Hybrid Financial Instruments, an amendment of FASB Statements No. 133 and 150. SFAS No. 155 (i) permits fair value remeasurement for any hybrid financial instrument that contains an embedded derivative that otherwise would require bifurcation, (ii) clarifies that certain instruments are not subject to the requirements of SFAS No. 133, Accounting for Derivative Instruments and Hedging Activities, (iii) establishes a requirement to evaluate interests in securitized financial assets to identify interests that may contain an embedded derivative requiring bifurcation,

(iv) clarifies what may be an embedded derivative for certain concentrations of credit risk and (v) amends SFAS No. 140, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities*, to eliminate certain prohibitions related to derivatives on a qualifying special-purpose entity. SFAS No. 155 is effective for the Company for all financial instruments acquired after January 1, 2007. On October 25, 2006, the FASB met and accepted a proposal that will exempt most securitized financial instruments that are subject to prepayment from the mark-to-market or bifurcation requirements of SFAS No. 133 and SFAS No. 155. The FASB will expose this exemption for comment for a 30 day period. After the comment period, the FASB is expected to issue the exemption. The Company is currently evaluating the impact that SFAS No. 155 may have on its financial statements.

In July 2006, the FASB issued FASB Interpretation No. 48 ( *FIN No. 48* ), *Accounting for Uncertainty in Income Taxes*, an interpretation of SFAS 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.

In September 2006, the FASB issued SFAS No. 157, *Fair Value Measurements*, which addresses how companies should measure fair value when they are required to use a fair value measure for recognition or disclosure purposes under GAAP. As a result of SFAS No. 157, there is now a common definition of fair value to be used throughout GAAP. The Company is reviewing the impact that adopting SFAS No. 157 will have on its financial statements. SFAS No. 157 is effective for the Company beginning in the 2008 first quarter. The FASB also issued Statement No. 158 ( *SFAS No. 158* ), *Employers Accounting for Defined Benefit Pension and Other Postretirement Plans*, which amends SFAS No. 87, *Employers Accounting for Pensions*, SFAS No. 88, *Employers Accounting for Settlements and Curtailments of Defined Benefit Pension Plans and for Termination Benefits*, SFAS No. 106, *Employers Accounting for Postretirement Benefits Other Than Pensions*, and SFAS No. 132 (revised 2003), *Employers Disclosures about Pensions and Other Postretirement Benefits*, and applies to all plan sponsors who offer defined benefit postretirement benefit plans. For purposes of providing employees with retirement benefits, the Company maintains a defined contribution retirement plan and does not utilize defined benefit pension or other postretirement benefit plans. Therefore, SFAS No. 158 will not impact the Company's financial statements as it does not change the accounting and reporting with respect to defined contribution plans.

In addition, in September 2006, the Securities and Exchange Commission ( *SEC* ) issued Staff Accounting Bulletin No. 108 ( *SAB No. 108* ), *Considering the Effects of Prior Year Misstatements when Quantifying Misstatements in Current Year Financial Statements*. *SAB No. 108* addresses quantifying the financial statement effects of misstatements, specifically, how the effects of prior year uncorrected errors must be considered in quantifying misstatements in the current year financial statements. *SAB No. 108* acknowledges the existing diversity in practice in this area and discusses the techniques commonly used to accumulate and quantify misstatements. There have been two widely-recognized methods for quantifying the effects of financial statement misstatements: the rollover method and the iron curtain method. The rollover method quantifies a misstatement based on the effects of correcting the misstatement existing in the current period income statement. The iron curtain method quantifies a misstatement based on the effects of correcting the misstatement existing in the balance sheet at the end of the current period, regardless of the misstatement's period(s) of origin. In *SAB No. 108*, the SEC established an approach (i.e., the dual approach) that requires quantifying errors under both the rollover and iron curtain methods and evaluating the misstatement of the current year financial statements calculated under each approach. After considering all relevant quantitative and qualitative factors, if either approach results in a misstatement that is material, a registrant's financial statements must be adjusted. *SAB No. 108* is effective for fiscal years ending after November 15, 2006. The Company expects that the adoption of *SAB No. 108* in the 2006 fourth quarter will have no impact on its financial statements.

## 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 \$3.65 billion in capital at September 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. As a result, 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).

#### **Investments 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**

See note 15, Recent Accounting Pronouncements, of the notes accompanying our consolidated financial statements for a description of recent accounting pronouncements.

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

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

(U.S. dollars in thousands, except share data)	<b>Three Months Ended September 30,</b>	
	<b>2006</b>	<b>2005</b>
Net income (loss) available to common shareholders	\$ 185,810	\$ (86,291 )
Diluted net income (loss) per common share (1)	\$ 2.44	\$ (2.48 )
Diluted weighted average common shares and common share equivalents outstanding (1)	76,283,910	34,750,770

(1) Due to the net loss recorded in the 2005 third quarter, diluted weighted average common shares and common share equivalents outstanding for the 2005 third quarter do not include 40.0 million shares of dilutive securities since the inclusion of such securities would have had an anti-dilutive effect on the loss per share under GAAP. As such, the comparison of per share amounts and diluted weighted average common shares and common share equivalents outstanding for the 2006 and 2005 third quarters is not meaningful.

