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

UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-K

x 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

o 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	**Name of each Exchange on which Registered**
Common Shares, $0.01 par value per share	NASDAQ Stock Market (Common Shares)
8.000% Non-Cumulative Preferred Shares, Series A, $0.01 par value per share	New York Stock Exchange
7.875% Non-Cumulative Preferred Shares, Series B, $0.01 par value per share	

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.

Yes x No o

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 o No x

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 x No o

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. o

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

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

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

Yes o No x

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.
TABLE OF CONTENTS

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 wit 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

3

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 Amount	% of Total	2005 Amount	% of Total	2004 Amount	% of Total
	(U.S. dollars in thousands)					
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	% of Total	Amount	% of Total	Amount	% of Total
	(U.S. dollars in thousands)					
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).

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 Estimated Fair Value	**% of Total**	**2005 Estimated Fair Value**	**% of Total**
	(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 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:

	December 31, 2006		**December 31, 2005**	
Rating(1)	**Estimated Fair Value**	**% of Total**	**Estimated Fair Value**	**% of Total**
	(U.S. dollars in thousands)			
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.

16

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 Poors, 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.

20

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

33

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.

Related Person Insurance Income Rules

Generally, we do not expect the gross related person insurance income (RPII) of any of our non-U.S. subsidiaries to equal or exceed 20% of its gross insurance income in any taxable year for the foreseeable future and do not expect the direct or indirect insureds (and related persons) of any such subsidiary to directly or indirectly own 20% or more of either the voting power or value of our stock. Consequently, we do not expect any U.S. person owning common shares or preferred shares to be required to include in gross income for U.S. federal income tax purposes RPII income, but there can be no assurance that this will be the case.

Section 953(c)(7) of the Code generally provides that Section 1248 of the Code (which generally would require a U.S. Holder to treat certain gains attributable to the sale, exchange or disposition of common shares or preferred shares as a dividend) will apply to the sale or exchange by a U.S. shareholder of shares in a foreign corporation that is characterized as a CFC under the RPII rules if the foreign corporation would be taxed as an insurance company if it were a domestic corporation, regardless of whether the U.S. shareholder is a 10% U.S. Voting Shareholder or whether the corporation qualifies for either the RPII 20% ownership exception or the RPII 20% gross income exception. Although existing Treasury Department regulations do not address the question, proposed Treasury regulations issued in April 1991 create some ambiguity as to whether Section 1248 and the requirement to file Form 5471 would apply when the foreign corporation has a foreign insurance subsidiary that is a CFC for RPII purposes and that would be taxed as an insurance company if it were a domestic corporation. We believe that Section 1248 and the requirement to file Form 5471 will not apply to a less than 10% U.S. Shareholder because ACGL is not directly engaged in the insurance business. There can be no assurance, however, that the U.S. Internal Revenue Service will interpret the proposed regulations in this manner or that the Treasury Department will not take the position that Section 1248 and the requirement to file Form 5471 will apply to dispositions of our common shares or our preferred shares.

If the U.S. Internal Revenue Service or U.S. Treasury Department were to make Section 1248 and the Form 5471 filing requirement applicable to the sale of our shares, we would notify shareholders that Section 1248 of the Code and the requirement to file Form 5471 will apply to dispositions of our shares. Thereafter, we would send a notice after the end of each calendar year to all persons who were shareholders during the year notifying them that Section 1248 and the requirement to file Form 5471 apply to dispositions of our shares by U.S. Holders. We would attach to this notice a copy of Form 5471 completed with all our information and instructions for completing the shareholder information.

Tax-Exempt Shareholders

Tax-exempt entities may be required to treat certain Subpart F insurance income, including RPII, that is includible in income by the tax-exempt entity as unrelated business taxable income. Prospective investors that are tax exempt entities are urged to consult their tax advisors as to the potential impact of the unrelated business taxable income provisions of the Code.

