

ARCH CAPITAL GROUP LTD.
Form 10-K
March 01, 2007

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-K

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

For the Fiscal Year Ended December 31, 2006

OR

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

For the transition period from to-----

Commission File No. 0-26456

ARCH CAPITAL GROUP LTD.

(Exact name of registrant as specified in its charter)

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)

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

Securities registered pursuant to Section 12(b) of the Exchange Act:

Title of Each Class
Common Shares, \$0.01 par value per share
8.000% Non-Cumulative Preferred Shares, Series A,
\$0.01 par value per share
7.875% Non-Cumulative Preferred Shares, Series B,
\$0.01 par value per share

Name of each Exchange on which Registered
NASDAQ Stock Market (Common Shares)
New York Stock Exchange

Securities registered pursuant to Section 12(g) of the Exchange Act:

Indicate by check mark if the registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act.

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Yes No

Indicate by check mark if the registrant is not required to file reports pursuant to Section 13 or Section 15(d) of the Exchange Act. Yes No

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Exchange Act 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 if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K is not contained herein, and will not be contained, to the best of registrant's knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendment to this Form 10-K.

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. (Check one):

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

The aggregate market value of the voting and non-voting common equity held by non-affiliates, computed by reference to the closing price as reported by the NASDAQ Stock Market as of the last business day of the Registrant's most recently completed second fiscal quarter, was approximately \$2.92 billion.

As of February 21, 2007, there were 74,360,307 of the registrant's common shares outstanding.

DOCUMENTS INCORPORATED BY REFERENCE

Portions of Part III and Part IV incorporate by reference our definitive proxy statement for the 2007 annual meeting of shareholders to be filed with the Securities and Exchange Commission before April 30, 2007.

ARCH CAPITAL GROUP LTD.
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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 Securities and Exchange Commission (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 December 31, 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.

PART I

ITEM 1. BUSINESS

We refer you to Item 1A Risk Factors for a discussion of risk factors relating to our business.

OUR COMPANY

General

Arch Capital Group Ltd. (ACGL and, together with its subsidiaries, the Company, we, or us) is a Bermuda public limited liability company with approximately \$3.9 billion in capital at December 31, 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.

We launched an underwriting initiative in October 2001 to meet current and future demand in the global insurance and reinsurance markets. Since that time, we have attracted a proven management team with extensive industry experience and enhanced our existing global underwriting platform for our insurance and reinsurance businesses. It is our belief that our underwriting platform, our experienced management team and our strong capital base that is unencumbered by significant pre-2002 risks have enabled us to establish a strong presence in the insurance and reinsurance markets. For the year ended December 31, 2006, our fifth full year of operation, we wrote \$3.02 billion of net premiums, reported net income available to common shareholders of \$692.6 million and earned a return on average equity of 24.1%. Diluted book value per share increased by 30% to \$43.97 at December 31, 2006 from \$33.82 per share at December 31, 2005.

Since late 2001, we have raised additional capital in support of the underwriting activities of our insurance and reinsurance operations. In October 2001, the commencement of our underwriting initiatives included an equity capital infusion of \$763.2 million led by funds affiliated with Warburg Pincus LLC (Warburg Pincus funds) and Hellman & Friedman LLC (Hellman & Friedman funds). In April 2002, we completed a public offering of 7,475,000 of our common shares and received net proceeds of \$179.2 million and, in September 2002, we received net proceeds of \$74.3 million from the exercise of class A warrants by our principal shareholders and other investors. In March 2004, we completed a public offering of 4,688,750 of our common shares and received net proceeds of \$179.3 million. In May 2004, we completed the public offering of \$300 million principal amount of our 7.35% senior notes due May 2034 and received net proceeds of \$296.4 million, of which \$200 million of the net proceeds was used to repay all amounts outstanding under our existing credit facility. In February 2006, we issued in a public offering \$200.0 million of our 8.00% series A non-cumulative preferred shares with a liquidation preference of \$25.00 per share and received net proceeds of \$193.5 million. In May 2006, we issued in a public offering \$125.0 million of our 7.875% series B non-cumulative preferred shares with a liquidation preference of \$25.00 per share and received net proceeds of \$120.9 million. The net proceeds of the offerings were used to support the underwriting activities of our insurance and reinsurance subsidiaries.

ACGL's registered office is located at Clarendon House, 2 Church Street, Hamilton HM 11, Bermuda (telephone number: (441) 295-1422), and its principal executive offices are located at Wessex House, 45 Reid Street, Hamilton HM 12, Bermuda (telephone number: (441) 278-9250). ACGL makes available free of charge through its website, located at <http://www.archcapgroup.bm>, its annual reports on Form 10-K, quarterly reports on Form 10-Q, current reports on Form 8-K, and all amendments to those reports as soon as reasonably practicable after such material is electronically filed with, or furnished to, the Securities and Exchange Commission (SEC). The public may read and copy any materials ACGL files with the SEC at the SEC's Public Reference Room at 450 Fifth Street, NW, Washington, D.C. 20549. The public may obtain information on the operation of the Public Reference Room by calling 1-800-SEC-0330. The

SEC also maintains an Internet site that contains reports, proxy and information statements, and other information regarding issuers that file electronically with the SEC (such as ACGL) and the address of that site is <http://www.sec.gov>.

Our History

ACGL was formed in September 2000 and became the sole shareholder of Arch Capital Group (U.S.) Inc. (Arch-U.S.) pursuant to an internal reorganization transaction completed in November 2000, as described below. Arch-U.S. is a Delaware company formed in March 1995 under the original name of Risk Capital Holdings, Inc., which commenced operations in September 1995 following the completion of an initial public offering. From that time until May 2000, Arch-U.S. provided reinsurance and other forms of capital for insurance companies through its wholly owned subsidiary, Arch Reinsurance Company (Arch Re U.S.), a Nebraska corporation formed in 1995 under the original name of Risk Capital Reinsurance Company.

On May 5, 2000, Arch-U.S. sold the prior reinsurance operations of Arch Re U.S. to Folksamerica Reinsurance Company (Folksamerica) in an asset sale, but retained its surplus and U.S.-licensed reinsurance platform. The sale was precipitated by, among other things, losses on the reinsurance business of Arch Re U.S. and increasing competition, which had been adversely affecting the results of operations and financial condition of Arch Re U.S. The Folksamerica transaction, which resulted from extensive arm's length negotiation, was structured as a transfer and assumption agreement (and not as reinsurance) and, accordingly, the loss reserves (and any related reinsurance recoverables) related to the transferred business are not included in the balance sheet of Arch Re U.S. However, in the event that Folksamerica refuses or is unable to make payment of claims on the reinsurance business assumed by it in the May 2000 sale and the notice given to reinsureds is found not to be an effective release by such reinsureds, Arch Re U.S. would be liable for such claims. In addition, Arch Re U.S. retained all liabilities not assumed by Folksamerica, including all liabilities not arising under reinsurance agreements transferred to Folksamerica in the asset sale. On November 8, 2000, following the approval by Arch-U.S.'s shareholders, Arch-U.S. completed an internal reorganization that resulted in Arch-U.S. becoming a wholly owned subsidiary of ACGL.

During the period from May 2000 through the announcement of our underwriting initiative in October 2001, we built and acquired insurance businesses that were intended to enable us to generate both fee-based revenue (e.g., commissions and advisory and management fees) and risk-based revenue (i.e., insurance premium). As part of this strategy, we built an underwriting platform that was intended to enable us to maximize risk-based revenue during periods in the underwriting cycle when we believed it was more favorable to assume underwriting risk. In October 2001, we concluded that underwriting conditions favored dedicating our attention exclusively to building our insurance and reinsurance business.

The development of our underwriting platform included the following steps: (1) after the completion of the Folksamerica asset sale, we retained our U.S.-licensed reinsurer, Arch Re U.S., and Arch Excess & Surplus Insurance Company (Arch E&S), currently an approved excess and surplus lines insurer in 46 states and the District of Columbia and an admitted insurer in one state; (2) in May 2001, we formed Arch Reinsurance Ltd. (Arch Re Bermuda), our Bermuda-based reinsurance and insurance subsidiary; (3) in June 2001, we acquired Arch Risk Transfer Services Ltd., which included Arch Insurance Company (Arch Insurance), currently an admitted insurer in 50 states, the District of Columbia, Puerto Rico and the U.S. Virgin Islands and rent-a-captive and other facilities that provide insurance and alternative risk transfer services; (4) in February 2002, we acquired Arch Specialty Insurance Company (Arch Specialty), currently an approved excess and surplus lines insurer in 49 states, the District of Columbia, Puerto Rico and the U.S. Virgin Islands and an admitted insurer in one state; (5) in June 2003, we acquired Western Diversified Casualty Insurance Company (Western Diversified), an admitted insurer in 48 states and the District of Columbia; (6) in May 2004, our London-based subsidiary, Arch Insurance Company (Europe)

Limited (Arch-Europe), was approved by the Financial Services Authority in the U.K. to commence insurance underwriting activities and began writing a range of specialty commercial lines in Europe and the U.K. during the 2004 third quarter; (7) in January 2005, Arch Insurance received its federal license to commence underwriting in Canada and began writing business in the first quarter of 2005; and (8) in November 2006, Arch Reinsurance Ltd., Hamilton (Bermuda), European Branch Zurich (Arch Re Swiss Branch), the Swiss branch of Arch Re Bermuda, was registered with the commercial register of the Canton of Zurich to commence reinsurance underwriting activities in Switzerland. All liabilities arising out of the business of Arch Specialty and Western Diversified prior to the closing of our acquisitions of such companies were reinsured and guaranteed by the respective sellers, Sentry Insurance a Mutual Company (Sentry) and Protective Life Corporation and certain of its affiliates.

In addition, during the 2004 fourth quarter, we completed the sale of two operating units which were not part of our core insurance and reinsurance operations. In October 2004, we sold Hales & Company Inc., our merchant banking operations. In December 2004, we sold American Independent Insurance Holding Company, Inc. (American Independent), The Personal Service Insurance Co. (PSIC) and affiliated entities, which conducted our non-standard automobile insurance operations. During specified periods, our reinsurance group will continue to provide reinsurance to American Independent and PSIC.

In the 2005 fourth quarter, the holders of 37,327,502 series A convertible preference shares converted all of such shares into an equal number of common shares pursuant to the certificate of designations relating to the preference shares. Following such conversion, there are no remaining outstanding series A convertible preference shares. Since the preference shares were treated as common share equivalents in our reported financial results, the conversion had no impact on diluted net income per share or diluted book value per share.

Operations

We classify our businesses into two underwriting segments, insurance and reinsurance. For an analysis of our underwriting results by segment, see note 3, Segment Information, of the notes accompanying our consolidated financial statements and Management's Discussion and Analysis of Financial Condition and Results of Operations.

Our Insurance Operations

Our insurance operations are conducted in Bermuda, the United States, Europe and Canada. Our insurance operations in Bermuda are conducted through Arch Insurance (Bermuda), a division of Arch Re Bermuda, which has an office in Hamilton, Bermuda. In the U.S., our insurance group's principal insurance subsidiaries are Arch Insurance, Arch E&S and Arch Specialty. The headquarters for our insurance group's U.S. operations is located in New York City. There are additional offices throughout the U.S., including principal offices located in: Atlanta, Georgia; Chicago, Illinois; New York, New York; San Francisco, California; and St. Paul, Minnesota. Arch Insurance has a branch office in Toronto, Canada, which began writing business in the first quarter of 2005. Our insurance group's European operations are conducted through Arch-Europe, based in London, which became operational during the 2004 third quarter. Arch-Europe also has offices in Germany. As of February 15, 2007, our insurance group had approximately 950 employees.

Strategy. Our insurance group's strategy is to operate in lines of business in which underwriting expertise can make a meaningful difference in operating results. They focus on talent rather than labor intensive business and seek to operate profitably (on both a gross and net basis) across all of their product lines. To achieve these objectives, our insurance group's operating principles are to:

- *Capitalize on Profitable Underwriting Opportunities.* Our insurance group believes that its experienced management and underwriting teams are positioned to locate and identify types of

business with attractive risk/reward characteristics. As profitable underwriting opportunities are identified, our insurance group will continue to seek to make additions to their product portfolio in order to take advantage of market trends. This could include adding underwriting and other professionals with specific expertise in specialty lines of insurance.

- *Centralize Responsibility for Underwriting.* Our insurance group consists of eight product lines. The underwriting executive in charge of each product line oversees the underwriting within such product line. Our insurance group believes that such centralized control allows for close control of underwriting and creates clear accountability for results. Our U.S. insurance group has four regional offices, and the executives in charge of these regions are primarily responsible for managing the distribution of our insurance group's products through its brokerage appointments.
- *Maintain a Disciplined Underwriting Philosophy.* Our insurance group's underwriting philosophy is to generate an underwriting profit through prudent risk selection and proper pricing. Our insurance group believes that the key to this approach is adherence to uniform underwriting standards across all types of business. Our insurance group's senior management closely monitors the underwriting process.
- *Focus on Providing Superior Claims Management.* Our insurance group believes that claims handling is an integral component of credibility in the market for insurance products. Therefore, our insurance group believes that its ability to handle claims expeditiously and satisfactorily is a key to its success. Our insurance group employs experienced claims professionals and also utilizes nationally recognized external claims managers (third party administrators).
- *Utilize a Brokerage Distribution System.* Our insurance group believes that by utilizing a brokerage distribution system, consisting of select regional and wholesale brokers, it can efficiently access a broad customer base while maintaining underwriting control and discipline.