Net income available to common shareholders was \$185.8 million for the 2006 third quarter, compared to a net loss of \$86.3 million for the 2005 third quarter. The improvement in our results of operations was primarily due to a lower level of catastrophic activity in the 2006 period, as discussed in Segment Information below, and growth in investment income. Our net income available to common shareholders represented a 26.0% annualized return on average common equity for the 2006 third quarter. 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 the 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.

### 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 September 30,	
	2006	2005
Gross premiums written	\$ 750,609	\$ 617,499
Net premiums written	470,619	377,536
Net premiums earned	\$ 424,657	\$ 339,962
Fee income	1,293	2,165
Losses and loss adjustment expenses	(261,553 )	(300,771 )
Acquisition expenses, net	(43,162 )	(34,976 )
Other operating expenses	(63,350 )	(53,644 )
Underwriting income (loss)	\$ 57,885	\$ (47,264 )
<b>Underwriting Ratios</b>		
Loss ratio	61.6	% 88.5
Acquisition expense ratio (1)	10.0	% 10.0
Other operating expense ratio	14.9	% 15.8
Combined ratio	86.5	% 114.3

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

*Underwriting Income (Loss).* The insurance segment reported underwriting income of \$57.9 million for the 2006 third quarter, compared to an underwriting loss of \$47.3 million for the 2005 third quarter. The combined ratio for the insurance segment was 86.5% for the 2006 third quarter, compared to 114.3% for the 2005 third quarter. In the 2005 third quarter, the insurance segment incurred \$96.5 million of estimated pre-tax net losses, after reinsurance and net of reinstatement premiums, related to the catastrophic events in the period, while the 2006 third quarter did not include any material catastrophic activity. The components of the insurance segment's underwriting income are discussed below.

*Premiums Written.* Gross premiums written by the insurance segment were \$750.6 million for the 2006 third quarter, compared to \$617.5 million for the 2005 third quarter, and ceded premiums written were 37.3% of gross premiums written for the 2006 third quarter, compared to 38.9% for the 2005 third quarter. Ceded premiums written in the 2005 third quarter included \$20.0 million, or 3.2 points, of reinstatements related to the catastrophic events in the period. Net premiums written by the insurance segment were \$470.6 million for the 2006 third quarter, compared to \$377.5 million for the 2005 third quarter. Over half of the increase was in worldwide property business, primarily as a result of rate increases which were tempered by higher reinsurance costs. In addition, gross premiums written were higher in professional liability business, mainly as a result of growth in policies written and in construction and surety business. This growth was partially offset by a reduction in U.S. primary casualty business in response to increasing competition. 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.

Effective September 1, 2006, Arch Insurance Company entered into an agreement to sell all of its in force U.S. ocean marine business (and renewal rights to such business) to a subsidiary of American International Group, Inc. (AIG). Under the terms of the agreement, the U.S. ocean marine insurance business previously underwritten by Arch Insurance Company will be serviced by AIG Global Marine, a division of the property and casualty insurance subsidiaries of AIG. The transaction is not expected to have a material effect on the insurance segment's financial results.

*Net Premiums Earned.* Net premiums earned by the insurance segment were \$424.7 million for the 2006 third quarter, compared to \$340.0 million for the 2005 third quarter, and 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 61.6% for the 2006 third quarter, compared to 88.5% for the 2005 third quarter. The insurance segment's results for the 2005 third quarter included \$76.5 million related to the hurricane activity in the period, or 22.5 points of the 2005 third quarter loss ratio, while the 2006 third quarter did not include any comparable events. The 2006 third quarter included \$4.9 million of estimated net adverse development in prior year loss reserves, compared to \$3.8 million of estimated net adverse development in the 2005 period. The estimated net adverse development in the 2006 third quarter primarily resulted from \$10.6 million of adverse development on short-tail lines, including \$8.0 million of adverse development related to the 2005 third quarter hurricane activity, partially offset by favorable development in medium-tail lines, mainly in program and marine business. Estimated net adverse development in the 2005 period was primarily in short-tail lines. The net impact of the change in prior year development resulted in a 0.3 point increase in the 2006 third quarter loss ratio. In addition, the 2006 third quarter included a substantially higher percentage of net premiums earned attributable to property business (than in the 2005 period) and, in periods of low catastrophic activity, such as the 2006 third quarter, property loss ratios generally are significantly lower than casualty loss ratios.