Passive Foreign Investment Companies

Sections 1291 through 1298 of the Code contain special rules applicable with respect to foreign corporations that are passive foreign investment companies (PFICs). In general, a foreign corporation will be a PFIC if 75% or more of its income constitutes passive income or 50% or more of its assets produce passive income. If we were to be characterized as a PFIC, U.S. Holders would be subject to a penalty tax at the time of their sale of (or receipt of an excess distribution with respect to) their common shares or preferred shares. In general, a shareholder receives an excess distribution if the amount of the distribution is more than 125% of the average distribution with respect to the shares during the three preceding taxable years (or shorter period during which the taxpayer held the stock). In general, the penalty tax is equivalent to an interest charge on taxes that are deemed due during the period the shareholder owned the shares, computed by assuming that the excess distribution or gain (in the case of a sale) with respect to the shares was taxable in equal portions throughout the holder s period of ownership. The interest charge is equal to the applicable rate imposed on underpayments of U.S. federal income tax for such period. A U.S. shareholder may avoid some of the adverse tax consequences of owning shares in a PFIC by making a qualified electing fund (QEF) election. A QEF election is revocable only with the consent of the IRS and has the following consequences to a shareholder:

- For any year in which ACGL is not a PFIC, no income tax consequences would result.
- For any year in which ACGL is a PFIC, the shareholder would include in its taxable income a proportionate share of the net ordinary income and net capital gains of ACGL and certain of its non-U.S. subsidiaries.

The PFIC statutory provisions contain an express exception for income derived in the active conduct of an insurance business by a corporation which is predominantly engaged in an insurance business . This exception is intended to ensure that income derived by a bona fide insurance company is not treated as passive income, except to the extent such income is attributable to financial reserves in excess of the reasonable needs of the insurance business. The PFIC statutory provisions contain a look-through rule that states that, for purposes of determining whether a foreign corporation is a PFIC, such foreign corporation shall be treated as if it received directly its proportionate share of the income and as if it held its proportionate share of the assets of any other corporation in which it owns at least 25% of the stock. We believe that we are not a PFIC, and we will use reasonable best efforts to cause us and each of our non-U.S. insurance subsidiaries not to constitute a PFIC.

No regulations interpreting the substantive PFIC provisions have yet been issued. Each U.S. Holder should consult his tax advisor as to the effects of these rules.

United States Taxation of Non-U.S. Shareholders

Taxation of Dividends

Cash distributions, if any, made with respect to common shares or preferred shares held by shareholders who are not United States Persons (Non-U.S. holders) generally will not be subject to United States withholding tax.

Sale, Exchange or Other Disposition

Non-U.S. holders of common shares or preferred shares generally will not be subject to U.S. federal income tax with respect to gain realized upon the sale, exchange or other disposition of such shares unless such gain is effectively connected with a U.S. trade or business of the Non-U.S. holder in the United States or such person is present in the United States for 183 days or more in the taxable year the gain is realized and certain other requirements are satisfied.

Information Reporting and Backup Withholding

Non-U.S. holders of common shares or preferred shares will not be subject to U.S. information reporting or backup withholding with respect to dispositions of common shares effected through a non-U.S. office of a broker, unless the broker has certain connections to the United States or is a United States person. No U.S. backup withholding will apply to payments of dividends, if any, on our common shares or our preferred shares.

Other Tax Laws

Shareholders should consult their own tax advisors with respect to the applicability to them of the tax laws of other jurisdictions.

ITEM 1A. RISK FACTORS

Set forth below are risk factors relating to our business. You should also refer to the other information provided in this report, including our Management s Discussion and Analysis of Financial Condition and Results of Operations and our accompanying consolidated financial statements, as well as the information under the heading Cautionary Note Regarding Forward-Looking Statements.

Risks Relating to Our Industry

We operate in a highly competitive environment, and we may not be able to compete successfully in our industry.

The insurance and reinsurance industry is highly competitive. We compete with major U.S. and non-U.S. insurers and reinsurers, many of which have greater financial, marketing and management resources than we do, as well as other potential providers of capital willing to assume insurance and/or reinsurance risk. 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.