Our insurance group writes business on both an admitted and non-admitted basis. Our insurance group focuses on the following areas:

- *Casualty.* Our insurance group's casualty unit writes casualty business on both a primary and excess basis for commercial clients including primary residential contractors insurance and railroad insurance.
- *Professional Liability.* Our insurance group's professional liability unit has the following principal areas of focus: (1) large law and accounting firms and professional programs; (2) miscellaneous professional liability, including coverages for consultants, systems integrations, wholesalers, captive agents and managing general agents; and (3) travel and accident insurance.
- *Programs.* Our insurance group's programs unit targets program managers with unique expertise and niche products offering general liability, commercial automobile, inland marine and non-catastrophe-exposed property business. This unit offers primarily package policies, underwriting workers' compensation and umbrella liability business in support of desirable package programs.
- *Property, Marine and Aviation.* Our insurance group's property unit provides property, technical risk, energy, aviation and marine insurance coverages for commercial clients, including catastrophe-exposed property coverage.
- *Construction and Surety.* Our insurance group's construction and surety unit provides primary and excess casualty coverages to middle and large accounts in the construction industry and contract surety coverages, including contract bonds (payment and performance bonds) for mid-size and large contractors and specialty contract bonds for homebuilders and developers. This unit also provides coverage for environmental and design professionals, including policies for architectural and

engineering firms and construction projects, pollution legal liability coverage for fixed sites, and alternative markets business, including corporate risk programs.

- *Executive Assurance.* Our insurance group's executive assurance unit focuses on directors' and officers' liability insurance coverages for corporate and financial institution clients. This unit also writes financial institution errors and omissions coverages, employment practices liability insurance, pension trust errors and omissions insurance and fidelity bonds.
- *Healthcare.* Our insurance group's healthcare unit provides medical professional and general liability insurance for the healthcare industry including excess professional liability programs for large, integrated hospital systems, outpatient facilities, clinics and long-term care facilities.
- *Other.* The other category is primarily comprised of collateral protection business. The other category also included our insurance group's non-standard automobile insurance operations until such operations were sold in the 2004 fourth quarter.

Underwriting Philosophy. Our insurance group's underwriting philosophy is to generate an underwriting profit (on both a gross and net basis) through prudent risk selection and proper pricing across all types of business. One key to this philosophy is the adherence to uniform underwriting standards across each product line that focuses on the following:

- risk selection;
- desired attachment point;
- limits and retention management;
- due diligence, including financial condition, claims history, management, and product, class and territorial exposure;
- underwriting authority and appropriate approvals; and
- collaborative decision-making.

Premiums Written and Geographic Distribution. Set forth below is summary information regarding net premiums written for our insurance group:

	Years Ended December 31, 2006		2005		2004	
	Amount (U.S. dollars in thousands)	% of Total	Amount	% of Total	Amount	% of Total
Net premiums written						
Property, marine and aviation	\$ 320,928	19.4	\$ 228,642	15.4	\$ 178,654	12.8
Professional liability	289,328	17.5	227,828	15.4	176,788	12.7
Construction and surety	274,460	16.6	233,133	15.7	199,659	14.3
Programs	225,653	13.7	232,156	15.7	284,911	20.5
Casualty	220,244	13.3	271,788	18.4	289,816	20.9
Executive assurance	193,694	11.8	169,430	11.4	128,224	9.2
Healthcare	68,026	4.1	70,928	4.8	62,885	4.5
Other	59,723	3.6	47,395	3.2	71,047	5.1
Total	\$ 1,652,056	100.0	\$ 1,481,300	100.0	\$ 1,391,984	100.0
Net premiums written by client location						
United States	\$ 1,340,792	81.2	\$ 1,293,938	87.4	\$ 1,330,165	95.6
Europe	182,815	11.0	107,283	7.2	29,397	2.1
Other	128,449	7.8	80,079	5.4	32,422	2.3
Total	\$ 1,652,056	100.0	\$ 1,481,300	100.0	\$ 1,391,984	100.0

Marketing. Our insurance group's products are marketed principally through a group of licensed independent brokers and wholesalers. Clients (insureds) are referred to our insurance group through a large number of international, national and regional brokers, acting as their agents, and captive managers who receive from the insured or ceding company a set fee or brokerage commission usually equal to a percentage of gross premiums. In the past, our insurance group had also entered into contingent commission arrangements with some intermediaries that provide for the payment of additional commissions based on volume or profitability of business. In general, our insurance group has no implied or explicit commitments to accept business from any particular broker and, neither brokers nor any other third party has the authority to bind our insurance group, except in the case where underwriting authority may be delegated contractually to selected program administrators. Such administrators are subject to a due diligence financial and operational review prior to any such delegation of authority and ongoing reviews and audits are carried out as deemed necessary by our insurance group to assure the continuing integrity of underwriting and related business operations. See Risk Factors Risks Relating to Our Company We could be materially adversely affected to the extent that managing general agents, general agents and other producers in our program business exceed their underwriting authorities or otherwise breach obligations owed to us. For information on major brokers, see note 11, Commitments and Contingencies Concentrations of Credit Risk, of the notes accompanying our consolidated financial statements.

Risk Management and Reinsurance. In the normal course of business, our insurance group may cede a portion of its premium through quota share, surplus share, excess of loss and facultative reinsurance agreements. Reinsurance arrangements do not relieve our insurance group from its obligations to insureds. 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, our insurance subsidiaries would be liable for such defaulted amounts. Our insurance subsidiaries, through reinsurance security committees (RSC), are selective with regard to reinsurers,

seeking to place reinsurance with only those reinsurers which meet and maintain specific standards of established criteria for financial strength. Each RSC evaluates the financial viability of its reinsurers through financial analysis, research and review of rating agencies' reports and also monitors reinsurance recoverables and letters of credit with unauthorized reinsurers and conducts ongoing assessments of reinsurers, including financial stability, appropriate licensing, reputation, claims paying ability and underwriting philosophy. Our insurance group will continue to evaluate its reinsurance requirements. See note 4, "Reinsurance," of the notes accompanying our consolidated financial statements.

For catastrophe exposed insurance business, our insurance group seeks to limit the amount of exposure it assumes to catastrophic losses through a combination of managing aggregate limits, underwriting guidelines and reinsurance. For a discussion of our risk management policies, see Management's Discussion and Analysis of Financial Condition and Results of Operations "Ceded Reinsurance" and "Risk Factors - Risks Relating to Our Industry." The failure of any of the loss limitation methods we employ could have a material adverse effect on our financial condition or results of operations.

Claims Management. Our insurance group's claims personnel provide underwriting and loss service support to the group. Members of our insurance group's claims departments work with underwriting professionals as functional teams in order to develop products and services that the group's customers desire and, in certain cases, use independent national claims firms (third party administrators) for investigations and field adjustments.

Our Reinsurance Operations

Our reinsurance operations are conducted on a worldwide basis through our reinsurance subsidiaries, Arch Re Bermuda and Arch Re U.S. Arch Re Bermuda has offices in Bermuda, as well as a branch office in Zurich, Switzerland. Arch Re U.S. operates out of its office in Morristown, New Jersey. As of February 15, 2007, our reinsurance group had approximately 110 employees.

Strategy. Our reinsurance group's strategy is to capitalize on our financial capacity, experienced management and operational flexibility to offer multiple products through our Bermuda-, U.S.- and Switzerland-based operations. The reinsurance group's operating principles are to:

- *Actively Select and Manage Risks.* Our reinsurance group only underwrites business that meets certain profitability criteria, and it emphasizes disciplined underwriting over premium growth. To this end, our reinsurance group maintains centralized control over reinsurance underwriting guidelines and authorities.
- *Maintain Flexibility and Respond to Changing Market Conditions.* Our reinsurance group's organizational structure and philosophy allows it to take advantage of increases or changes in demand or favorable pricing trends. Our reinsurance group believes that its existing Bermuda-, U.S.- and Switzerland-based platform, broad underwriting expertise and substantial capital facilitates adjustments to its mix of business geographically and by line and type of coverage. Our reinsurance group believes that this flexibility allows it to participate in those market opportunities that provide the greatest potential for underwriting profitability.
- *Maintain a Low Cost Structure.* Our reinsurance group believes that maintaining tight control over its staffing level and operating as a broker market reinsurer permits it to maintain low operating costs relative to its capital and premiums.

Our reinsurance group writes business on both a proportional and non-proportional basis. In a proportional reinsurance arrangement (also known as pro rata reinsurance, quota share reinsurance or participating reinsurance), the reinsurer shares a proportional part of the original premiums and losses of the reinsured. The reinsurer pays the cedent a commission which is generally based on the cedent's cost of

acquiring the business being reinsured (including commissions, premium taxes, assessments and miscellaneous administrative expenses) and may also include a profit factor. Non-proportional (or excess of loss) reinsurance indemnifies the reinsured against all or a specified portion of losses on underlying insurance policies in excess of a specified amount, which is called a retention. Non-proportional business is written in layers and a reinsurer or group of reinsurers accepts a band of coverage up to a specified amount. The total coverage purchased by the cedent is referred to as a program. Any liability exceeding the upper limit of the program reverts to the cedent.

Our reinsurance group generally seeks to write significant lines on less commoditized classes of coverage, such as specialty property and casualty reinsurance treaties. However, with respect to other classes of coverage, such as property catastrophe and casualty clash, our reinsurance group participates in a relatively large number of treaties and assumes smaller lines where it believes that it can underwrite and process the business efficiently.

Our reinsurance group focuses on the following areas:

- *Casualty.* Our reinsurance group reinsures third party liability and workers compensation exposures from ceding company clients primarily on a treaty basis. The exposures that it reinsures include, among others, directors and officers liability, professional liability, automobile liability, workers compensation and excess and umbrella liability. Our reinsurance group writes this business on a proportional and non-proportional basis. On proportional and non-proportional working casualty business, which is treated separately from casualty clash business, our reinsurance group prefers to write treaties where there is a meaningful amount of actuarial data and where loss activity is more predictable.
- *Property Excluding Property Catastrophe.* Our reinsurance group reinsures individual property risks of ceding company clients on a treaty basis. Property per risk treaty and pro rata reinsurance contracts written by our reinsurance group cover claims from individual insurance policies issued by reinsureds and include both personal lines and commercial property exposures (principally covering buildings, structures, equipment and contents). The primary perils in this business include fire, explosion, collapse, riot, vandalism, wind, tornado, flood and earthquake.
- *Other Specialty.* Our reinsurance group writes other specialty lines, including non-standard automobile, surety, accident and health, trade credit and political risk.
- *Property Catastrophe.* Our reinsurance group reinsures catastrophic perils for our reinsureds on a treaty basis. Treaties in this type of business provide protection for most catastrophic losses that are covered in the underlying policies written by our reinsureds. The primary perils in our reinsurance group's portfolio include hurricane, earthquake, flood, tornado, hail and fire. Our reinsurance group may also provide coverage for other perils on a case-by-case basis. Property catastrophe reinsurance provides coverage on an excess of loss basis when aggregate losses and loss adjustment expense from a single occurrence of covered peril exceed the retention specified in the contract. The multiple claimant nature of property catastrophe reinsurance requires careful monitoring and control of cumulative aggregate exposure.
- *Marine and Aviation.* Our reinsurance group writes marine business, which includes coverages for hull, cargo, transit and offshore oil and gas operations, and aviation business, which includes coverages for airline and general aviation risks. Business written may also include space business, which includes coverages for satellite assembly, launch and operation for commercial space programs.
- *Other.* Our reinsurance group also writes non-traditional business, which is intended to provide insurers with risk management solutions that complement traditional reinsurance, and casualty clash business.

Underwriting Philosophy. Our reinsurance group employs a disciplined, analytical approach to underwriting reinsurance risks that is designed to specify an adequate premium for a given exposure commensurate with the amount of capital it anticipates placing at risk. A number of our reinsurance group's underwriters are also actuaries. It is our reinsurance group's belief that employing actuaries on the front-end of the underwriting process gives it an advantage in evaluating risks and constructing a high quality book of business.

As part of the underwriting process, our reinsurance group typically assesses a variety of factors, including:

- adequacy of underlying rates for a specific class of business and territory;
- the reputation of the proposed cedent and the likelihood of establishing a long-term relationship with the cedent, the geographic area in which the cedent does business, together with its catastrophe exposures, and our aggregate exposures in that area;
- historical loss data for the cedent and, where available, for the industry as a whole in the relevant regions, in order to compare the cedent's historical loss experience to industry averages;
- projections of future loss frequency and severity; and
- the perceived financial strength of the cedent.