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 \$120.7 million through such coverage for Hurricane Katrina and \$7.2 million for Hurricane Wilma with approximately \$58.6 million of remaining available coverage for Hurricane Katrina and \$182.8 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 24.9% in the 2006 third quarter, compared to 25.8% in the 2005 third quarter. The acquisition expense ratio was 10.0% for the 2006 and 2005 third quarters and 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 insurance segment's other operating expense ratio was 14.9% for the 2006 third quarter, compared to 15.8% for the 2005 third quarter. The lower ratio for the 2006 third quarter 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)	Three Months Ended		
	September 30, 2006	2005	
Gross premiums written	\$ 366,833	\$ 445,628	
Net premiums written	276,606	409,768	
Net premiums earned	\$ 332,916	\$ 407,813	
Fee income	976	74	
Losses and loss adjustment expenses	(184,195 )	(371,453 )	
Acquisition expenses, net	(74,367 )	(107,827 )	
Other operating expenses	(12,987 )	(12,420 )	
Underwriting income (loss)	\$ 62,343	\$ (83,813 )	
<b>Underwriting Ratios</b>			
Loss ratio	55.3	% 91.1	%
Acquisition expense ratio	22.3	% 26.4	%
Other operating expense ratio	3.9	% 3.0	%
Combined ratio	81.5	% 120.5	%

*Underwriting Income (Loss).* The reinsurance segment reported underwriting income of \$62.3 million for the 2006 third quarter, compared to an underwriting loss of \$83.8 million for the 2005 third quarter. The combined ratio for the reinsurance segment was 81.5% for the 2006 third quarter, compared to 120.5% for the 2005 third quarter. In the 2005 third quarter, the reinsurance segment incurred \$159.5 million of estimated pre-tax net losses, after reinsurance and net of reinstatement premiums, related to the catastrophic events in the

period, while the 2006 third quarter did not include significant catastrophic activity. The components of the reinsurance segment's underwriting income are discussed below.

*Premiums Written.* Gross premiums written by the reinsurance segment were \$366.8 million in the 2006 third quarter, compared to \$445.6 million for the 2005 third quarter. Part of the decrease was due to the fact that gross premiums written in the 2005 third quarter included \$18.2 million of reinstatement premiums, primarily in non-traditional and marine business, related to the catastrophic events in the period. In addition, during the 2006 third quarter, the reinsurance segment recorded premium portfolios out on two property treaties which reduced premiums written by \$9.3 million, compared to \$7.8 million of additional premiums written on such treaties in the 2005 third quarter, and recorded a \$9.0 million reduction in premiums written related to certain treaties written in prior underwriting years, compared to \$5.9 million of additional premiums written on such treaties in the 2005 third quarter. Further, during the 2006 second quarter, the reinsurance segment wrote certain property business which, in 2005, was written during the 2005 third quarter. A significant portion of the remaining decrease in gross premiums written in the period came in international and U.S. casualty business as a result of reduced participations on a number of quota share treaties in the 2006 period. The decreases in gross premiums written noted above were partially offset by continued growth in property and marine business, due to higher rates and an increase in exposure, which 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.

Ceded premiums written by the reinsurance segment were 24.6% of gross premiums written for the 2006 third quarter, compared to 8.0% for the 2005 third quarter. The higher ceded percentage in the 2006 third quarter primarily resulted from the \$77.8 million of premiums written ceded by Arch Reinsurance Ltd. ( Arch Re Bermuda ), the reinsurance segment's Bermuda operations, to Flatiron Re Ltd. (\$52.0 million on an earned basis) 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.

Net premiums written by the reinsurance segment were \$276.6 million for the 2006 third quarter, compared to \$409.8 million for the 2005 third quarter. The decrease in net premiums written was primarily due to the reasons noted in the discussion of gross premiums written above. In addition, the growth in property and marine gross premiums written was more than offset by the amounts ceded to Flatiron Re Ltd. 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 by the reinsurance segment were \$332.9 million for the 2006 third quarter, compared to \$407.8 million for the 2005 third quarter, and generally reflect changes in net premiums written over the previous five quarters, including the mix and type of business written. In addition, the premium portfolios out and the reduction in premiums written related to certain treaties written in prior underwriting years noted above were fully recognized as a decrease in net premiums earned during the 2006 third quarter.

*Losses and Loss Adjustment Expenses.* The loss ratio for the reinsurance segment was 55.3% for the 2006 third quarter, compared to 91.1% for the 2005 third quarter. The reinsurance segment's results for the 2005 third quarter included \$177.7 million related to the catastrophic events in the period, or 43.6 points of the 2005 third quarter loss ratio, while the 2006 third quarter did not include any comparable events. The 2006 third quarter included estimated net favorable development in prior year loss reserves of \$27.8 million, including \$1.1 million of favorable development related to the 2005 third quarter catastrophic events, compared to estimated net favorable development in the 2005 third quarter of \$34.8 million, which included \$6.6 million resulting from the commutation of a treaty. The net favorable development in both periods was primarily attributable to property and other short tail business. The net impact of the change in estimated net prior year development was a 2.1 point increase in the 2006 third quarter loss ratio. In addition, the 2006 third quarter reflected a substantially higher percentage of net premiums earned attributable to property business (than in the 2005 period) and, in

periods of low catastrophic activity, such as the 2006 third quarter, property loss ratios generally are significantly lower than casualty loss ratios.

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 26.2% in the 2006 third quarter, compared to 29.4% in the 2005 third quarter. The acquisition expense ratio for the 2006 third quarter was 22.3%, compared to 26.4% for the 2005 third 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 third quarter acquisition expense ratio by 2.4 points. The 2006 third quarter also included a \$1.5 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 third quarter related to the commutation of a treaty as noted above. The net impact of the change in estimated net prior year development resulted in a 1.8 point decrease in the 2006 third quarter acquisition expense ratio. The reinsurance segment's other operating expense ratio was 3.9% for the 2006 third quarter, compared to 3.0% for the 2005 third quarter, with the higher ratio in the 2006 third quarter primarily driven by the lower level of net premiums earned in the period.