Trends toward consolidation in the insurance industry could also lead to pricing pressure and lower margins for insurers and reinsurers. In addition, the impact of weather-related catastrophic events in the second half of 2005 has led to several newly formed offshore entities which have entered the insurance and reinsurance markets. Several publicly traded insurance and reinsurance companies have also raised additional capital to meet perceived demand in the current environment. Financial institutions and other capital markets participants also offer alternative products and services similar to our own or alternative products that compete with insurance and reinsurance products. In addition, we may not be aware of other companies that may be planning to enter the segments of the insurance and reinsurance market in which we operate.

Our competitive position is based on many factors, including our perceived overall financial strength, ratings assigned by independent rating agencies, geographic scope of business, client relationships, premiums charged, contract terms and conditions, products and services offered (including the ability to design customized programs), speed of claims payment, reputation, experience and qualifications of employees and local presence. We may not be successful in competing with others on any of these bases, and the intensity of competition in our industry may erode profitability and result in less favorable policy terms and conditions for insurance and reinsurance companies generally, including us.

The insurance and reinsurance industry is highly cyclical, and we expect to continue to experience periods characterized by excess underwriting capacity and unfavorable premium rates.

Historically, insurers and reinsurers have experienced significant fluctuations in operating results due to competition, frequency of occurrence or severity of catastrophic events, levels of capacity, general economic conditions, changes in legislation, case law and prevailing concepts of liability and other factors. In particular, demand for reinsurance is influenced significantly by the underwriting results of primary insurers and prevailing general economic conditions. The supply of insurance and reinsurance is related to prevailing prices and levels of surplus capacity that, in turn, may fluctuate in response to changes in rates of return being realized in the insurance and reinsurance industry. As a result, the insurance and reinsurance business historically has been a cyclical industry characterized by periods of intense price competition due to excessive underwriting capacity as well as periods when shortages of capacity permitted favorable premium levels and changes in terms and conditions.

We could face unanticipated losses from war, terrorism and political unrest, and these or other unanticipated losses could have a material adverse effect on our financial condition and results of operations.

Although we believe that we do not have exposure to the events of September 11, 2001 because we did not have insurance in-force at that time with respect to exposure to such events, we now have substantial exposure to unexpected, large losses resulting from future man-made catastrophic events, such as acts of war, acts of terrorism and political instability. These risks are inherently unpredictable, although recent events may lead to increased frequency and severity of losses. It is difficult to predict the timing of such events with statistical certainty or estimate the amount of loss any given occurrence will generate. In certain instances, we specifically insure and reinsure risks resulting from acts of terrorism. Even in cases where we attempt to exclude losses from terrorism and certain other similar risks from some coverages written by us, we may not be successful in doing so. Moreover, irrespective of the clarity and inclusiveness of policy language, there can be no assurance that a court or arbitration panel will limit enforceability of policy language or otherwise issue a ruling adverse to us. Accordingly, while we believe our reinsurance programs, together with the coverage provided under TRIEA, are sufficient to reasonably limit our net losses relating to potential future terrorist attacks, we can offer no assurance that our reserves will be adequate to cover losses when they materialize. To the extent that an act of terrorism is certified by the Secretary of the Treasury, our U.S. insurance operations may be covered under TRIEA for up to 90% of its losses for 2005 and 2006 and up to 85% of its losses for 2007, in each case subject to certain mandatory deductibles. It is not possible to eliminate completely our exposure to unforecasted or unpredictable events, and to the extent that losses from such risks occur, our financial condition and results of operations could be materially adversely affected.

The insurance and reinsurance industry is subject to regulatory and legislative initiatives or proposals from time to time which could adversely affect our business.

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. 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.

A recent legislative initiative was enacted in Florida in January 2007. This legislation doubles the aggregate reinsurance capacity of the Florida Hurricane Catastrophe Fund (the FHCF), the reinsurance facility established by the state, and also reduces the industry loss retention level. In addition, the legislation adds coverage above and below the existing FHCF program during the 2007 to 2009 hurricane seasons. Under this legislation, the state-run insurer of last resort, Citizens Property Insurance Corporation, will also increase its underwriting capacity and have greater freedom to charge lower rates. The capacity extension and lower retention levels will lead to an increase in government-sponsored entities share of Florida s property catastrophe reinsurance market. Although we expect that reinsurance pricing in Florida may decrease as a result of this legislation, we do not believe that this will have a material adverse effect on our financial condition given our portfolio of business. We believe that rates in the worldwide insurance and reinsurance property and other markets may decrease due to the redirection of the capital that previously supported Florida property business, as this capital may be used to target other exposures. In addition, our U.S.-based insurers will be subject to additional assessments under this legislation.