Premiums Written and Geographic Distribution. Set forth below is summary information regarding net premiums written for our reinsurance group:

	Years Ended December 31, 2006		2005		2004	
	Amount (U.S. dollars in thousands)	% of Total	Amount	% of Total	Amount	% of Total
Net premiums written						
Casualty ⁽¹⁾	\$ 591,219	43.3	\$ 753,829	45.5	\$ 828,672	52.2
Property excluding property catastrophe	297,080	21.8	339,643	20.5	281,317	17.7
Other specialty	218,157	16.0	251,519	15.2	243,474	15.3
Property catastrophe	146,751	10.7	162,519	9.8	103,372	6.5
Marine and aviation	109,865	8.0	108,981	6.6	89,156	5.6
Other	2,290	0.2	40,981	2.4	42,057	2.7
Total	\$ 1,365,362	100.0	\$ 1,657,472	100.0	\$ 1,588,048	100.0
Net premiums written by client location						
United States	\$ 770,309	56.4	\$ 898,980	54.2	\$ 943,972	59.4
Europe	368,332	27.0	437,663	26.4	350,263	22.1
Bermuda	132,618	9.7	188,321	11.4	136,566	8.6
Other	94,103	6.9	132,508	8.0	157,247	9.9
Total	\$ 1,365,362	100.0	\$ 1,657,472	100.0	\$ 1,588,048	100.0

(1) Includes professional liability and executive assurance business.

Marketing. Our reinsurance group markets its reinsurance products through brokers. Brokers do not have the authority to bind our reinsurance group with respect to reinsurance agreements, nor does our reinsurance group commit in advance to accept any portion of the business that brokers submit to them. Our reinsurance group generally pays brokerage fees to brokers based on negotiated percentages of the

premiums written through such brokers. For information on major brokers, see note 11, Commitments and Contingencies Concentrations of Credit Risk, of the notes accompanying our consolidated financial statements.

Risk Management and Retrocession. Our reinsurance group currently purchases retrocessional coverage as part of their risk management program. They also participate in common account retrocessional arrangements for certain treaties. Such arrangements reduce the effect of individual or aggregate losses to all companies participating in such treaties, including the reinsurers. Arch Re Bermuda, our Bermuda-based reinsurer, entered into a quota share reinsurance treaty (Flatiron Treaty) with Flatiron Re Ltd., a newly-formed Bermuda reinsurance company, pursuant to which Flatiron Re Ltd. is assuming a 45% quota share 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). Effective June 28, 2006, the parties amended the Flatiron 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. For the year ended December 31, 2006, Arch Re Bermuda ceded \$273.2 million of premiums written to Flatiron Re Ltd. (\$157.4 million on an earned basis) under the Flatiron Treaty. Our reinsurance group will continue to evaluate its retrocessional requirements. See note 4, Reinsurance, of the notes accompanying our consolidated financial statements.

For catastrophe exposed reinsurance business, our reinsurance group seeks to limit the amount of exposure it assumes from any one reinsured and the amount of the aggregate exposure to catastrophe losses in any one geographic zone. For a discussion of our risk management policies, see Management's Discussion and Analysis of Financial Condition and Results of Operations Ceded Reinsurance and Risk Factors Risks Relating to Our Industry The failure of any of the loss limitation methods we employ could have a material adverse effect on our financial condition or results of operations.

Claims Management. Claims management includes the receipt of initial loss reports, creation of claim files, determination of whether further investigation is required, establishment and adjustment of case reserves and payment of claims. Additionally, audits are conducted for both specific claims and overall claims procedures at the offices of selected ceding companies. Our reinsurance group makes use of outside consultants for claims work from time to time.

Employees

As of February 15, 2007, ACGL and its subsidiaries employed approximately 1,100 full-time employees.

Reserves

We believe we apply a conservative reserving philosophy for both our insurance and reinsurance operations. Reserve estimates are derived after extensive consultation with individual underwriters, actuarial analysis of the loss reserve development and comparison with market benchmarks. We continue to build our actuarial staff and utilize both internal and external actuaries. Generally, reserves are established without regard to whether we may subsequently contest the claim. We do not currently discount our loss reserves.

Loss reserves represent estimates of what the insurer or reinsurer ultimately expects to pay on claims at a given time, based on facts and circumstances then known, and it is probable that the ultimate liability may exceed or be less than such estimates. Even actuarially sound methods can lead to subsequent adjustments to reserves that are both significant and irregular due to the nature of the risks written. Loss reserves are inherently subject to uncertainty. In establishing the reserves for losses and loss adjustment expenses, we have made various assumptions relating to the pricing of our reinsurance contracts and insurance policies and have also considered available historical industry experience and current industry conditions. The timing and amounts of actual claim payments related to recorded 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. This may result in significant variability in loss payment patterns and, therefore, may impact the related asset/liability investment management process in order to be in a position, if necessary, to make these payments. See Management's Discussion and Analysis of Financial Condition and Results of Operations Critical Accounting Policies, Estimates and Recent Accounting Pronouncements Reserves for Losses and Loss Adjustment Expenses.

The following table represents the development of loss reserves as determined under accounting principles generally accepted in the United States of America (GAAP) for the years ended December 31, 1996 through 2006. This table does not present accident or policy year development data. Results for the years ended December 31, 1996 to 2000 relate to our prior reinsurance operations, which were sold on May 5, 2000 to Folksamerica. With respect to the year ended December 31, 2000, no reserves are reported in the table below because all reserves for business written through May 5, 2000 were assumed by Folksamerica in the May 5, 2000 asset sale, and we did not write or assume any business during 2000 subsequent to the asset sale. Activity subsequent to 2000 relates to acquisitions made by us and our underwriting initiatives that commenced in October 2001.

The top line of the table shows the reserves, net of reinsurance recoverables, at the balance sheet date for each of the indicated years. This represents the estimated amounts of net losses and loss adjustment expenses arising in all prior years that are unpaid at the balance sheet date, including incurred but not reported (IBNR) reserves. The table also shows the re-estimated amount of the previously recorded reserves based on experience as of the end of each succeeding year. The estimate changes as more information becomes known about the frequency and severity of claims for individual years. The cumulative redundancy (deficiency) represents the aggregate change in the estimates over all prior years. The table also shows the cumulative amounts paid as of successive years with respect to that reserve liability. In addition, the table reflects the claim development of the gross balance sheet reserves for the years ended December 31, 1996 through 2006. With respect to the information in the table, it should be noted that each amount includes the effects of all changes in amounts for prior periods.

**Development of GAAP Reserves
Cumulative Redundancy (Deficiency)**

	Years Ended December 31,										
	1996	1997	1998	1999	2000	2001	2002	2003 (a)	2004	2005	2006
(U.S. dollars in millions)											
Reserve for losses and loss adjustment expenses, net of reinsurance recoverables	\$ 20	\$ 71	\$ 186	\$ 309		\$ 21	\$ 381	\$ 1,543	\$ 2,875	\$ 4,063	\$ 4,911
Cumulative net paid losses as of:											
One year later	9	19	88	311		15	82	278	449	745	
Two years later	10	33	216	311		19	141	437	811		
Three years later	12	64	216	311		24	172	596			
Four years later	18	64	216	311		26	204				
Five years later	18	64	216	311		26					
Six years later	18	64	216	311							
Seven years later	18	64	216	311							
Eight years later	18	64	216								
Nine years later	18	64									
Ten years later	18										
Net re-estimated reserve as of:											
One year later	20	68	216	311		25	340	1,444	2,756	3,986	
Two years later	19	65	216	311		25	335	1,353	2,614		
Three years later	18	64	216	311		27	335	1,259			
Four years later	18	64	216	311		27	312				
Five years later	18	64	216	311		28					
Six years later	18	64	216	311							
Seven years later	18	64	216	311							
Eight years later	18	64	216								
Nine years later	18	64									
Ten years later	18										
Cumulative net redundancy (deficiency)	\$ 2	\$ 7	(\$30)	(\$2)		(\$7)	\$ 69	\$ 283	\$ 261	\$ 77	
Cumulative net redundancy (deficiency) as a percentage of net reserves	10.0	8.5	(16.1)	(1.0)		(31.6)	18.0	18.4	9.1	1.9	
Gross reserve for losses and loss adjustment expenses	\$ 20	\$ 71	\$ 216	\$ 365		\$ 111	\$ 592	\$ 1,912	\$ 3,493	\$ 5,453	\$ 6,463
Reinsurance recoverable			(30)	(56)		(90)	(211)	(369)	(618)	(1,390)	(1,552)
Net reserve for losses and loss adjustment expenses	20	71	186	309		21	381	1,543	2,875	4,063	\$ 4,911
Gross re-estimated reserve	18	64	246	367		187	563	1,590	3,198	5,481	
Re-estimated reinsurance recoverable			(30)	(56)		(159)	(250)	(330)	(584)	(1,495)	
Net re-estimated reserve	18	64	216	311		28	313	1,260	2,614	3,986	
Gross re-estimated redundancy (deficiency)	\$ 2	\$ 7	(\$30)	(\$2)		(\$76)	\$ 29	\$ 322	\$ 295	(\$28)	

(a) Paid amounts include \$21.9 million of reserves related to our non-standard automobile business that was sold in 2004 (see Our History).

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The following table represents an analysis of losses and loss adjustment expenses and a reconciliation of the beginning and ending reserve for losses and loss adjustment expenses.

	Years Ended December 31,		
	2006	2005	2004
	(U.S. dollars in thousands)		
Reserve for losses and loss adjustment expenses at beginning of year	\$ 5,452,826	\$ 3,492,759	\$ 1,911,596
Unpaid losses and loss adjustment expenses recoverable	1,389,768	617,607	369,080
Net reserve for losses and loss adjustment expenses at beginning of year	4,063,058	2,875,152	1,542,516
Increase (decrease) in net losses and loss adjustment expenses incurred relating to losses occurring in:			
Current year	1,867,344	2,120,962	1,975,312
Prior years	(76,795)	(119,013)	(98,707)
Total net incurred losses and loss adjustment expenses	1,790,549	2,001,949	1,876,605
Net losses and loss adjustment expense reserves of acquired (sold) companies			(21,944)
Exchange rate effects	47,711	(55,854)	39,930
Less net losses and loss adjustment expenses paid relating to losses occurring in:			
Current year	245,856	308,954	314,545
Prior years	744,578	449,235	247,410
Total net paid losses and loss adjustment expenses	990,434	758,189	561,955
Net reserve for losses and loss adjustment expenses at end of year	4,910,884	4,063,058	2,875,152
Unpaid losses and loss adjustment expenses recoverable	1,552,157	1,389,768	617,607
Reserve for losses and loss adjustment expenses at end of year	\$ 6,463,041	\$ 5,452,826	\$ 3,492,759

Our reserving method to date has to a large extent been the expected loss method, which is commonly applied when limited loss experience exists. We select the initial expected loss and loss adjustment expense ratios based on information derived by our underwriters and actuaries during the initial pricing of the business, supplemented by industry data where appropriate. These ratios consider, among other things, rate changes and changes in terms and conditions that have been observed in the market. Any estimates and assumptions made as part of the reserving process could prove to be inaccurate due to several factors, including the fact that limited historical information has been reported to us through December 31, 2006. As actual loss information is reported to us and we develop our own loss experience, we will give more emphasis to other actuarial techniques.

During 2006, on a gross basis, we recorded a deficiency on reserves recorded in prior years of approximately \$28.3 million while, on a net basis, we recorded a redundancy on reserves recorded in prior years of approximately \$76.8 million. The gross deficiency primarily resulted from adverse development on the 2005 catastrophic events while, on a net basis, a significant portion of the adverse development was covered by reinsurance. The net favorable development consisted of \$68.5 million from the reinsurance segment and \$8.3 million from the insurance segment. Of the net favorable development in the reinsurance segment, \$37.1 million came from short-tail lines, and \$31.4 million came from longer-tail lines. The development resulted from better than anticipated loss emergence and was net of \$38.1 million of adverse development on the 2005 catastrophic events, primarily in short-tail lines. The net favorable development was partially offset by an increase in acquisition expenses of \$7.8 million, primarily as a result of the commutation of certain treaties. In addition, in its reserving process in 2002 and 2003, the reinsurance segment recognized that there is a possibility that the assumptions made could prove to be inaccurate due to several factors primarily related to the start up nature of its operations. Due to the availability of additional data, and based on reserve analyses, it was determined that it was no longer necessary to

continue to include such factors. Following reserve reviews, and based on the level of claims activity reported to date, the reinsurance segment reduced the amount of reserves it had recorded in 2002 and 2003 by \$7.7 million in 2006. Except as discussed above, the estimated favorable development in the reinsurance segment's prior year reserves did not reflect any significant changes in the key assumptions it made to estimate these reserves at December 31, 2005. The insurance segment's net favorable development of \$8.3 million was primarily due to reductions in reserves in certain medium-tailed and long-tailed lines of business, in particular for those lines of business written on a claims-made basis and for which it now has a reasonable level of credible data, partially offset by adverse development of \$44.0 million from short-tail lines which included \$30.8 million of adverse development on the 2005 catastrophic events.