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

Net investment income was \$101.6 million for the 2006 third quarter, compared to \$59.3 million for the 2005 third quarter. The increase in net investment income in the 2006 third 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 4.78% for the 2006 third quarter, compared to 3.55% for the 2005 third 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)	<b>Three Months Ended September 30,</b>	
	<b>2006</b>	<b>2005</b>
Fixed maturities	\$ (17,488 )	\$ (13,086 )
Other investments	299	2,463
Other	6,074	332
Total	\$ (11,115 )	\$ (10,291 )

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 third quarter was 2.94%, compared to (0.39%) for the 2005 third quarter. The higher total return in the 2006 third quarter compared to the 2005 third quarter was primarily due to movements in interest rates during the periods, as interest rates decreased in the 2006 period and increased during the 2005 period.

For the 2006 third quarter, net realized losses on our fixed maturities of \$17.5 million included a provision of \$13.6 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 third quarter. In periods subsequent to the recognition of an other-than-temporary impairment on fixed maturities, we account for such securities as if they had been purchased on the measurement date of the other-than temporary impairment and the provision for the other-than-temporary impairment (reflected as a discount or reduced premium based on the new cost basis) is amortized into net investment income over the remaining life of the fixed maturities, or until such securities are sold. The declines in market value on such securities were primarily due to the current interest rate environment. For the 2005 third quarter, we did not consider any declines in the market value of investments to be other-than-temporary. The balance of \$3.9 million in net realized losses on our fixed maturities in the 2006 third quarter resulted from the sale of securities, compared to net realized losses from the sale of fixed maturities of \$13.1 million in the 2005 third quarter. In the 2006 and 2005 third 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 third quarters, we realized gross losses from the sale of fixed maturities of \$14.7 million and \$30.9 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)	<b>Three Months Ended September 30,</b>	
	<b>2006</b>	<b>2005</b>
Less than 6 months	\$ 8,137	\$ 14,158
At least 6 months but less than 12 months	4,952	8,682
Over 12 months	1,618	8,098
Total	\$ 14,707	\$ 30,938

***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 and 2005 third quarters. 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 third quarter are not comparable to the 2005 third quarter.

As required by the provisions of SFAS 123(R), we recorded pre-tax share-based compensation expense related to stock options of \$2.0 million in the 2006 third quarter. Under the modified prospective method of transition, no expense related to stock options was recorded in the 2005 third quarter. For the 2006 fourth quarter, we expect to record pre-tax share-based compensation expense related to stock options of approximately \$1.7 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 September 30, 2006, there was approximately \$26.2 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).

***Interest Expense***

Interest expense was \$5.4 million for the 2006 third quarter, compared to \$5.6 million for the 2005 third quarter. Such amounts primarily relate to the \$300 million in 7.35% senior notes outstanding in both periods.

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

Net foreign exchange losses for the 2006 third quarter of \$4.3 million consisted of net unrealized losses of \$10.9 million and net realized gains of \$6.6 million, compared to net foreign exchange gains for the 2005 third quarter of \$7.3 million, which consisted of net unrealized gains of \$7.6 million and net realized losses of \$0.3 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 third 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 third quarter and nine months ended September 30, 2006, the effective tax rates on income before income taxes was 1.2% and 5.7%, respectively. The lower effective tax rate in the 2006 third quarter than in the nine months ended September 30, 2006 resulted from a change in the relative mix of income reported by jurisdiction. The 1.2% effective tax rate in the 2006 third quarter resulted from a reduction in the effective tax rate on income before income taxes from 8.6% for the six months ended June 30, 2006 to 5.7% for the nine months ended September 30, 2006. 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 Nine Months Ended September 30, 2006 and 2005**

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

(U.S. dollars in thousands, except share data)	<b>Nine Months Ended September 30, 2006</b>	<b>2005</b>
Net income available to common shareholders	\$ 453,281	\$ 155,593
Diluted net income per common share	\$ 5.96	\$ 2.09
Diluted weighted average common shares and common share equivalents outstanding	76,108,510	74,458,013

Net income available to common shareholders was \$453.3 million for the 2006 period, compared to \$155.6 million for the 2005 period. The improvement in our results of operations was primarily due to a lower level of catastrophic activity in the 2006 period, as discussed in Segment Information below, and growth in investment income. Our net income available to common shareholders for the 2006 period represented a 22.0% annualized return on average common equity, compared to 9.0% 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 1.7 million shares, or 2.2%, 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)	Nine Months Ended September 30,	
	2006	2005
Gross premiums written	\$ 2,013,910	\$ 1,701,663
Net premiums written	1,277,175	1,073,316
Net premiums earned	\$ 1,190,788	\$ 1,015,084
Fee income	3,950	4,657
Losses and loss adjustment expenses	(760,727 )	(737,604 )
Acquisition expenses, net	(122,322 )	(96,752 )
Other operating expenses	(189,115 )	(168,474 )
Underwriting income	\$ 122,574	\$ 16,911
<b>Underwriting Ratios</b>		
Loss ratio	63.9	% 72.7
Acquisition expense ratio (1)	10.1	% 9.3
Other operating expense ratio	15.9	% 16.6
Combined ratio	89.9	% 98.6

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

*Underwriting Income.* The insurance segment's underwriting income was \$122.6 million for the 2006 period, compared to \$16.9 million for the 2005 period. The combined ratio for the insurance segment was 89.9% for the 2006 period, compared to 98.6% for the 2005 period. In the 2005 third quarter, the insurance segment incurred \$96.5 million of estimated pre-tax net losses, after reinsurance and net of reinstatement premiums, related to the catastrophic events in the period, while the 2006 third quarter did not include any material catastrophic activity. The components of the insurance segment's underwriting income are discussed below.