Claims for catastrophic events could cause large losses and substantial volatility in our results of operations, and, as a result, the value of our securities, including our common shares and preferred shares, may fluctuate widely.

We have large aggregate exposures to natural disasters. Catastrophes can be caused by various events, including hurricanes, floods, windstorms, earthquakes, hailstorms, tornados, explosions, severe winter weather, fires and other natural disasters. Catastrophes can also cause losses in non-property business such as workers compensation or general liability. In addition to the nature of the property business, we believe that economic and geographic trends affecting insured property, including inflation, property value appreciation and geographic concentration tend to generally increase the size of losses from catastrophic events over time. Our previously disclosed estimates relating to Hurricanes Katrina, Rita and Wilma and other catastrophic events that occurred in the second half of 2005 are based on currently available information derived from modeling techniques, industry assessments of exposure, claims information obtained from our clients and brokers to date and a review of our in-force contracts. Our actual losses from these events, as well as any additional catastrophic events which may occur, may vary materially from our current estimates due to the inherent uncertainties in making such determinations resulting from several factors, including the preliminary nature of the available information, the potential inaccuracies and inadequacies in the data provided by clients and brokers, the modeling techniques and the application of such techniques, the contingent nature of business interruption exposures, the effects of any resultant demand surge on claims activity and attendant coverage issues. In addition, actual losses may increase if our reinsurers dispute or fail to meet their obligations to us or the reinsurance protections purchased by us are exhausted or are otherwise unavailable.

The weather-related catastrophic events that occurred in the second half of 2005 have resulted in a substantial improvement in current market conditions in property and certain marine lines of business. In order to take advantage of these current opportunities, we have increased our writings in certain property and marine lines of business and, as a result, these lines represent a larger proportion of our overall book of business in 2006 and may continue to represent a larger portion of our overall book of business in future periods.

In addition, over the past several years, changing weather patterns and climatic conditions, such as global warming, have added to the unpredictability and frequency of natural disasters in certain parts of the world and created additional uncertainty as to future trends and exposures. Furthermore, some experts have attributed the recent high incidence of hurricanes in the Gulf of Mexico and the Caribbean to a permanent change in weather patterns resulting from rising surface ocean temperature in the region (the warm ocean theory). Therefore, claims for catastrophic events could expose us to large losses and cause substantial volatility in our results of operations, which could cause the value of our securities, including our common shares and preferred shares, to fluctuate widely.

Underwriting claims and reserving for losses are based on probabilities and related modeling, which are subject to inherent uncertainties.

Our success is dependent upon our ability to assess accurately the risks associated with the businesses that we insure and reinsure. We establish reserves for losses and loss adjustment expenses which represent estimates involving actuarial and statistical projections, at a given point in time, of our expectations of the ultimate settlement and administration costs of losses incurred. We utilize actuarial models as well as available historical insurance industry loss ratio experience and loss development patterns to assist in the establishment of loss reserves. Actual losses and loss adjustment expenses paid will deviate, perhaps substantially, from the reserve estimates reflected in our financial statements.

If our loss reserves are determined to be inadequate, we will be required to increase loss reserves at the time of such determination with a corresponding reduction in our net income in the period in which the deficiency becomes known. It is possible that claims in respect of events that have occurred could exceed our claim reserves and have a material adverse effect on our results of operations, in a particular period, or our financial condition in general. As a compounding factor, although most insurance contracts have policy limits, the nature of property and casualty insurance and reinsurance is such that losses can exceed policy limits for a variety of reasons and could significantly exceed the premiums received on the underlying policies, thereby further adversely affecting our financial condition.