During 2005, on a gross and net basis, we recorded a redundancy on reserves recorded in prior years of approximately \$113.9 million and \$119.0 million, respectively. The net favorable development consisted of \$91.2 million from the reinsurance segment and \$27.8 million from the insurance segment. Of the net favorable development in the reinsurance segment, \$85.3 million was primarily due to short-tail lines, mainly property, and resulted from better than anticipated loss emergence. Such amount was partially offset by an increase in acquisition expenses of \$9.0 million, primarily as a result of the commutation of certain treaties. As noted above, in its reserving process in 2002 and 2003, the reinsurance segment recognized that there is a possibility that the assumptions made could prove to be inaccurate due to several factors primarily related to the start up nature of its operations. Following reserve reviews, and based on the level of claims activity reported to date, the reinsurance segment reduced the amount of reserves it had recorded in 2002 and 2003 by \$12.1 million in 2005. Except as discussed above, the estimated favorable development in the reinsurance segment's prior year reserves did not reflect any significant changes in the key assumptions it made to estimate these reserves at December 31, 2004. Prior to 2005, the insurance segment's reserving method relied heavily on industry data. In 2005, the insurance segment began to give a relatively small amount of weight to its own experience. The insurance segment's net favorable development of \$27.8 million was primarily due to reductions in reserves in certain medium-tailed and long-tailed lines of business, in particular for those lines of business written on a claims-made basis and for which it now has a reasonable level of credible data.

During 2004, on a gross and net basis, we recorded a redundancy on reserves recorded in prior years of approximately \$98.5 million and \$98.7 million, respectively. The net favorable development consisted of \$85.3 million from our reinsurance segment and \$13.4 million from our insurance segment. Of the net favorable development in the reinsurance segment, \$74.1 million was due to short-tail lines and primarily resulted from better than anticipated loss emergence. Such amount was partially offset by an increase in acquisition expenses of \$21.7 million, primarily as a result of the commutation of certain treaties. As noted above, in its reserving process in 2002 and 2003, the reinsurance segment recognized that there is a possibility that the assumptions made could prove to be inaccurate due to several factors primarily related to the start up nature of its operations. Following a reserve review in the 2004 fourth quarter, and based on the level of claims activity reported to date, the reinsurance segment reduced the amount of reserves it had recorded in 2002 and 2003 by \$7.3 million. Except as discussed above, the estimated favorable development in the reinsurance segment's prior year reserves did not reflect any significant changes in the key assumptions we made to estimate these reserves at December 31, 2003. The insurance segment's \$13.4 million of net favorable development was primarily due to the fact that both the frequency and severity of reported losses were less than the levels anticipated for property and other short-tail business at December 31, 2003. Such amounts were partially offset by \$8.8 million of estimated adverse development in program business during 2004.

We are subject to credit risk with respect to our reinsurance and retrocessions because the ceding of risk to reinsurers and retrocessionaires does not relieve us of our liability to the clients or companies we insure or reinsure. Our failure to establish adequate reinsurance or retrocessional arrangements or the failure of our existing reinsurance or retrocessional arrangements to protect us from overly concentrated

risk exposure could adversely affect our financial condition and results of operations. Although we monitor the financial condition of our reinsurers and retrocessionaires and attempt to place coverages only with substantial, financially sound carriers, we may not be successful in doing so. See Management's Discussion and Analysis of Financial Condition and Results of Operations Collection of Insurance-Related Balances and Provision for Doubtful Accounts.

Investments

At December 31, 2006, consolidated cash and invested assets totaled approximately \$9.32 billion, consisting of \$1.27 billion of cash and short-term investments, \$7.74 billion of fixed maturities and fixed maturities pledged under securities lending agreements and \$307.1 million of other investments. See Management's Discussion and Analysis of Financial Condition and Results of Operations Investments.

The following table summarizes the fair value of our cash and invested assets at December 31, 2006 and 2005:

	December 31, 2006	% of Total	2005	% of Total
	Estimated Fair Value		Estimated Fair Value	
	(U.S. dollars in thousands)			
Cash and short-term investments(1)	\$ 1,274,715	13.7	\$ 905,464	12.7
Fixed maturities and fixed maturities pledged under securities lending agreements(1):				
U.S. government and government agencies	1,922,511	20.6	2,106,866	29.6
Corporate bonds	1,504,989	16.2	1,595,559	22.4
Mortgage backed securities	1,183,805	12.7	376,793	5.3
Asset backed securities	907,829	9.7	591,401	8.3
Commercial mortgage backed securities	868,586	9.3	469,984	6.6
Municipal bonds	815,204	8.8	623,822	8.8
Non-U.S. government securities	534,427	5.7	379,328	5.3
Sub-total	7,737,351	83.0	6,143,753	86.3
Other investments	307,082	3.3	70,233	1.0
Total cash and invested assets(1)(2)	\$ 9,319,148	100.0	\$ 7,119,450	100.0

(1) In our securities lending transactions, we receive collateral in excess of the fair value of the fixed maturities and short-term investments pledged under securities lending agreements. For purposes of this table, we have excluded \$891.4 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 \$860.8 million and \$863.9 million, respectively, of fixed maturities and short-term investments pledged under securities lending agreements, at fair value at December 31, 2006 and 2005.

(2) Includes certain securities transactions entered into but not settled at the balance sheet date. Net of such amounts, total cash and investments were approximately \$9.09 billion at December 31, 2006 and \$7.11 billion at December 31, 2005.

Our current investment guidelines and approach stress preservation of capital, market liquidity and diversification of risk. Our investments are subject to market-wide risks and fluctuations, as well as to risks inherent in particular securities. At December 31, 2006 and 2005, approximately 98% of our fixed maturities and fixed maturities pledged under securities lending agreements were rated investment grade by Standard & Poor's Rating Services (Standard & Poor's). At December 31, 2006 and 2005, our fixed maturities, fixed maturities pledged under securities lending agreements and short-term investments had

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an average Standard & Poor's quality rating of AAA and AA+, respectively, and an average effective duration of approximately 3.2 years and 3.3 years, respectively.

During the 2005 third quarter, we began a securities lending program under which certain of our 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. We maintain control over the securities we lend, retain the earnings and cash flows associated with the loaned securities and receive 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 fair value of the loaned securities (or 104% of the fair 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 December 31, 2006, the fair value and amortized cost of fixed maturities and short-term investments pledged under securities lending agreements were \$860.8 million and \$854.8 million, respectively, while collateral received totaled \$891.4 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.

The credit quality distribution of our fixed maturities and fixed maturities pledged under securities lending agreements at December 31, 2006 and 2005 are shown below:

Rating(1)	December 31, 2006		December 31, 2005	
	Estimated Fair Value	% of Total	Estimated Fair Value	% of Total
AAA	\$ 6,366,059	82.3	\$ 4,692,579	76.4
AA	605,427	7.8	654,129	10.6
A	430,103	5.6	538,570	8.8
BBB	194,408	2.5	146,325	2.4
BB	32,572	0.4	24,472	0.4
B	64,636	0.8	53,178	0.9
Lower than B	11,149	0.2	7,388	0.1
Not rated	32,997	0.4	27,112	0.4
Total	\$ 7,737,351	100.0	\$ 6,143,753	100.0

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

For the years ended December 31, 2006 and 2005, set forth below is the pre-tax total return (before investment expenses) of our investment portfolio (including fixed maturities, short-term investments and fixed maturities and short-term investments pledged under securities lending agreements) compared to the benchmark return against which we measured our portfolio during the year. Our investment expenses were approximately 0.15% of average invested assets in 2006 and 2005.

	Arch Portfolio	Benchmark Return (1)
Pre-tax total return (before investment expenses):		
Year ended December 31, 2006	5.24 %	4.88 %
Year ended December 31, 2005	2.09 %	1.70 %

(1) The benchmark return is a weighted average of the benchmarks assigned to each of our investment managers. The benchmarks used vary based on the nature of the portfolios under management. In all but a few instances, the benchmarks used are Lehman indices.

Ratings

The Company's ability to underwrite business is dependent upon the quality of its claims paying ability and financial strength ratings as evaluated by independent agencies. Such ratings from third party internationally recognized statistical rating organizations or agencies are instrumental in establishing the competitive positions of companies in our industry. The Company believes that the primary users of such ratings include commercial and investment banks, policyholders, brokers, ceding companies and investors. Insurance ratings are also used by insurance and reinsurance intermediaries as an important means of assessing the financial strength and quality of insurers and reinsurers, and have become an increasingly important factor in establishing the competitive position of insurance and reinsurance companies. These ratings are often an important factor in the decision by an insured or intermediary of whether to place business with a particular insurance or reinsurance provider. Periodically, rating agencies evaluate us to confirm that we continue to meet their criteria for the ratings assigned to us by them. A.M. Best Company maintains a letter scale rating system ranging from A++ (Superior) to F (In Liquidation). Moody's Investors Service maintains a letter scale rating from Aaa (Exceptional) to NP (Not Prime). Standard & Poor's maintains a letter scale rating system ranging from AAA (Extremely Strong) to R (Under Regulatory Supervision). Our reinsurance subsidiaries, Arch Re U.S. and Arch Re Bermuda, and our principal insurance subsidiaries, Arch Insurance, Arch E&S, Arch Specialty and Arch-Europe, each currently has a financial strength rating of A (Excellent, the third highest out of fifteen rating levels) with a stable outlook from A.M. Best Company, A2 (Good, the sixth highest out of 21 rating levels) with a stable outlook from Moody's Investors Service and A- (Strong, the seventh highest out of 21 rating levels) with a positive outlook from Standard and Poor's. Fitch Ratings has assigned a financial strength rating of A (Strong, the sixth highest out of 24 rating levels) with a stable outlook to Arch Re Bermuda. A.M. Best Company has assigned a financial strength rating of NR-3 (Rating Procedure Inapplicable) to Western Diversified, which currently is not writing business, and Moody's Investors Service and Standard & Poor's did not rate Western Diversified.

ACGL has received counterparty (issuer) credit ratings of BBB (ninth highest out of 22 rating levels) with a positive outlook from Standard & Poor's, Baa1 (eighth highest out of 21 rating levels) with a stable outlook from Moody's Investors Service and A- (eighth highest out of 23 rating levels) with a stable outlook from Fitch Ratings. A counterparty credit rating provides an opinion on an issuer's overall capacity and willingness to meet its financial commitments as they become due, but is not specific to a particular financial obligation. ACGL's senior debt was assigned a rating of BBB from Standard and Pooers, Baa1 from Moody's Investors Service and BBB+ from Fitch Ratings. ACGL's series A non-cumulative preferred shares and series B non-cumulative preferred shares were both assigned a BB+ rating by Standard & Poor's, a Baa3 by Moody's Investors Service and a BBB rating by Fitch Ratings.

The objective of these ratings systems is to assist policyholders and to provide an opinion of an insurer's or reinsurer's financial strength and ability to meet ongoing obligations to its policyholders. The financial strength ratings assigned by rating agencies to insurance and reinsurance companies represent independent opinions of financial strength and ability to meet policyholder obligations and are not directed toward the protection of investors, nor are they recommendations to buy, hold or sell any securities. We can offer no assurances that our ratings will remain at their current levels, or that our security will be accepted by brokers and our insureds and reinsureds. A ratings downgrade or the potential for such a downgrade, or failure to obtain a necessary rating, could adversely affect both our relationships with agents, brokers, wholesalers and other distributors of our existing products and services and new sales of our products and services. In addition, under certain of the reinsurance agreements assumed by our reinsurance operations, upon the occurrence of a ratings downgrade or other specified triggering event with respect to our reinsurance operations, such as a reduction in surplus by specified amounts during specified periods, our ceding company clients may be provided with certain rights, including, among other things, the right to terminate the subject reinsurance agreement and/or to require that our reinsurance operations post

additional collateral. In the event of a ratings downgrade or other triggering event, the exercise of such contract rights by our clients could have a material adverse effect on our financial condition and results of operations, as well as our ongoing business and operations. See Management's Discussion and Analysis of Financial Condition and Results of Operations Liquidity and Capital Resources.

Competition

The worldwide reinsurance and insurance businesses are highly competitive. We compete, and will continue to compete, with major U.S. and non-U.S. insurers and reinsurers, some of which have greater financial, marketing and management resources than we have and have had longer-term relationships with insureds and brokers than us. We compete with other insurers and reinsurers primarily on the basis of overall financial strength, ratings assigned by independent rating agencies, geographic scope of business, strength of client relationships, premiums charged, contract terms and conditions, products and services offered, speed of claims payment, reputation, employee experience, and qualifications and local presence. We also compete with new companies that continue to be formed to enter the insurance and reinsurance markets.

In our insurance business, we compete with insurers that provide specialty property and casualty lines of insurance, including: ACE Limited, Allied World Assurance Company, Ltd., American International Group, Inc., AXIS Capital Holdings Limited, Berkshire Hathaway, Inc., Chubb Corporation, Endurance Specialty Holdings Ltd., The Hartford Financial Services Group, Inc., HCC Insurance Holdings, Inc., Lloyd's of London, The St. Paul Travelers Companies, W.R. Berkley Corp., XL Capital Ltd. and Zurich Insurance Group. In our reinsurance business, we compete with reinsurers that provide property and casualty lines of reinsurance, including ACE Limited, AXIS Capital Holdings Limited, Endurance Specialty Holdings Ltd., Everest Re Group Ltd., General Reinsurance Corporation, Hannover Rückversicherung AG, Lloyd's of London, Montpelier Re Holdings Ltd., Munich Re Group, PartnerRe Ltd., Platinum Underwriters Holdings, Ltd., RenaissanceRe Holdings Ltd., Swiss Reinsurance Company, Transatlantic Holdings, Inc. and XL Capital Ltd. We do not believe that we have a significant market share in any of our markets.