*Premiums Written.* Gross premiums written by the insurance segment were \$2.01 billion for the 2006 period, compared to \$1.70 billion for the 2005 period, and ceded premiums written were 36.6% of gross premiums written for the 2006 period, compared to 36.9% for the 2005 period. Net premiums written by the insurance segment were \$1.28 billion for the 2006 period, compared to \$1.07 billion for the 2005 period. Roughly half of the increase was in worldwide property business, primarily as a result of rate increases which were tempered by higher reinsurance costs. The balance of the growth was generated from increases in construction business, primarily due to growth in large deductible construction accounts, surety business, and in professional liability and executive assurance business, as a result of growth in policies written and a decrease in the usage of reinsurance in the 2006 period. This growth was partially offset by a reduction in U.S. primary casualty business in response to increasing competition. 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 \$1.19 billion for the 2006 period, compared to \$1.02 billion 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 63.9% for the 2006 period, compared to 72.7% for the 2005 period. The insurance segment's results for the 2005 period included \$76.5 million related to the hurricane activity in the 2005 third quarter, or 6.4 points of the 2005 period loss.

ratio, while the 2006 period did not include any comparable events. Losses incurred for the 2006 period included \$2.0 million of estimated net favorable development in prior year loss reserves, compared to \$11.2 million of estimated net adverse development in the 2005 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 \$44.2 million of adverse development on short-tail lines which included \$31.2 million of adverse development related to the 2005 third quarter hurricane activity. The net impact of the change in estimated net prior year development was a 1.1 point decrease in the loss ratio for the 2006 period.

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 \$120.7 million through such coverage for Hurricane Katrina and \$7.2 million for Hurricane Wilma with approximately \$58.6 million of remaining available coverage for Hurricane Katrina and \$182.8 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 26.0% 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 9.3% 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 15.9% for the 2006 period, compared to 16.6% 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)	Nine Months Ended September 30,	
	2006	2005
Gross premiums written	\$ 1,430,742	\$ 1,311,226
Net premiums written	1,138,327	1,237,517
Net premiums earned	\$ 1,125,836	\$ 1,169,651
Fee income	3,592	4,719
Losses and loss adjustment expenses	(615,454 )	(804,074 )
Acquisition expenses, net	(273,460 )	(320,722 )
Other operating expenses	(40,418 )	(35,241 )
Underwriting income	\$ 200,096	\$ 14,333
<b>Underwriting Ratios</b>		
Loss ratio	54.7	% 68.7
Acquisition expense ratio	24.3	% 27.4
Other operating expense ratio	3.6	% 3.0
Combined ratio	82.6	% 99.1

*Underwriting Income.* The reinsurance segment's underwriting income was \$200.1 million for the 2006 period, compared to \$14.3 million for the 2005 period. The combined ratio for the reinsurance segment was 82.6% for the 2006 period, compared to 99.1% 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 \$1.43 billion in the 2006 period, compared to \$1.31 billion for the 2005 period. The growth primarily occurred in international property and marine lines, due to 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 growth in property and marine business was partially offset by decreases in international casualty business, as a result of reduced participations on a number of quota share treaties in the 2006 period, and U.S. property business.

Ceded premiums written by the reinsurance segment were 20.4% of gross premiums written for the 2006 period, compared to 5.6% for the 2005 period. The higher ceded percentage in the 2006 period primarily resulted from the \$237.9 million of premiums written ceded by Arch Re Bermuda to Flatiron Re Ltd. (\$95.6 million on an earned basis) under a quota-share reinsurance treaty, as previously disclosed.

Net premiums written by the reinsurance segment were \$1.14 billion for the 2006 period, compared to \$1.24 billion for the 2005 period. The lower level of net premiums written in the 2006 period primarily resulted from the decrease in international casualty business and U.S. property business noted above, which more than offset the growth in international property and marine lines, net of the amounts ceded to Flatiron Re Ltd. noted above. 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 \$1.13 billion for the 2006 period, compared to \$1.17 billion 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 \$3.6 million of fee income for the 2006 period, compared to \$4.7 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 \$34.1 million, which consisted of \$27.8 million of reductions in incurred losses and \$6.3 million of reductions in acquisition expenses. The 2006 period estimated net favorable development consisted of \$65.8 million of favorable development, primarily in short-tail lines, partially offset by \$38.0 million of adverse development related to the 2005 third quarter large catastrophic events. For the 2005 period, underwriting income benefited from estimated net favorable development in prior year loss reserves, net of related adjustments, of \$65.5 million, which consisted of \$74.5 million of reductions in losses incurred and \$9.0 million of increases to acquisition expenses.