As of December 31, 2006, our reserves for unpaid losses and loss adjustment expenses, net of unpaid losses and loss adjustment expenses recoverable, were approximately $4.91 billion. Such reserves were established in accordance with applicable insurance laws and GAAP. Although we believe we have applied a conservative reserving philosophy for both our insurance and reinsurance operations, 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. 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.

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.

We have large aggregate exposures to natural and man-made catastrophic events. Catastrophes can be caused by various events, including, but not limited to, hurricanes, floods, windstorms, earthquakes, hailstorms, explosions, severe winter weather and fires. Catastrophes can also cause losses in non-property business such as workers compensation or general liability. In addition to the nature of property business, we believe that economic and geographic trends affecting insured property, including inflation, property value appreciation and geographic concentration, tend to generally increase the size of losses from catastrophic events over time.

We have substantial exposure to unexpected, large losses resulting from future man-made catastrophic events, such as acts of war, acts of terrorism and political instability. These risks are inherently unpredictable and recent events may lead to increased frequency and severity of losses. It is difficult to predict the timing of such events with statistical certainty or estimate the amount of loss any given occurrence will generate. It is not possible to eliminate completely our exposure to unforecasted or unpredictable events and, to the extent that losses from such risks occur, our financial condition and results of operations could be materially adversely affected. Therefore, claims for natural and man-made catastrophic events could expose us to large losses and cause substantial volatility in our results of operations, which could cause the value of our common shares to fluctuate widely. In certain instances, we specifically insure and reinsure risks resulting from terrorism. Even in cases where we attempt to exclude losses from terrorism and certain other similar risks from some coverages written by us, we may not be successful in doing so. Moreover, irrespective of the clarity and inclusiveness of policy language, there can be no assurance that a court or arbitration panel will limit enforceability of policy language or otherwise issue a ruling adverse to us.

We seek to limit our loss exposure by writing a number of our reinsurance contracts on an excess of loss basis, adhering to maximum limitations on reinsurance written in defined geographical zones, limiting program size for each client and prudent underwriting of each program written. In the case of proportional treaties, we may seek per occurrence limitations or loss ratio caps to limit the impact of losses from any one or series of events. In our insurance operations, we seek to limit our exposure through the purchase of reinsurance. We cannot be certain that any of these loss limitation methods will be effective. We also seek to limit our loss exposure by geographic diversification. Geographic zone limitations involve significant underwriting judgments, including the determination of the area of the zones and the inclusion of a particular policy within a particular zone s limits. There can be no assurance that various provisions of our policies, such as limitations or exclusions from coverage or choice of forum, will be enforceable in the manner we intend. Disputes relating to coverage and choice of legal forum may also arise. Underwriting is inherently a matter of judgment, involving important assumptions about matters that are inherently unpredictable and beyond our control, and for which historical experience and probability analysis may not provide sufficient guidance. One or more catastrophic or other events could result in claims that substantially exceed our expectations, which could have a material adverse effect on our financial condition or our results of operations, possibly to the extent of eliminating our shareholders equity.

For our natural catastrophe exposed business, we seek to limit the amount of exposure we will assume from any one insured or reinsured and the amount of the exposure to catastrophe losses in any geographic zone. We monitor our exposure to catastrophic events, including earthquake and wind and periodically reevaluate the estimated probable maximum pre-tax loss for such exposures. Our estimated probable maximum pre-tax loss is determined through the use of modeling techniques, but such estimate does not represent our total potential loss for such exposures. We seek to limit the probable maximum pre-tax loss to a specific level for severe catastrophic events. Currently, we generally seek to limit the probable maximum pre-tax loss to approximately 25% of total shareholders equity for a severe catastrophic event in any geographic zone that could be expected to occur once in every 250 years, although we reserve the right to change this threshold at any time. There can be no assurances that we will not suffer pre-tax losses greater than 25% of our total shareholders equity from one or more catastrophic events due to several factors, including the inherent uncertainties in estimating the frequency and severity of such events and the margin of error in making such determinations resulting from potential inaccuracies and inadequacies in the data provided by clients and brokers, the modeling techniques and the application of such techniques or as a result of a decision to change the percentage of shareholders equity exposed to a single catastrophic event. In addition, depending on business opportunities and the mix of business that may comprise our insurance and reinsurance portfolio, we may seek to adjust our self-imposed limitations on probable maximum pre-tax loss for catastrophe exposed business.