Regulation

U.S. Insurance Regulation

General. In common with other insurers, our U.S.-based insurance subsidiaries are subject to extensive governmental regulation and supervision in the various states and jurisdictions in which they are domiciled and licensed and/or approved to conduct business. The laws and regulations of the state of domicile have the most significant impact on operations. This regulation and supervision is designed to protect policyholders rather than investors. Generally, regulatory authorities have broad regulatory powers over such matters as licenses, standards of solvency, premium rates, policy forms, marketing practices, claims practices, investments, security deposits, methods of accounting, form and content of financial statements, reserves and provisions for unearned premiums, unpaid losses and loss adjustment expenses, reinsurance, minimum capital and surplus requirements, dividends and other distributions to shareholders, periodic examinations and annual and other report filings. In addition, transactions among affiliates, including reinsurance agreements or arrangements, as well as certain third party transactions, require prior regulatory approval from, or prior notice to, the applicable regulator under certain circumstances. Certain insurance regulatory requirements are highlighted below. In addition, regulatory authorities conduct periodic financial, claims and market conduct examinations. Arch-Europe is also subject to certain governmental regulation and supervision in the various states where it has been approved as an excess and surplus lines insurer.

The New York Attorney General, various state insurance regulatory authorities and others are investigating contingent commission payments to brokers (and the disclosures relating to such payments), alleged bid-rigging, steering, and other practices in the insurance industry involving brokers and agents, as well as certain finite insurance and/or reinsurance products. Although certain brokers have announced new fee structures in response to the industry investigations and, as part of these new initiatives, have requested that our insurance subsidiaries enter into standardized payment arrangements, we have determined to negotiate payment arrangements with our brokers on a case by case basis. We cannot predict the effect that these investigations, and any changes in industry practice, including future legislation or regulations that may become applicable to us, will have on the insurance industry, or our business. See Risk Factors Risks Relating to Our Industry Our reliance on brokers subjects us to their credit risk.

Credit for Reinsurance. Arch Re U.S. is subject to insurance regulation and supervision that is similar to the regulation of licensed primary insurers. However, except for certain mandated provisions that must be included in order for a ceding company to obtain credit for reinsurance ceded, the terms and conditions of reinsurance agreements generally are not subject to regulation by any governmental authority. This contrasts with primary insurance policies and agreements, the rates and terms of which generally are regulated by state insurance regulators. As a practical matter, however, the rates charged by primary insurers do have an effect on the rates that can be charged by reinsurers.

A primary insurer ordinarily will enter into a reinsurance agreement only if it can obtain credit for the reinsurance ceded on its U.S. statutory-basis financial statements. In general, credit for reinsurance is allowed in the following circumstances:

- if the reinsurer is licensed in the state in which the primary insurer is domiciled or, in some instances, in certain states in which the primary insurer is licensed;
- if the reinsurer is an accredited or otherwise approved reinsurer in the state in which the primary insurer is domiciled or, in some instances, in certain states in which the primary insurer is licensed;
- in some instances, if the reinsurer (a) is domiciled in a state that is deemed to have substantially similar credit for reinsurance standards as the state in which the primary insurer is domiciled and (b) meets certain financial requirements; or
- if none of the above apply, to the extent that the reinsurance obligations of the reinsurer are collateralized appropriately, typically through the posting of a letter of credit for the benefit of the primary insurer or the deposit of assets into a trust fund established for the benefit of the primary insurer.

As a result of the requirements relating to the provision of credit for reinsurance, Arch Re U.S. and Arch Re Bermuda are indirectly subject to certain regulatory requirements imposed by jurisdictions in which ceding companies are licensed.

As of February 15, 2007: (1) Arch Re U.S. is licensed or is an accredited or otherwise approved reinsurer in 50 states and the District of Columbia; (2) Arch Insurance is licensed as an insurer in 50 states, the District of Columbia, Puerto Rico and the U.S. Virgin Islands; (3) Arch Specialty is licensed in one state and approved as an excess and surplus lines insurer in 49 states, the District of Columbia, Puerto Rico and the U.S. Virgin Islands; (4) Arch E&S is licensed in one state and approved as an excess and surplus lines insurer in 46 states and the District of Columbia; (5) Western Diversified is licensed as an insurer in 48 states and the District of Columbia; and (6) Arch-Europe is approved as an excess and surplus lines insurer in seven states. Arch Re Bermuda does not expect to become, licensed, accredited or so approved in any U.S. jurisdiction.

Holding Company Acts. All states have enacted legislation that regulates insurance holding company systems. These regulations generally provide that each insurance company in the system is required to register with the insurance department of its state of domicile and furnish information concerning the operations of companies within the holding company system which may materially affect the operations, management or financial condition of the insurers within the system. All transactions within a holding company system affecting insurers must be fair and equitable. Notice to the insurance departments is required prior to the consummation of transactions affecting the ownership or control of an insurer and of certain material transactions between an insurer and any entity in its holding company system. In addition, certain of such transactions cannot be consummated without the applicable insurance department's prior approval.

Regulation of Dividends and Other Payments from Insurance Subsidiaries. The ability of an insurer to pay dividends or make other distributions is subject to insurance regulatory limitations of the insurance company's state of domicile. Generally, such laws limit the payment of dividends or other distributions above a specified level. Dividends or other distributions in excess of such thresholds are extraordinary and are subject to prior regulatory approval. Such dividends or distributions may be subject to applicable withholding or other taxes. See Management's Discussion and Analysis of Financial Condition and Results of Operations Liquidity and Capital Resources and note 15, Statutory Information, of the notes accompanying our financial statements.

Insurance Regulatory Information System Ratios. The National Association of Insurance Commissioners (NAIC) Insurance Regulatory Information System (IRIS) was developed by a committee of state insurance regulators and is intended primarily to assist state insurance departments in executing their statutory mandates to oversee the financial condition of insurance companies operating in their respective states. IRIS identifies 13 industry ratios (referred to as IRIS ratios) and specifies usual values for each ratio. Departure from the usual values of the IRIS ratios can lead to inquiries from individual state insurance commissioners as to certain aspects of an insurer's business. For the year ended December 31, 2006, certain of our U.S.-based subsidiaries generated IRIS ratios that were outside of the usual values. To date, none of these subsidiaries has received any notice of regulatory review but there is no assurance that we may not be notified in the future.

Accreditation. The NAIC has instituted its Financial Regulatory Accreditation Standards Program (FRASP) in response to federal initiatives to regulate the business of insurance. FRASP provides a set of standards designed to establish effective state regulation of the financial condition of insurance companies. Under FRASP, a state must adopt certain laws and regulations, institute required regulatory practices and procedures, and have adequate personnel to enforce such items in order to become an accredited state. If a state is not accredited, other states may not accept certain financial examination reports of insurers prepared solely by the regulatory agency in such unaccredited state. The respective states in which Arch Re U.S., Arch Insurance, Arch E&S, Arch Specialty and Western Diversified are domiciled are accredited states.

Risk-Based Capital Requirements. In order to enhance the regulation of insurer solvency, the NAIC adopted in December 1993 a formula and model law to implement risk-based capital requirements for property and casualty insurance companies. These risk-based capital requirements are designed to assess capital adequacy and to raise the level of protection that statutory surplus provides for policyholder obligations. The risk-based capital model for property and casualty insurance companies measures three major areas of risk facing property and casualty insurers:

- underwriting, which encompasses the risk of adverse loss developments and inadequate pricing;
- declines in asset values arising from credit risk; and
- declines in asset values arising from investment risks.

An insurer will be subject to varying degrees of regulatory action depending on how its statutory surplus compares to its risk-based capital calculation. Equity investments in common stock typically are valued at 85% of their market value under the risk-based capital guidelines. For equity investments in an insurance company affiliate, the risk-based capital requirements for the equity securities of such affiliate would generally be our U.S. insurance subsidiaries' proportionate share of the affiliate's risk-based capital requirement.

Under the approved formula, an insurer's total adjusted capital is compared to its authorized control level risk-based capital. If this ratio is above a minimum threshold, no company or regulatory action is necessary. Below this threshold are four distinct action levels at which a regulator can intervene with increasing degrees of authority over an insurer as the ratio of surplus to risk-based capital requirement decreases. The four action levels include:

- insurer is required to submit a plan for corrective action;
- insurer is subject to examination, analysis and specific corrective action;
- regulators may place insurer under regulatory control; and
- regulators are required to place insurer under regulatory control.

Each of our U.S. insurance subsidiaries' surplus (as calculated for statutory purposes) is above the risk-based capital thresholds that would require either company or regulatory action.

Arch Specialty, which was previously domiciled in Wisconsin, 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 (the 275% RBC requirement) required to be maintained, among other things, by Arch Specialty under the Stipulation. Following its receipt during 2006 of a capital contribution in the amount of \$57.0 million provided by subsidiaries of ACGL, as of September 30, 2006, Arch Specialty was in compliance with the 275% RBC requirement under the Stipulation. Likewise, Western Diversified, a subsidiary of Arch Insurance which was also previously domiciled in Wisconsin, entered into a Stipulation with the Wisconsin OCI in connection with our acquisition of Western Diversified in 2003 whereby Western Diversified was required to maintain, among other things, the 275% RBC requirement. As of September 30, 2006, Western Diversified was in compliance with the 275% RBC requirement. On December 28, 2006, each of Arch Specialty and Western Diversified received approval to re-domesticate their state of domicile from Wisconsin to Nebraska. As part of the redomestication of such entities, the OCI rescinded the Stipulations, including the 275% RBC requirement, and the Nebraska Department of Insurance did not impose any similar stipulation or requirement.

Guaranty Funds and Assigned Risk Plans. Most states require all admitted insurance companies to participate in their respective guaranty funds which cover certain claims against insolvent insurers. Solvent insurers licensed in these states are required to cover the losses paid on behalf of insolvent insurers by the guaranty funds and are generally subject to annual assessments in the states by the guaranty funds to cover these losses. Participation in state-assigned risk plans may take the form of reinsuring a portion of a pool of policies or the direct issuance of policies to insureds. The calculation of an insurer's participation in these plans is usually based on the amount of premium for that type of coverage that was written by the insurer on a voluntary basis in a prior year. Assigned risk pools tend to produce losses which result in assessments to insurers writing the same lines on a voluntary basis.

Federal Regulation. Although state regulation is the dominant form of regulation for insurance and reinsurance business, the federal government has shown increasing concern over the adequacy of state

regulation. It is not possible to predict the future impact of any potential federal regulations or other possible laws or regulations on our U.S. subsidiaries' capital and operations, and such laws or regulations could materially adversely affect their business.

Terrorism Risk Insurance Act of 2002. On November 26, 2002, President Bush signed into law the Terrorism Risk Insurance Act of 2002, which was amended and extended by the Terrorism Risk Insurance Extension Act of 2005 (TRIEA) through December 31, 2007. TRIEA provides a federal backstop for insurance-related losses resulting from any act of terrorism carried out by foreign powers on U.S. soil or against U.S. air carriers, vessels or foreign missions. Under TRIEA, all U.S.-based property and casualty insurers are required to make terrorism insurance coverage available in specified commercial property and casualty insurance lines. Under TRIEA, the federal government will pay 90% and 85% in 2006 and 2007, respectively, of covered losses after an insurer's losses exceed a deductible determined by a statutorily prescribed formula, up to a combined annual aggregate limit for the federal government and all insurers of \$100 billion. If an act (or acts) of terrorism result in covered losses exceeding the \$100 billion annual limit, insurers with losses exceeding their deductibles will not be responsible for additional losses. The deductible for each year is based on the insurer's direct commercial earned premiums for property and casualty insurance, excluding certain lines of business such as commercial auto, surety, professional liability and earthquake lines of business, for the prior calendar year multiplied by a specified percentage. The specified percentages are 7% for 2003, 10% for 2004, 15% for 2005, 17.5% for 2006 and 20% for 2007.

Our U.S.-based property and casualty insurers, Arch Insurance, Arch Specialty, Arch E&S and Western Diversified, are subject to TRIEA. TRIEA specifically excludes reinsurance business and, accordingly, does not apply to our reinsurance operations. Our U.S. insurance group's deductible for 2006 was approximately \$226 million (i.e., 17.5% of earned premiums). Based on 2006 direct commercial earned premiums, our U.S. insurance group's deductible for 2007 is approximately \$274 million (i.e., 20.0% of such earned premiums).

The Gramm-Leach-Bliley Act. The Gramm-Leach-Bliley Act of 1999 (GLBA), which implements fundamental changes in the regulation of the financial services industry in the United States, was enacted on November 12, 1999. The GLBA permits the transformation of the already converging banking, insurance and securities industries by permitting mergers that combine commercial banks, insurers and securities firms under one holding company, a financial holding company. Bank holding companies and other entities that qualify and elect to be treated as financial holding companies may engage in activities, and acquire companies engaged in activities, that are financial in nature or incidental or complementary to such financial activities. Such financial activities include acting as principal, agent or broker in the underwriting and sale of life, property, casualty and other forms of insurance and annuities.