The loss ratio for the reinsurance segment was 54.7% for the 2006 period, compared to 68.7% for the 2005 period. The reinsurance segment's results included \$177.7 million related to the 2005 third quarter large catastrophic events, or 15.2 points of the 2005 period loss ratio, while the 2006 third quarter did not include any comparable events. Partially offsetting this, as noted above, the 2006 period included \$27.8 million of estimated net favorable development in prior year loss reserves, compared to \$74.5 million of estimated net favorable development in the 2005 period. The net impact of the change in estimated net prior year development was a 4.2 point increase in the loss ratio for the 2006 period. In addition, the 2006 period reflected a substantially higher percentage of net premiums earned attributable to property business (than in the 2005 period) and, in periods of low catastrophic activity, such as the 2006 period, property loss ratios generally are significantly lower than casualty loss ratios.

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 27.9% for the 2006 period, compared to 30.4% for the 2005 period. The acquisition expense ratio for the 2006 period was 24.3%, compared to 27.4% 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 1.3 points in the 2006 period. The 2006 period also included a \$6.3 million reduction in acquisition expenses related to estimated net development in prior year loss reserves, compared to an increase of \$9.0 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 1.4 point decrease in the acquisition expense ratio for the 2006 period. The reinsurance segment's other operating expense ratio was 3.6% 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 and a lower level of net premiums earned in the 2006 period.

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

Net investment income was \$272.5 million for the 2006 period, compared to \$162.8 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 4.57% for the 2006 period, compared to 3.43% for the 2005 period, 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)	Nine Months Ended September 30,	
	2006	2005
Fixed maturities	\$ (55,133 )	\$ (10,613 )
Other investments	3,441	1,012
Other	4,992	1,876
Total	\$ (46,700 )	\$ (7,725 )

Total return on our portfolio under management, as reported to us by our investment advisors, for the 2006 period was 3.75%, compared to 1.48% for the 2005 period. The higher total return in the 2006 period compared to the 2005 period was primarily due to movements in interest rates during the periods. The increase in interest rates in the 2005 period was greater than the increase in the 2006 period and resulted in a lower relative return compared to the 2006 period. For the 2006 period, net realized losses on our fixed maturities of \$55.1 million included a provision of \$30.1 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 period. In periods subsequent to the recognition of an other-than-temporary impairment on fixed maturities, we account for such securities as if they had been purchased on the measurement date of the other-than-temporary impairment and the provision for the other-than-temporary impairment (reflected as a discount or reduced premium based on the new cost basis) is amortized into net investment income over the remaining life of the fixed maturities, or until such securities are sold. The declines in market value on such securities were primarily due to the current interest rate environment. For the nine months ended September 30, 2005, we did not consider any declines in the market value of investments to be other-than-temporary. The balance of \$25.0 million in net realized losses on our fixed maturities in the 2006 period resulted from the sale of securities, compared to net realized losses from the sale of fixed maturities of \$10.6 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 \$65.3 million and \$39.5 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)	Nine Months Ended September 30,	
	2006	2005
Less than 6 months	\$ 45,474	\$ 18,913
At least 6 months but less than 12 months	16,696	10,745
Over 12 months	3,136	9,809
Total	\$ 65,306	\$ 39,467

### *Other Expenses*

Other expenses, which are included in our other operating expenses and part of our corporate and other segment (non-underwriting), were \$20.6 million for the 2006 period, compared to \$18.0 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 \$5.5 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).

### *Interest Expense*

Interest expense was \$16.6 million for the 2006 period, compared to \$16.9 million for the 2005 period. Such amounts primarily relate to the \$300 million in 7.35% senior notes outstanding in both periods.

### *Net Foreign Exchange Gains or Losses*

Net foreign exchange losses for the nine months ended September 30, 2006 of \$15.7 million consisted of net unrealized losses of \$18.9 million and net realized gains of \$3.2 million, compared to net foreign exchange gains of \$20.8 million for the 2005 period, which consisted of net unrealized gains of \$21.1 million and net realized losses of \$0.3 million. 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 5.7% for the 2006 period, compared to 9.6% for the 2005 period. The lower 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 \$8.91 billion at September 30, 2006, compared to \$7.12 billion at December 31, 2005. At September 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 3.2 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 \$15.5 million at September 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 September 30, 2006 and December 31, 2005, such amounts approximated \$1.0 billion. In addition, Arch Re Bermuda maintains assets in trust accounts as collateral for insurance and reinsurance transactions with affiliated companies. At September 30, 2006 and December 31, 2005, such amounts approximated \$3.42 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. 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 September 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 September 30, 2006 and December 31, 2005, approximately 93.6% 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 September 30, 2006 and December 31, 2005, the largest reinsurance recoverables from any one carrier were less than 5.4% 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 \$1.25 billion for the nine months ended September 30, 2006, compared to \$1.11 billion 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 \$151.5 million to paid losses for the nine months ended September 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

depository 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 August 2006, we entered into a five-year agreement for a \$300 million unsecured revolving loan and letter of credit facility and a \$1.0 billion secured letter of 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.