The risk associated with reinsurance underwriting could adversely affect us, and while reinsurance and retrocessional coverage will be used to limit our exposure to risks, the availability of such arrangements may be limited, and counterparty credit and other risks associated with our reinsurance arrangements may result in losses which could adversely affect our financial condition and results of operations.

Like other reinsurers, our reinsurance group does not separately evaluate each of the individual risks assumed under reinsurance treaties. Therefore, we are largely dependent on the original underwriting decisions made by ceding companies. We are subject to the risk that the ceding companies may not have adequately evaluated the risks to be reinsured and that the premiums ceded may not adequately compensate us for the risks we assume.

For the purposes of managing risk, we use reinsurance and also may use retrocessional arrangements. In the normal course of business, our insurance subsidiaries cede a substantial portion of their premiums through pro rata, excess of loss and facultative reinsurance agreements. Our reinsurance subsidiaries purchase a limited amount of retrocessional coverage as part of their aggregate risk management program. In addition, our reinsurance subsidiaries participate in common account retrocessional arrangements for certain pro rata treaties. Such arrangements reduce the effect of individual or aggregate losses to all companies participating on such treaties, including the reinsurers, such as our reinsurance subsidiaries, and the ceding company. For the year ended December 31, 2006, ceded premiums written represented approximately 29.5% of gross premiums written, compared to 21.8% and 18.8%, respectively, for the years ended December 31, 2005 and 2004.

The availability and cost of reinsurance and retrocessional protection is subject to market conditions, which are beyond our control. Although we believe that our insurance subsidiaries have been successful in obtaining reinsurance protection since the commencement of our underwriting initiative in October 2001, it is not certain that we will be able to continue to obtain adequate protection at cost effective levels. As a result of such market conditions and other factors, we may not be able successfully to mitigate risk through reinsurance and retrocessional arrangements.

Further, 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 losses for a given event or occurrence may increase if our reinsurers or retrocessionaires dispute or fail to meet their obligations to us or the reinsurance or retrocessional protections purchased by us are exhausted or are otherwise unavailable for any reason. 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. We monitor the financial condition of our reinsurers and attempt to place coverages only with carriers we view as substantial and financially sound. At December 31, 2006 and 2005, approximately 92.3% and 92.6%, respectively, of our reinsurance recoverables on paid and unpaid losses (not including prepaid reinsurance premiums) of $1.67 billion and $1.47 billion, respectively, were due from carriers which had an A.M. Best rating of A- or better. At December 31, 2006 and 2005, the largest reinsurance recoverables from any one carrier were less than 5.1% and 5.6%, respectively, of our total shareholders equity. In connection with our acquisition of Arch Specialty in February 2002, the seller, Sentry Insurance a Mutual Company (Sentry), agreed to reinsure and guarantee all liabilities arising out of Arch Specialty s business prior to the closing of the acquisition. In addition to the guarantee provided by Sentry, substantially all of the recoverable from Sentry is still subject to the original reinsurance agreements inuring to Arch Specialty and, to the extent Sentry fails to comply with its payment obligations to us, we may obtain reimbursement from the third party reinsures under such agreements.

Our reliance on brokers subjects us to their credit risk.

In accordance with industry practice, we generally pay amounts owed on claims under our insurance and reinsurance contracts to brokers, and these brokers, in turn, pay these amounts to the clients that have purchased insurance or reinsurance from us. In some jurisdictions, if a broker fails to make such payment, we may remain liable to the insured or ceding insurer for the deficiency. Likewise, in certain jurisdictions, when the insured or ceding company pays premium for these contracts to brokers for payment to us, these premiums are considered to have been paid and the insured or ceding company will no longer be liable to us for those amounts, whether or not we have actually received the premiums from the broker. Consequently, we assume a degree of credit risk associated with our brokers. To date, we have not experienced any losses related to this credit risk.