Until the passage of the GLBA, the Glass-Steagall Act of 1933 had limited the ability of banks to engage in securities-related businesses, and the Bank Holding Company Act of 1956 had restricted banks from being affiliated with insurers. With the passage of the GLBA, among other things, bank holding companies may acquire insurers, and insurance holding companies may acquire banks. The ability of banks to affiliate with insurers may affect our U.S. subsidiaries' product lines by substantially increasing the number, size and financial strength of potential competitors.

Legislative and Regulatory Proposals. From time to time various regulatory and legislative changes have been proposed in the insurance and reinsurance industry. Among the proposals that have in the past been or are at present being considered are the possible introduction of federal regulation in addition to, or in lieu of, the current system of state regulation of insurers. In addition, there are a variety of proposals being considered by various state legislatures. We are unable to predict whether any of these laws and regulations will be adopted, the form in which any such laws and regulations would be adopted, or the effect, if any, these developments would have on our operations and financial condition. See U.S. Insurance Regulation General.

Bermuda Insurance Regulation

The Insurance Act 1978, as Amended, and Related Regulations of Bermuda (the Insurance Act) As a holding company, ACGL is not subject to Bermuda insurance regulations. The Insurance Act, which regulates the insurance business of Arch Re Bermuda, provides that no person shall carry on any insurance business in or from within Bermuda unless registered as an insurer under the Insurance Act by the Bermuda Monetary Authority (the BMA), which is responsible for the day-to-day supervision of insurers. Under the Insurance Act, insurance business includes reinsurance business. The registration of an applicant as an insurer is subject to its complying with the terms of its registration and such other conditions as the BMA may impose from time to time.

The Insurance Act imposes solvency and liquidity standards and auditing and reporting requirements on Bermuda insurance companies and grants to the BMA powers to supervise, investigate and intervene in the affairs of insurance companies. Certain significant aspects of the Bermuda insurance regulatory framework are set forth below.

Classification of Insurers. The Insurance Act distinguishes between insurers carrying on long-term business and insurers carrying on general business. There are four classifications of insurers carrying on general business, with Class 4 insurers subject to the strictest regulation. Arch Re Bermuda is registered as both a long-term insurer and a Class 4 insurer in Bermuda, which we refer to in this annual report as a composite insurer, and is regulated as such under the Insurance Act.

Cancellation of Insurer's Registration. An insurer's registration may be canceled by the BMA on certain grounds specified in the Insurance Act, including failure of the insurer to comply with its obligations under the Insurance Act or if, in the opinion of the BMA, the insurer has not been carrying on business in accordance with sound insurance principles. We believe we are in compliance with applicable regulations under the Insurance Act.

Principal Representative. An insurer is required to maintain a principal office in Bermuda and to appoint and maintain a principal representative in Bermuda. It is the duty of the principal representative upon reaching the view that there is a likelihood of the insurer for which the principal representative acts becoming insolvent or that a reportable event has, to the principal representative's knowledge, occurred or is believed to have occurred, to immediately notify the BMA and to make a report in writing to the BMA within 14 days setting out all the particulars of the case that are available to the principal representative.

Approved Independent Auditor. Every registered insurer must appoint an independent auditor who annually audits and reports on the statutory financial statements and the statutory financial return of the insurer, both of which, in the case of Arch Re Bermuda, are required to be filed annually with the BMA. The independent auditor must be approved by the BMA.

Approved Actuary. Arch Re Bermuda, as a registered long-term insurer, is required to submit an annual actuary's certificate when filing its statutory financial returns. The actuary, who is normally a qualified life actuary, must be approved by the BMA.

Approved Loss Reserve Specialist. As a registered Class 4 insurer, Arch Re Bermuda is required to submit an opinion of its approved loss reserve specialist with its statutory financial return in respect of its loss and loss expense provisions. The loss reserve specialist, who will normally be a qualified casualty actuary, must be approved by the BMA.

Annual Statutory Financial Statements. An insurer must prepare annual statutory financial statements. The Insurance Act prescribes rules for the preparation and substance of such statutory financial statements (which include, in statutory form, a balance sheet, an income statement, a statement of capital and surplus and notes thereto). The insurer is required to give detailed information and analyses

regarding premiums, claims, reinsurance and investments. The statutory financial statements are not prepared in accordance with GAAP and are distinct from the financial statements prepared for presentation to the insurer's shareholders under the Companies Act 1981 of Bermuda (the Companies Act), which financial statements are prepared in accordance with GAAP. Arch Re Bermuda, as a general business insurer, is required to submit the annual statutory financial statements as part of the annual statutory financial return.

Annual Statutory Financial Return. Arch Re Bermuda is required to file with the BMA in Bermuda a statutory financial return no later than four months after its financial year end (unless specifically extended upon application to the BMA). The statutory financial return for a Class 4 insurer includes, among other matters, a report of the approved independent auditor on the statutory financial statements of such insurer, solvency certificates, the statutory financial statements themselves, the opinion of the loss reserve specialist and a schedule of reinsurance ceded.

Minimum Solvency Margin and Restrictions on Dividends and Distributions. Under the Insurance Act, Arch Re Bermuda must ensure that the value of its long-term business assets exceed the amount of its long-term business liabilities by at least \$250,000. The Insurance Act also provides that the value of the general business assets of Arch Re Bermuda, as a Class 4 insurer, must exceed the amount of its general business liabilities by an amount greater than the prescribed minimum solvency margin. Arch Re Bermuda:

- is required, with respect to its general business, to maintain a minimum solvency margin (the prescribed amount by which the value of its general business assets must exceed its general business liabilities) equal to the greatest of:

(A) \$100 million,

(B) 50% of net premiums written (being gross premiums written less any premiums ceded by Arch Re Bermuda but Arch Re Bermuda may not deduct more than 25% of gross premiums when computing net premiums written), and

(C) 15% of loss and other insurance reserves;

- is prohibited from declaring or paying any dividends during any financial year if it is in breach of its minimum solvency margin or minimum liquidity ratio or if the declaration or payment of such dividends would cause it to fail to meet such margin or ratio (if it has failed to meet its minimum solvency margin or minimum liquidity ratio on the last day of any financial year, Arch Re Bermuda will be prohibited, without the approval of the BMA, from declaring or paying any dividends during the next financial year);
- 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 7 days before payment of such dividends) with the BMA an affidavit stating that it will continue to meet the required margins;
- is prohibited, without the approval of the BMA, from reducing by 15% or more its total statutory capital as set out in its previous year's financial statements and any application for such approval must include an affidavit stating that it will continue to meet the required margins;
- is required, at any time it fails to meet its solvency margin, within 30 days (45 days where total statutory capital and surplus falls to \$75 million or less) after becoming aware of that failure or having reason to believe that such failure has occurred, to file with the BMA a written report containing certain information;
- is required to establish and maintain a long-term business fund; and

- is required to obtain a certain certification from its approved actuary prior to declaring or paying any dividends and such certificate will not be given unless the value of its long-term business assets exceeds its long-term business liabilities, as certified by its approved actuary, by the amount of the dividend and at least \$250,000. The amount of any such dividend shall not exceed the aggregate of the excess referenced in the preceding sentence and other funds properly available for the payment of dividends, being funds arising out of its business, other than its long-term business.

Minimum Liquidity Ratio. The Insurance Act provides a minimum liquidity ratio for general business insurers such as Arch Re Bermuda. An insurer engaged in general business is required to maintain the value of its relevant assets at not less than 75% of the amount of its relevant liabilities. Relevant assets include cash and time deposits, quoted investments, unquoted bonds and debentures, first liens on real estate, investment income due and accrued, accounts and premiums receivable and reinsurance balances receivable. The relevant liabilities are total general business insurance reserves and total other liabilities less deferred income tax and sundry liabilities (by interpretation, those not specifically defined).

Long-Term Business Fund. An insurer carrying on long-term business is required to keep its accounts in respect of its long-term business separate from any accounts kept in respect of any other business and all receipts of its long-term business form part of its long-term business fund. No payment may be made directly or indirectly from an insurer's long-term business fund for any purpose other than a purpose related to the insurer's long-term business, unless such payment can be made out of any surplus certified by the insurer's approved actuary to be available for distribution otherwise than to policyholders. Arch Re Bermuda may not declare or pay a dividend to any person other than a policyholder unless the value of the assets in its long-term business fund, as certified by its approved actuary, exceeds the liabilities of the insurer's long-term business (as certified by the insurer's approved actuary) by the amount of the dividend and at least the \$250,000 minimum solvency margin prescribed by the Insurance Act, and the amount of any such dividend may not exceed the aggregate of that excess (excluding the said \$250,000) and any other funds properly available for payment of dividends, such as funds arising out of business of the insurer other than long-term business.

Restrictions on Transfer of Business and Winding-Up. Arch Re Bermuda, as a long-term insurer, is subject to the following provisions of the Insurance Act:

- all or any part of the long-term business, other than long-term business that is reinsurance business, may be transferred only with and in accordance with the sanction of the applicable Bermuda court; and
- an insurer or reinsurer carrying on long-term business may only be wound-up or liquidated by order of the applicable Bermuda court, and this may increase the length of time and costs incurred in the winding-up of Arch Re Bermuda when compared with a voluntary winding-up or liquidation.

Supervision, Investigation and Intervention. The BMA may appoint an inspector with extensive powers to investigate the affairs of an insurer if the BMA believes that an investigation is required in the interest of the insurer's policyholders or persons who may become policyholders. In order to verify or supplement information otherwise provided to the BMA, the BMA may direct an insurer to produce documents or information relating to matters connected with the insurer's business.

If it appears to the BMA that there is a risk of the insurer becoming insolvent, or that it is in breach of the Insurance Act or any conditions imposed upon its registration, the BMA may, among other things, direct the insurer (1) not to take on any new insurance business, (2) not to vary any insurance contract if the effect would be to increase the insurer's liabilities, (3) not to make certain investments, (4) to realize certain investments, (5) to maintain in, or transfer to the custody of, a specified bank, certain assets, (6) not to declare or pay any dividends or other distributions or to restrict the making of such payments and/or (7) to limit its premium income.

Shareholder Controllers. Any person who, directly or indirectly, becomes a holder of at least 10%, 20%, 33% or 50% of the common shares of ACGL must notify the BMA in writing within 45 days of becoming such a holder or 30 days from the date they have knowledge of having such a holding, whichever is later. The BMA may, by written notice, object to such a person if it appears to the BMA that the person is not fit and proper to be such a holder. The BMA may require the holder to reduce their holding of common shares in ACGL and direct, among other things, that voting rights attaching to the common shares shall not be exercisable. A person that does not comply with such a notice or direction from the BMA will be guilty of an offense.

For so long as ACGL has a subsidiary an insurer registered under the Insurance Act, the BMA may at any time, by written notice, object to a person holding 10% or more of the its common shares if it appears to the BMA that the person is not or is no longer fit and proper to be such a holder. In such a case, the BMA may require the shareholder to reduce its holding of common shares in ACGL and direct, among other things, that such shareholder's voting rights attaching to the common shares shall not be exercisable. A person who does not comply with such a notice or direction from the BMA will be guilty of an offense.

Certain Bermuda Law Considerations

ACGL and Arch Re Bermuda have been designated as non-resident for exchange control purposes by the BMA and are required to obtain the permission of the BMA for the issue and transfer of all of their shares. The BMA has given its consent for:

- the issue and transfer of ACGL's shares, up to the amount of its authorized capital from time to time, to and among persons that are non-residents of Bermuda for exchange control purposes; and
- the issue and transfer of up to 20% of ACGL's shares in issue from time to time to and among persons resident in Bermuda for exchange control purposes.

Transfers and issues of ACGL's common shares to any resident in Bermuda for exchange control purposes may require specific prior approval under the Exchange Control Act 1972. Arch Re Bermuda's common shares cannot be issued or transferred without the consent of the BMA. Because we are designated as non-resident for Bermuda exchange control purposes, we are allowed to engage in transactions, and to pay dividends to Bermuda non-residents who are holders of our common shares, in currencies other than the Bermuda Dollar.

In accordance with Bermuda law, share certificates are issued only in the names of corporations or individuals. In the case of an applicant acting in a special capacity (for example, as an executor or trustee), certificates may, at the request of the applicant, record the capacity in which the applicant is acting. Notwithstanding the recording of any such special capacity, we are not bound to investigate or incur any responsibility in respect of the proper administration of any such estate or trust. We will take no notice of any trust applicable to any of our common shares whether or not we have notice of such trust.

ACGL and Arch Re Bermuda are incorporated in Bermuda as exempted companies. As a result, they are exempt from Bermuda laws restricting the percentage of share capital that may be held by non-Bermudians, but they may not participate in certain business transactions, including (1) the acquisition or holding of land in Bermuda (except that required for their business and held by way of lease or tenancy for terms of not more than 50 years) without the express authorization of the Bermuda legislature, (2) the taking of mortgages on land in Bermuda to secure an amount in excess of \$50,000 without the consent of the Minister of Finance, (3) the acquisition of any bonds or debentures secured by any land in Bermuda, other than certain types of Bermuda government securities or (4) the carrying on of business of any kind in Bermuda, except in furtherance of their business carried on outside Bermuda or under license granted by the Minister of Finance. While an insurer is permitted to reinsure risks undertaken by any company incorporated in Bermuda and permitted to engage in the insurance and reinsurance business, generally it is

not permitted without a special license granted by the Minister of Finance to insure Bermuda domestic risks or risks of persons of, in or based in Bermuda.