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 September 30, 2006, we had declared an aggregate of \$3.3 million of dividends to be paid to holders of the Preferred Shares.

At September 30, 2006, ACGL's capital of \$3.65 billion consisted of \$300.0 million of senior notes, representing 8.2% of the total, \$325.0 million of preferred shares, representing 8.9% of the total, and common shareholders' equity of \$3.02 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 \$865.7 million was primarily attributable to net income for the nine months ended September 30, 2006 and the issuance of \$325.0 million of preferred shares.

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

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



On December 29, 2005, Arch Re Bermuda entered into a quota share reinsurance treaty with Flatiron Re Ltd., a newly-formed Bermuda reinsurance company, pursuant to which Flatiron Re Ltd. is assuming a 45% quota share (the Treaty) of certain lines of property and marine business underwritten by Arch Re Bermuda for unaffiliated third parties for the 2006 and 2007 underwriting years (January 1, 2006 to December 31, 2007). The quota share is subject to decrease by Arch Re Bermuda under certain circumstances. In addition, in certain circumstances, Flatiron Re Ltd. may extend at its option the coverage provided by the Treaty to Arch Re Bermuda's 2008 underwriting year. Effective June 28, 2006, the parties amended the Treaty to increase the percentage ceded to Flatiron Re Ltd. from 45% to 70% of all covered business bound by Arch Re Bermuda from (and including) June 28, 2006 until (and including) August 15, 2006 provided such business did 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 September 30, 2006 and December 31, 2005:

(U.S. dollars in thousands)	September 30, 2006	December 31, 2005
Fixed maturities available for sale, at fair value	\$ 6,727,113	\$ 5,280,987
Fixed maturities pledged under securities lending agreements, at fair value (1)	815,268	862,766
Total fixed maturities	7,542,381	6,143,753
Short-term investments available for sale, at fair value	887,187	681,887
Short-term investments pledged under securities lending agreements, at fair value (1)		1,100
Other investments, at fair value	290,305	70,233
Cash	188,139	222,477
Total cash and invested assets (1)	\$ 8,908,012	\$ 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 \$844.4 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 \$815.3 million and \$863.9 million, respectively, of fixed maturities and short-term investments pledged under securities lending agreements, at fair value at September 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 Investments Investment-Related Derivatives and additional disclosures concerning derivatives.

At September 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 3.2 years and 3.3 years, respectively, an average Standard & Poor's quality rating of AA+ and an imbedded book yield, before investment expenses, of 4.88% and 4.19%, 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 September 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)	September 30, 2006	December 31, 2005
<b>Insurance:</b>		
Case reserves	\$ 543,544	\$ 421,131
IBNR reserves	1,743,668	1,413,243
Total net reserves	\$ 2,287,212	\$ 1,834,374
<b>Reinsurance:</b>		
Case reserves	\$ 631,157	\$ 488,593
Additional case reserves	71,577	116,788
IBNR reserves	1,757,219	1,623,303
Total net reserves	\$ 2,459,953	\$ 2,228,684
<b>Total:</b>		
Case reserves	\$ 1,174,701	\$ 909,724
Additional case reserves	71,577	116,788
IBNR reserves	3,500,887	3,036,546
Total net reserves	\$ 4,747,165	\$ 4,063,058

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At September 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)	September 30, 2006	December 31, 2005
Casualty	\$ 537,913	\$ 420,113
Construction and surety Programs	351,668	267,569
Executive assurance	334,960	323,527
Professional liability	329,586	222,949
Property, marine and aviation	313,840	226,815
Healthcare	291,254	259,686
Other	118,205	104,464
Total net reserves	\$ 2,287,212	\$ 1,834,374

At September 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)	September 30, 2006	December 31, 2005
Casualty	1,485,122	\$ 1,304,859
Property excluding property catastrophe	307,191	265,355
Other specialty	255,349	267,850
Marine and aviation	171,863	175,364
Property catastrophe	139,730	107,307
Other	100,698	107,949
Total net reserves	\$ 2,459,953	\$ 2,228,684

### Calculation of Book Value Per Common Share

The following presents the calculation of book value per common share for September 30, 2006 and December 31, 2005. The shares and per share numbers set forth below exclude the effects of 5,940,929 and 5,637,108 stock options and 93,469 and 93,545 restricted stock units outstanding at September 30, 2006 and December 31, 2005, respectively.

(U.S. dollars in thousands, except share data)	(Unaudited) September 30, 2006	December 31, 2005
Total shareholders' equity	\$ 3,346,249	\$ 2,480,527
Less preferred shareholders' equity	(325,000)	( )
Common shareholders' equity	3,021,249	\$ 2,480,527
Common shares outstanding	74,006,652	73,334,870
Book value per common share	\$ 40.82	\$ 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 September 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 September 30, 2006, material changes in market risk exposures that affect the quantitative and qualitative disclosures presented as of December 31, 2005 are as follows:

### **Investment Market Risk**

**Fixed Income Securities.** 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, short-term investments and certain of our other investments which invest in fixed income securities 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 September 30, 2006 and December 31, 2005. Based on historical observations, there is a low probability that all interest rate yield curves would shift in the same direction at the same time and, accordingly, the actual effect of interest rate movements may differ materially from the amounts set forth below. For further discussion on investment activity, please refer to Results of Operations.

