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)

x 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

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

For the transition period to

Commission file number: 0-26456

ARCH CAPITAL GROUP LTD.

(Exact name of registrant as specified in its charter)

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

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

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

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days.

Yes x No o

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

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

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

Yes o No x

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

Class	**Outstanding at 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
Assets		
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
Total investments	8,749,035	6,926,486
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
Total Assets	$ 13,953,876	$ 11,488,436
Liabilities		
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
Total Liabilities	10,607,627	9,007,909
Commitments and Contingencies		
Shareholders Equity		
Non-cumulative preferred shares ($0.01 par value, 50,000,000 shares authorized)		
- Series A (issued: 2006, 8,000,000)	80	
- Series B (issued: 2006, 5,000,000)	50	
Common shares ($0.01 par value, 200,000,000 shares authorized, issued: 2006, 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)
Total Shareholders Equity	3,346,249	2,480,527
Total Liabilities and Shareholders Equity	$ 13,953,876	$ 11,488,436

See Notes to Consolidated Financial Statements

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

	(Unaudited) Three Months Ended September 30, 2006	2005	(Unaudited) Nine Months Ended September 30, 2006	2005
Revenues				
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
Total revenues	850,349	798,993	2,549,917	2,349,232
Expenses				
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)
Total expenses	655,680	885,926	2,054,315	2,177,041
Income (loss) before income taxes	194,669	(86,933)	495,602	172,191
Income tax expense (benefit)	2,371	(642)	28,127	16,598
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
Net income (loss) per common share				
Basic	$ 2.54	$ (2.48)	$ 6.20	$ 4.50
Diluted	$ 2.44	$ (2.48)	$ 5.96	$ 2.09
Weighted average common shares and common share equivalents outstanding				
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

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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
Series A Convertible Preference Shares		
Balance at beginning of year	$	$ 373
Converted to common shares		(0)
Balance at end of period		373
Non-Cumulative Preferred Shares		
Series A preferred shares issued	80	
Series B preferred shares issued	50	
Balance at end of period	130	
Common Shares		
Balance at beginning of year	733	349
Common shares issued, net	7	6
Balance at end of period	740	355
Additional Paid-in Capital		
Balance at beginning of year	1,595,440	1,560,291
Cumulative effect of change in accounting for unearned stock grant compensation	(9,646)	
Series A non-cumulative preferred shares issued	193,377	
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
Deferred Compensation Under Share Award Plan		
Balance at beginning of year	(9,646)	(9,879)
Cumulative effect of change in accounting for unearned stock grant compensation	9,646	
Restricted common shares issued		(1,488)
Deferred compensation expense recognized		5,742
Balance at end of period		(5,625)
Retained Earnings		
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
Accumulated Other Comprehensive Income (Loss)		
Balance at beginning of year	(7,348)	45,910
Change in unrealized appreciation (decline) in value of investments, net of deferred income tax	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)
Total Shareholders Equity	$ 3,346,249	$ 2,351,531

See Notes to Consolidated Financial Statements

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

	(Unaudited) Nine Months Ended September 30, 2006	2005
Comprehensive Income		
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)
Other comprehensive income (loss)	69,184	(65,780)
Comprehensive Income	$ 536,659	$ 89,813

See Notes to Consolidated Financial Statements

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ARCH CAPITAL GROUP LTD. AND SUBSIDIARIES

CONSOLIDATED STATEMENTS OF CASH FLOWS

(U.S. dollars in thousands)

	(Unaudited) Nine Months Ended September 30, 2006	2005
Operating Activities		
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)
Net Cash Provided By Operating Activities	1,249,986	1,105,494
Investing Activities		
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)
Net Cash Used For Investing Activities	(1,556,956)	(2,021,388)
Financing Activities		
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)	
Net Cash Provided By Financing Activities	270,418	964,765
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
Cash end of period	$ 188,139	$ 161,759
Income taxes paid, net	$ 35,446	$ 37,099
Interest paid	$ 11,067	$ 11,141

See Notes to Consolidated Financial Statements

ARCH CAPITAL GROUP LTD. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

1. General

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

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

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

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

2. Share-Based Compensation

Stock Options

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

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

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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.

	(Unaudited) Three Months Ended September 30, 2006		2005	
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:

	(Unaudited) Nine Months Ended September 30, 2006 Number of Options	Weighted Average Exercise Price	
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.

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.

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)
Net income			192,298
Preferred dividends			(6,488)
Net income available to common shareholders			$ 185,810
Underwriting Ratios			
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.

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(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
Net income (loss)			(86,291)
Preferred dividends			
Net income (loss) available to common shareholders			$ (86,291)
Underwriting Ratios			
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 %

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(1) Certain amounts included in the gross premiums written of each segment are related to intersegment transactions. Accordingly, the sum of gross premiums written for each segment does not agree to the total gross premiums written as shown in the table above due to the elimination of intersegment transactions in the total. The insurance segment and reinsurance segment results include $0.8 million and $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.

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(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)
Net income			467,475
Preferred dividends			(14,194)
Net income available to common shareholders			$ 453,281
Underwriting Ratios			
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)
Net income			155,593
Preferred dividends			
Net income available to common shareholders			$ 155,593
Underwriting Ratios			
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.

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 Amount	% of Total	2005 Amount	% of Total
Net premiums written (1)				
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	74,870	15.9	59,353	15.7
Programs	64,558	13.7	56,335	14.9
Executive assurance	51,769	11.0	49,257	13.0
Casualty	51,659	11.0	70,924	18.8
Healthcare	17,051	3.6	19,507	5.2
Other	14,369	3.1	11,537	3.1
Total	$ 470,619	100.0	$ 377,536	100.0
Net premiums earned (1)				
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	65,696	15.5	56,965	16.8
Programs	58,066	13.7	54,392	16.0
Executive assurance	49,641	11.7	37,791	11.1
Casualty	61,903	14.6	76,200	22.4
Healthcare	17,595	4.1	18,099	5.3
Other	11,297	2.7	10,819	3.2
Total	$ 424,657	100.0	$ 339,962	100.0
Net premiums written by client location (1)				
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 Amount	% of Total	2005 Amount	% of Total
Net premiums written (1)				
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
Net premiums earned (1)				
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