ACGL and Arch Re Bermuda also need to comply with the provisions of the Companies Act regulating the payment of dividends and making distributions from contributed surplus. A company shall not declare or pay a dividend, or make a distribution out of contributed surplus, if there are reasonable grounds for believing that: (a) the company is, or would after the payment be, unable to pay its liabilities as they become due; or (b) the realizable value of the company's assets would thereby be less than the aggregate of its liabilities and its issued share capital and share premium accounts. See Management's Discussion and Analysis of Financial Condition and Results of Operations Liquidity and Capital Resources and note 15, Statutory Information, of the notes accompanying our financial statements.

Under Bermuda law, only persons who are Bermudians, spouses of Bermudians, holders of a permanent resident's certificate or holders of a working resident's certificate (exempted persons) may engage in gainful occupation in Bermuda without an appropriate governmental work permit. Our success may depend in part upon the continued services of key employees in Bermuda. Certain of our current key employees are not exempted persons and, as such, require specific approval to work for us in Bermuda. A work permit may be granted or extended upon showing that, after proper public advertisement, no exempted person is available who meets the minimum standards reasonably required by the employer. The Bermuda government has a policy that places a six-year term limit on individuals with work permits, subject to certain exemptions for key employees.

United Kingdom Insurance Regulation

General. The Financial Services Authority (the FSA) regulates insurance and reinsurance companies operating in the U.K. under the Financial Services and Markets Act 2000 (the FSMA), including Arch-Europe, our U.K.-based subsidiary. Arch-Europe was licensed and authorized by the FSA to underwrite all relevant classes of wholesale general insurance in the U.K. in May 2004. All U.K. companies are also subject to a range of statutory provisions, including the laws and regulations of the Companies Act 1985 (as amended) (the Companies Act).

The primary statutory goals of the FSA are to maintain and promote confidence in the U.K. financial system, secure the appropriate degree of protection for consumers and reduce financial crime. The FSA regulatory regime imposes risk management, solvency and capital requirements on U.K. insurance companies. The FSA has broad authority to supervise and regulate insurance companies which extends to enforcement of the provisions of the FSMA and intervention in the operations of an insurance company. The FSA regime is based on principles from which all of its rules and guidance derive. Among these principles, the FSA increasingly emphasizes a culture of compliance in those firms it regulates. During the first three years of Arch-Europe's operations, the FSA will closely monitor Arch-Europe as a new insurer, including measuring its progress against the business plan it submitted to the FSA as part of the authorization process. The FSA conducted a risk assessment of Arch-Europe in 2004 and in 2006, and will continue to do so again on a regular schedule. The assessment provided the FSA's views on Arch-Europe's risk profile and its regulatory capital requirements. In some cases, the FSA may require remedial action or adjustments to a company's management, operations, capital requirements, claims management or business plan. The FSA recently announced that greater focus will be placed on senior management arrangements, systems and controls, the fair treatment of clients and making further progress towards the development of enhanced risk-based minimum capital requirements for non life insurance companies, working together with the regulatory bodies of the Member States of the European Union (EU) and the European Commission, which acts as the initiator of action and executive body of the EU.

Financial Resources. As part of its application for authorization from the FSA, Arch-Europe was required to demonstrate to the FSA that it had adequate financial assets to meet the financial resources

requirement for its category. This included submitting a detailed plan of operations. The FSA also gave Arch-Europe individual guidance on the amount of its capitalization or solvency margin during the application process. The FSA requires that Arch-Europe maintain a margin of solvency calculation based on the classes of business for which it is authorized and within its premium income projections applied to the whole of its worldwide general business. In January 2004, the FSA implemented a revised approach to calculating the solvency requirement, which was designed to reflect a risk-based approach to solvency requirements and is part of a two stage process of revision of the EU solvency requirements. The first stage is aimed at strengthening the existing methodology by increasing the margin for liability business by 50% and to take account of inflation. The second stage, which took effect in 2005, involves the introduction of a risk-based solvency regime. This entailed Arch-Europe providing the FSA with its own risk-based assessment of its capital needs, taking into account comprehensive risk factors, including market, credit, operational, liquidity and group risks to generate a revised calculation of its expected liabilities which, in turn, enabled the FSA to provide individual capital guidance to Arch-Europe. Arch-Europe's surplus is above the risk-based capital threshold allowed by the FSA's individual capital assessment of Arch-Europe.

Reporting Requirements. Like all U.K. companies, Arch-Europe must file and submit its annual audited financial statements and related reports to the Registrar of Companies under the Companies Act together with an annual return of certain core corporate information and changes from the prior year. This requirement is in addition to the regulatory returns required to be filed annually with the FSA.

Restrictions on Payment of Dividends. Under U.K. law, all U.K. companies are restricted from declaring a dividend to their shareholders unless they have profits available for distribution. The calculation as to whether a company has sufficient profits is based on its accumulated realized profits minus its accumulated realized losses. U.K. insurance regulatory laws do not prohibit the payment of dividends, but the FSA requires that insurance companies maintain certain solvency margins and may restrict the payment of a dividend by Arch-Europe. See Management's Discussion and Analysis of Financial Condition and Results of Operations Liquidity and Capital Resources and note 15, Statutory Information, of the notes accompanying our financial statements.

European Union Considerations. As a licensed insurance company in the U.K., a Member State of the EU, Arch-Europe's authorization as an insurer is recognized throughout the European Economic Area (EEA), subject only to certain notification and application requirements. This authorization enables Arch-Europe to establish a branch in any other Member State of the EU, where it will be subject to the insurance regulations of each such Member State with respect to the conduct of its business in such Member State, but remain subject only to the financial and operational supervision by the FSA. The framework for the establishment of branches in Member States of the EU other than the U.K. was generally set forth, and remains subject to, directives by European Council, the legislative body of the EU, which directives are then implemented in each Member State. Arch-Europe currently has branches in Germany, Italy and Spain, and may establish branches in other Member States of the EU in the future. Further, as an insurer in an EU Member State, Arch-Europe has the freedom to provide insurance services anywhere in the Europe Community subject to compliance with certain rules governing such provision, including notification to and approval by the FSA.

Canada Insurance Regulation

The Canadian branch office of Arch Insurance is subject to federal, as well as provincial and territorial, regulation in Canada. The Office of the Superintendent of Financial Institutions (OSFI) is the federal regulatory body that, under the Insurance Companies Act (Canada) 1991 (as amended), regulates federal Canadian and non-Canadian insurance companies operating in Canada. The primary goal of OSFI is to supervise the safety and soundness of insurance companies with the aim of securing the appropriate level of protection of insureds by imposing risk management, solvency and capital requirements on such companies. The Canadian branch received its federal order to operate as a property

and casualty insurer from OSFI in January 2005. In addition, the Canadian branch is subject to regulation in the provinces and territories in which it underwrites insurance, and the primary goal of insurance regulation at the provincial and territorial levels is to govern the market conduct of insurance companies. The Canadian branch is licensed to carry on insurance business in each province and territory, except for Prince Edward Island.

Switzerland Insurance Regulation

In November 2006, Arch Re Bermuda opened a branch office in Zurich, Switzerland named Arch Reinsurance Ltd., Hamilton (Bermuda), European Branch Zurich. The activities of the Arch Re Swiss Branch are limited to reinsurance so it is not required to be licensed by the Swiss insurance regulatory authorities.

European Union Reinsurance Regulation

The single system established in the EU for regulation and supervision of the general insurance sector and its single passport regime have until now applied only to direct insurance, and there has been no common regulation of reinsurance in the EU. On December 9, 2005, the EU published the Reinsurance Directive (the Directive) as a first step in harmonization of reinsurance regulation in the single market. Member States are required to implement the Directive by December 2007. Once implemented, pure reinsurers established in a Member State of the EU will have freedom to establish branches in and provide services to EEA states similar to that enjoyed by direct insurers and they will be subject to similar rules in relation to licensing and financial supervision. Arch-Europe is not currently authorized to write reinsurance, but if it applies for and obtains such authorization, it will, from the time of implementation of the Directive, be able to establish branches and provide reinsurance services in other EEA states. The Directive itself does not prohibit EEA insurers from obtaining reinsurance from reinsurers licensed outside the EEA, such as Arch Re Bermuda. As such, Arch Re Bermuda may do business from Bermuda with EEA Member States but it may not operate its reinsurance business within the EEA. Unless agreement is reached between the European Commission and Bermuda to accord Bermuda-based reinsurers market access on the basis of the prudential nature of Bermuda regulation, each individual EEA Member State may impose conditions on reinsurance provided by Bermuda-based reinsurers which could restrict their future provision of reinsurance to the EEA Member State concerned. There are no indications as yet that any EEA Member State will take this course.

TAX MATTERS

The following summary of the taxation of ACGL and the taxation of our shareholders is based upon current law and is for general information only. Legislative, judicial or administrative changes may be forthcoming that could affect this summary.

The following legal discussion (including and subject to the matters and qualifications set forth in such summary) of certain tax considerations (a) under Taxation of ACGL Bermuda and Taxation of Shareholders Bermuda Taxation is based upon the advice of Conyers Dill & Pearman, Hamilton, Bermuda and (b) under Taxation of ACGL United States, Taxation of Shareholders United States Taxation, Taxation of Our U.S. Shareholders and United States Taxation of Non-U.S. Shareholders is based upon the advice of Cahill Gordon & Reindel LLP, New York, New York (the advice of such firms does not include accounting matters, determinations or conclusions relating to the business or activities of ACGL). The summary is based upon current law and is for general information only. The tax treatment of a holder of our shares (common shares, series A non-cumulative preferred shares or series B non-cumulative preferred shares), or of a person treated as a holder of our shares for U.S. federal income, state, local or non-U.S. tax purposes, may vary depending on the holder's particular tax situation.

Legislative, judicial or administrative changes or interpretations may be forthcoming that could be retroactive and could affect the tax consequences to us or to holders of our shares.

Taxation of ACGL

Bermuda

Under current Bermuda law, ACGL is not subject to tax on income or capital gains. ACGL has obtained from the Minister of Finance under the Exempted Undertakings Tax Protection Act 1966 an assurance that, in the event that Bermuda enacts legislation imposing tax computed on profits, income, any capital asset, gain or appreciation, or any tax in the nature of estate duty or inheritance, the imposition of any such tax shall not be applicable to ACGL or to any of our operations or our shares, debentures or other obligations until March 28, 2016. We could be subject to taxes in Bermuda after that date. This assurance will be subject to the proviso that it is not to be construed so as to prevent the application of any tax or duty to such persons as are ordinarily resident in Bermuda (we are not so currently affected) or to prevent the application of any tax payable in accordance with the provisions of the Land Tax Act 1967 or otherwise payable in relation to any property leased to us or our insurance subsidiary. We pay annual Bermuda government fees, and our Bermuda insurance and reinsurance subsidiary pays annual insurance license fees. In addition, all entities employing individuals in Bermuda are required to pay a payroll tax and other sundry taxes payable, directly or indirectly, to the Bermuda government.

United States

ACGL and its non-U.S. subsidiaries intend to conduct their operations in a manner that will not cause them to be treated as engaged in a trade or business in the United States and, therefore, will not be required to pay U.S. federal income taxes (other than U.S. excise taxes on insurance and reinsurance premium and withholding taxes on dividends and certain other U.S. source investment income). However, because definitive identification of activities which constitute being engaged in a trade or business in the U.S. is not provided by the Internal Revenue Code of 1986, as amended (the Code), or regulations or court decisions, there can be no assurance that the U.S. Internal Revenue Service will not contend successfully that ACGL or its non-U.S. subsidiaries are or have been engaged in a trade or business in the United States. A foreign corporation deemed to be so engaged would be subject to U.S. income tax, as well as the branch profits tax, on its income, which is treated as effectively connected with the conduct of that trade or business unless the corporation is entitled to relief under the permanent establishment provisions of a tax treaty. Such income tax, if imposed, would be based on effectively connected income computed in a manner generally analogous to that applied to the income of a domestic corporation, except that deductions and credits generally are not permitted unless the foreign corporation has timely filed a U.S. federal income tax return in accordance with applicable regulations. Penalties may be assessed for failure to file tax returns. The 30% branch profits tax is imposed on net income after subtracting the regular corporate tax and making certain other adjustments.

Under the income tax treaty between Bermuda and the United States (the Treaty), ACGL's Bermuda insurance subsidiaries will be subject to U.S. income tax on any insurance premium income found to be effectively connected with a U.S. trade or business only if that trade or business is conducted through a permanent establishment in the United States. No regulations interpreting the Treaty have been issued. While there can be no assurances, ACGL does not believe that any of its Bermuda insurance subsidiaries has a permanent establishment in the United States. Such subsidiaries would not be entitled to the benefits of the Treaty if (i) less than 50% of ACGL's shares were beneficially owned, directly or indirectly, by Bermuda residents or U.S. citizens or residents, or (ii) any such subsidiary's income were used in substantial part to make disproportionate distributions to, or to meet certain liabilities to, persons who are not Bermuda residents or U.S. citizens or residents. While there can be no assurances, ACGL believes that its Bermuda insurance subsidiaries are eligible for Treaty benefits.