(U.S. dollars in millions)	Interest Rate Shift in Basis Points				
	-100	-50	0	50	100
<b>September 30, 2006:</b>					
Total market value	\$ 8,915.7	\$ 8,771.6	\$ 8,629.6	\$ 8,490.2	\$ 8,353.3
Market value change from base	3.32	% 1.65	%	(1.62 )%	(3.20 )%
Change in unrealized value	\$ 286.1	\$ 142.0		\$ (139.4 )	\$ (276.3 )
<b>December 31, 2005:</b>					
Total market value	\$ 7,090.6	\$ 6,971.4	\$ 6,855.5	\$ 6,743.1	\$ 6,634.8
Market value change from base	3.43	% 1.69	%	(1.64 )%	(3.22 )%
Change in unrealized value	\$ 235.1	\$ 115.9		\$ (112.4 )	\$ (220.7 )

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 September 30, 2006, our portfolio's VaR was estimated to be 2.76%, compared to an estimated 3.29% at December 31, 2005.

**Equities and Privately Held Securities.** Our investment portfolio includes an allocation to other investments which include investments in certain stock index funds, other preferred stocks and privately held securities. At September 30, 2006 and December 31, 2005, the fair value of our investments in equities and privately held securities totaled \$110.5 million and \$41.5 million, respectively. These securities are exposed to price risk, which is the potential loss arising from decreases in the market value of equities. An immediate hypothetical 10% depreciation in the value of each equity position would reduce the fair value of such investments by approximately \$11.0 million and \$4.2 million at September 30, 2006 and December 31, 2005, respectively, and would have decreased book value per common share by approximately \$0.15 and \$0.06, respectively.

**Investment-Related Derivatives.** We began to invest in certain derivative instruments in 2006 to replicate investment positions and to manage market exposures and duration risk. The notional value of the net long position for equity futures was \$73.7 million at September 30, 2006 and the notional value of the net short position for Treasury note futures was \$16.9 million at September 30, 2006. A 10% depreciation of the

underlying exposure to these derivative instruments at September 30, 2006 would have resulted in a reduction in net income of approximately \$9.1 million and would have decreased book value per common share by \$0.12.

### ***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 September 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 \$0.6 million and \$7.7 million, respectively, and would have decreased book value per common share by approximately \$0.01 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 September 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 nine months ended September 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 third 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 September 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 September 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 were granted in an Opinion and Order dated September 20, 2006, in which the court dismissed all counts of the second amended complaint with prejudice. Although it is possible that plaintiffs may appeal this Order, management does not believe that any of the plaintiffs' claims are meritorious.

## **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 third quarter:

Period	Issuer Purchases of Equity Securities		Total Number of Shares Purchased as Part of Publicly Announced Plans or Programs	Maximum Number of Shares that May Yet be Purchased Under the Plan or Programs
	Total Number of Shares Purchased (1)	Average Price Paid per Share		
7/1/2006-7/31/2006				
8/1/2006-8/31/2006	1,957	\$ 60.44		
9/1/2006-9/30/2006	8,038	\$ 62.52		
Total	9,995	\$ 62.11		

(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 5. Other Information**

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

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

**Item 6. Exhibits**

<b>Exhibit No.</b>	<b>Description</b>
10.1	Amendment, dated September 18, 2006, to the Employment Agreement, dated as of April 6, 2004, between ACGL and Paul B. Ingrey
10.2	Stock Option Agreement, dated as of February 23, 2006, substantially in the form signed by ACGL and each of Constantine Iordanou, John D. Vollaro, Marc Grandisson and Ralph E. Jones III
10.3	Stock Option Agreement, dated as of February 23, 2006, substantially in the form signed by ACGL and each of W. Preston Hutchings and Louis T. Petrillo
10.4	Restricted Share Agreement, dated as of February 23, 2006, substantially in the form signed by ACGL and each of Constantine Iordanou, John D. Vollaro and Marc Grandisson
10.5	Restricted Share Agreement, dated as of February 23, 2006, substantially in the form signed by ACGL and each of W. Preston Hutchings and Louis T. Petrillo
10.6	Restricted Share Unit Agreement, dated as of February 23, 2006, signed by ACGL and Ralph E. Jones III
15	Accountants Awareness Letter (regarding unaudited interim financial information)
31.1	Certification of Chief Executive Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002
31.2	Certification of Chief Financial Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002
32.1	Certification of Chief Executive Officer pursuant to Section 906 of the Sarbanes-Oxley Act of 2002
32.2	Certification of Chief Financial Officer pursuant to Section 906 of the Sarbanes-Oxley Act of 2002

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***SIGNATURES***

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

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

Date: November 9, 2006

/s/ Constantine Iordanou  
Constantine Iordanou  
President and Chief Executive Officer  
(Principal Executive Officer) and Director

Date: November 9, 2006

/s/ John D. Vollaro  
John D. Vollaro  
Executive Vice President, Chief Financial  
Officer and Treasurer (Principal Financial and  
Accounting Officer)

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**EXHIBIT INDEX**

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