The Treaty clearly applies to premium income, but may be construed as not protecting investment income. If ACGL's Bermuda insurance subsidiaries were considered to be engaged in a U.S. trade or business and were entitled to the benefits of the Treaty in general, but the Treaty were not found to protect investment income, a portion of such subsidiaries' investment income could be subject to U.S. federal income tax.

Non-U.S. insurance companies carrying on an insurance business within the United States have a certain minimum amount of effectively connected net investment income, determined in accordance with a formula that depends, in part, on the amount of U.S. risk insured or reinsured by such companies. If any of ACGL's non-U.S. insurance subsidiaries is considered to be engaged in the conduct of an insurance business in the United States, a significant portion of such company's investment income could be subject to U.S. income tax.

Non-U.S. corporations not engaged in a trade or business in the United States are nonetheless subject to U.S. income tax on certain fixed or determinable annual or periodic gains, profits and income derived from sources within the United States as enumerated in Section 881(a) of the Code (such as dividends and certain interest on investments), subject to exemption under the Code or reduction by applicable treaties.

The United States also imposes an excise tax on insurance and reinsurance premiums paid to non-U.S. insurers or reinsurers with respect to risks located in the United States. The rates of tax, unless reduced by an applicable U.S. tax treaty, are four percent for non-life insurance premiums and one percent for life insurance and all reinsurance premiums.

Personal Holding Company Rules. A domestic corporation will not be classified as a personal holding company (a PHC) in a given taxable year unless both (i) at some time during the last half of such taxable year, five or fewer individuals (without regard to their citizenship or residency) own or are deemed to own (pursuant to certain constructive ownership rules) more than 50% of the corporation's shares by value, and (ii) at least 60% of the adjusted ordinary gross income of the corporation for such taxable year consists of PHC income (as defined in Section 543 of the Code). For purposes of the 50% share ownership test, all of our shares owned by an investment partnership will be attributed to each of its partners, if any, who are individuals. As a result of this attribution rule, we believe that currently five or fewer individuals are treated as owning more than 50% of the value of our shares. Consequently, one or more of our domestic subsidiaries could be or become PHCs, depending on whether any of our subsidiaries satisfy the PHC gross income test.

We will use reasonable best efforts to cause each of our domestic subsidiaries not to satisfy the gross income requirement set forth in Section 542(a) of the Code. If, however, any of our domestic subsidiaries is or were to become a PHC in a given taxable year, such company would be subject to PHC tax (at a 15% rate for taxable years before January 1, 2011, and thereafter at the highest marginal rate on ordinary income applicable to individuals) on its undistributed PHC income. PHC income generally would not include underwriting income. If any of our subsidiaries is or becomes a PHC, there can be no assurance that the amount of PHC income would be immaterial.

Certain of our U.S. subsidiaries have been PHCs. Such subsidiaries did not have undistributed personal holding company income and do not expect to have undistributed personal holding company income in 2006.

There can be no assurance that each of our domestic subsidiaries is not or will not become a PHC in the future because of factors including factual uncertainties regarding the application of the PHC rules, the makeup of our shareholder base and other circumstances that affect the application of the PHC rules to our domestic subsidiaries.

United Kingdom

Our European subsidiaries, Arch-Europe and Arch Capital U.K. Ltd. (Arch-U.K.), are companies incorporated in the U.K. and are therefore resident in the U.K. for U.K. corporation tax purposes and will be subject to U.K. corporate tax on their respective worldwide profits. The current rate of U.K. corporation tax is generally 30% on profits.

Canada

In January 2005, Arch Insurance received its federal license to commence underwriting in Canada and began writing business in the first quarter of 2005 through its branch operation. The branch operation is taxed on net business income earned in Canada at the federal corporate rate of 22.12%. Provincial and territorial tax rates are added to the federal tax and generally vary between 8.9% and 17%. Canadian income taxes are also creditable to the Company's US operations.

Switzerland

Arch Re Swiss Branch, established as a branch office of Arch Re Bermuda, is subject to Swiss corporation tax on the profit which is allocated to the branch. Pending the approval of a mixed company ruling, the effective tax rate is expected to be between 11.4% and 12.6%. The annual capital tax on the equity which is allocated to Arch Re Swiss Branch is approximately .035%.

Taxation of Shareholders

The following summary sets forth certain United States federal income tax considerations related to the purchase, ownership and disposition of our common shares and our series A non-cumulative preferred shares and our series B non-cumulative preferred shares (collectively referred to as the preferred shares). Unless otherwise stated, this summary deals only with shareholders (U.S. Holders) that are United States Persons (as defined below) who hold their common shares and preferred shares as capital assets and as beneficial owners. The following discussion is only a general summary of the United States federal income tax matters described herein and does not purport to address all of the United States federal income tax consequences that may be relevant to a particular shareholder in light of such shareholder's specific circumstances. In addition, the following summary does not describe the United States federal income tax consequences that may be relevant to certain types of shareholders, such as banks, insurance companies, regulated investment companies, real estate investment trusts, financial asset securitization investment trusts, dealers in securities or traders that adopt a mark-to-market method of tax accounting, tax exempt organizations, expatriates or persons who hold the common shares or preferred shares as part of a hedging or conversion transaction or as part of a straddle, who may be subject to special rules or treatment under the Code. This discussion is based upon the Code, the Treasury regulations promulgated thereunder and any relevant administrative rulings or pronouncements or judicial decisions, all as in effect on the date of this annual report and as currently interpreted, and does not take into account possible changes in such tax laws or interpretations thereof, which may apply retroactively. This discussion does not include any description of the tax laws of any state or local governments within the United States, or of any foreign government, that may be applicable to our common shares or preferred shares or the shareholders. Persons considering making an investment in the common shares or preferred shares should consult their own tax advisors concerning the application of the United States federal tax laws to their particular situations as well as any tax consequences arising under the laws of any state, local or foreign taxing jurisdiction prior to making such investment.

If a partnership holds our common shares or preferred shares, the tax treatment of a partner will generally depend upon the status of the partner and the activities of the partnership. If you are a partner of a partnership holding our common shares or preferred shares, you should consult your tax advisor.

For purposes of this discussion, the term *United States Person* means:

- a citizen or resident of the United States,
- a corporation or entity treated as a corporation created or organized in or under the laws of the United States, or any political subdivision thereof,
- an estate the income of which is subject to United States federal income taxation regardless of its source,
- a trust if either (x) a court within the United States is able to exercise primary supervision over the administration of such trust and one or more United States Persons have the authority to control all substantial decisions of such trust or (y) the trust has a valid election in effect to be treated as a United States Person for U.S. federal income tax purposes or
- any other person or entity that is treated for U.S. federal income tax purposes as if it were one of the foregoing.

Bermuda Taxation

Currently, there is no Bermuda withholding tax on dividends paid by us.

United States Taxation

Taxation of Dividends. The preferred shares should be properly classified as equity rather than debt for U.S. federal income tax purposes. Subject to the discussions below relating to the potential application of the CFC and PFIC rules, as defined below, cash distributions, if any, made with respect to our common shares or preferred shares will constitute dividends for U.S. federal income tax purposes to the extent paid out of our current or accumulated earnings and profits (as computed using U.S. tax principles). If a U.S. Holder of our common shares or our preferred shares is an individual or other non-corporate holder, dividends paid, if any, to that holder in taxable years beginning before January 1, 2011 that constitute qualified dividend income will be taxable at the rate applicable for long-term capital gains (generally up to 15%), provided that such person meets a holding period requirement. Generally in order to meet the holding period requirement, the United States Person must hold the common shares for more than 60 days during the 121-day period beginning 60 days before the ex-dividend date and must hold preferred shares for more than 90 days during the 181-day period beginning 90 days before the ex-dividend date. Dividends paid, if any, with respect to common shares or preferred shares generally will be qualified dividend income, provided the common shares or preferred shares are readily tradable on an established securities market in the United States in the year in which the shareholder receives the dividend (which should be the case for shares that are listed on the NASDAQ Stock Market or the New York Stock Exchange) and ACGL is not considered to be a passive foreign investment company in either the year of the distribution or the preceding taxable year. No assurance can be given that the preferred shares will be considered readily tradable on an established securities market in the United States. See *Taxation of Our U.S. Shareholders* below. After December 31, 2010, qualified dividend income will no longer be taxed at the rate applicable for long-term capital gains unless Congress enacts legislation providing otherwise.

Distributions with respect to the common shares and the preferred shares will not be eligible for the dividends-received deduction allowed to U.S. corporations under the Code. To the extent distributions on our common shares and preferred shares exceed our earnings and profits, they will be treated first as a return of the U.S. Holder's basis in our common shares and our preferred shares to the extent thereof, and then as gain from the sale of a capital asset.

Sale, Exchange or Other Disposition. Subject to the discussions below relating to the potential application of the CFC and PFIC rules, holders of common shares and preferred shares generally will

recognize capital gain or loss for U.S. federal income tax purposes on the sale, exchange or disposition of common shares or preferred shares, as applicable.

Redemption of Preferred Shares. A redemption of the preferred shares will be treated under section 302 of the Code as a dividend if we have sufficient earnings and profits, unless the redemption satisfies one of the tests set forth in section 302(b) of the Code enabling the redemption to be treated as a sale or exchange, subject to the discussion herein relating to the potential application of the CFC, RPII and PFIC rules. Under the relevant Code section 302(b) tests, the redemption should be treated as a sale or exchange only if it (1) is substantially disproportionate, (2) constitutes a complete termination of the holder's stock interest in us or (3) is not essentially equivalent to a dividend. In determining whether any of these tests are met, shares considered to be owned by the holder by reason of certain constructive ownership rules set forth in the Code, as well as shares actually owned, must generally be taken into account. It may be more difficult for a United States Person who owns, actually or constructively by operation of the attribution rules, any of our other shares to satisfy any of the above requirements. The determination as to whether any of the alternative tests of section 302(b) of the Code is satisfied with respect to a particular holder of the preference shares depends on the facts and circumstances as of the time the determination is made.

Taxation of Our U.S. Shareholders

Controlled Foreign Corporation Rules

Under our bye-laws, the 9.9% voting restriction applicable to the Controlled Shares of a U.S. Person (as defined in our bye-laws) generally does not apply to certain of our investors. As a result of certain attribution rules, we believe, therefore, that we and our foreign subsidiaries might be controlled foreign corporations (CFCs). That status as a CFC would not cause us or any of our subsidiaries to be subject to U.S. federal income tax. Such status also would have no adverse U.S. federal income tax consequences for any U.S. Holder that is considered to own less than 10% of the total combined voting power of our shares or those of our foreign subsidiaries. Only U.S. Holders that are considered to own 10% or more of the total combined voting power of our shares or those of our foreign subsidiaries (taking into account shares actually owned by such U.S. Holder as well as shares attributed to such U.S. Holder under the Code or the regulations thereunder) (a 10% U.S. Voting Shareholder) would be affected by our status as a CFC. The preferred shares generally should not be considered voting stock for purposes of determining whether a United States Person would be a 10% U.S. Voting Shareholder. The shares may, however, become entitled to vote (as a class along with any other class of preferred shares of ACGL then outstanding) for the election of two additional members of the board of directors of ACGL if ACGL does not declare and pay dividends for the equivalent of six or more dividend periods. In such case, the preferred shares should be treated as voting stock for as long as such voting rights continue. Our bye-laws are intended to prevent any U.S. Holder from being considered a 10% U.S. Voting Shareholder by limiting the votes conferred by the Controlled Shares (as defined in our bye-laws) of any U.S. Person to 9.9% of the total voting power of all our shares entitled to vote. However, because under our bye-laws certain funds associated with Warburg Pincus and Hellman & Friedman generally are entitled to vote their directly owned common shares in full, a U.S. Holder that is attributed (under the Code or the regulations thereunder) common shares owned by such funds may be considered a 10% U.S. Voting Shareholder. If you are a direct or indirect investor in a fund associated with Warburg Pincus or Hellman & Friedman additional common shares could be attributed to you for purposes of determining whether you are considered to be a 10% U.S. Voting Shareholder. If we are a CFC, a U.S. Holder that is considered a 10% U.S. Voting Shareholder would be subject to current U.S. federal income taxation (at ordinary income tax rates) to the extent of all or a portion of the undistributed earnings and profits of ACGL and our subsidiaries attributable to subpart F income (including certain insurance premium income and investment income) and may be taxable at ordinary income tax rates on any gain realized on a sale or other disposition

(including by way of repurchase or liquidation) of our shares to the extent of the current and accumulated earnings and profits attributable to such shares.

While our bye-laws are intended to prevent any member from being considered a 10% U.S. Voting Shareholder (except as described above), there can be no assurance that a U.S. Holder will not be treated as a 10% U.S. Voting Shareholder, by attribution or otherwise, under the Code or any applicable regulations thereunder. See Risk Factors Risks Relating to Taxation U.S. persons who hold our common shares or preferred shares may be subject to U.S. income taxation at ordinary income rates on our undistributed earnings and profits.