We cannot predict the effect that the investigation currently being conducted by the New York Attorney General and others will have on the industry or our business, and the effects of emerging claims and coverage issues and certain proposed legislation are uncertain.

The New York Attorney General and others are investigating allegations relating to contingent commission payments, bid-rigging and other practices in the insurance industry. We cannot predict the effect that these investigations, and any changes in insurance practice, including future legislation or regulations that may become applicable to us, will have on the insurance industry, the regulatory framework or our business.

The effects of emerging claims and coverage issues are uncertain. The insurance industry is also affected by political, judicial and legal developments which have in the past resulted in new or expanded theories of liability. These or other changes could impose new financial obligations on us by extending coverage beyond our underwriting intent or otherwise require us to make unplanned modifications to the products and services that we provide, or cause the delay or cancellation of products and services that we provide. In some instances, these changes may not become apparent until some time after we have issued insurance or reinsurance contracts that are affected by the changes. As a result, the full extent of liability under our insurance or reinsurance contracts may not be known for many years after a contract is issued. The effects of unforeseen developments or substantial government intervention could adversely impact our ability to achieve our goals.

Risks Relating to Our Company

Our success will depend on our ability to maintain and enhance effective operating procedures and internal controls.

We continue to enhance our operating procedures and internal controls (including the timely and successful implementation of our information technology initiatives, which include the implementation of improved computerized systems and programs to replace and support manual systems, and including controls over financial reporting) to effectively support our business and our regulatory and reporting requirements. Our management does not expect that our disclosure controls or our internal controls will prevent all errors and all fraud. A control system, no matter how well conceived and operated, can provide only reasonable, not absolute, assurance that the objectives of the control system are met. Further, the design of a control system must reflect the fact that there are resource constraints, and the benefits of controls must be considered relative to their costs. As a result of the inherent limitations in all control systems, no evaluation of controls can provide absolute assurance that all control issues and instances of fraud, if any, within the company have been detected. These inherent limitations include the realities that judgments in decision-making can be faulty, and that breakdowns can occur because of simple error or mistake. Additionally, controls can be circumvented by the individual acts of some persons or by collusion of two or more people. The design of any system of controls also is based in part upon certain assumptions about the likelihood of future events, and there can be no assurance that any design will succeed in achieving its stated goals under all potential future conditions; over time, controls may become inadequate because of changes in conditions, or the degree of compliance with the policies or procedures may deteriorate. As a result of the inherent limitations in a cost-effective control system, misstatement due to error or fraud may occur and not be detected. Accordingly, our disclosure controls and procedures are designed to provide reasonable, not absolute, assurance that the disclosure controls and procedures are met.

A downgrade in our ratings or our inability to obtain a rating for our operating insurance and reinsurance subsidiaries may adversely affect our relationships with clients and brokers and negatively impact sales of our products.

Our operating insurance and reinsurance subsidiaries are rated by ratings agencies. Brokers negotiate contracts of reinsurance between a primary insurer and reinsurer, on behalf of the primary insurer. Third-party rating agencies, such as A.M. Best Company, assess and rate the financial strength of insurers and reinsurers based upon criteria established by the rating agencies, which criteria are subject to change. Ratings have become an increasingly important factor in establishing the competitive position of insurance and reinsurance companies. Insurers and intermediaries use these ratings as one measure by which to assess the financial strength and quality of insurers and reinsurers. 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. Our financial strength ratings are subject to periodic review as rating agencies evaluate us to confirm that we continue to meet their criteria for ratings assigned to us by them. Such ratings may be revised downward or revoked at the sole discretion of such ratings agencies in response to a variety of factors, including a minimum capital adequacy ratio, management, earnings, capitalization and risk profile. Although since the commencement of our underwriting initiative in October 2001 our ratings have not been downgraded, we can offer no assurances that our ratings will remain at their current levels. 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. Any ratings downgrade or failure to obtain a necessary rating could adversely affect our ability to compete in our markets, could cause our premiums and earnings to decrease and have a material adverse impact on our financial condition and results of operations. In addition, a downgrade in ratings of certain of our operating subsidiaries would in certain cases constitute an event of default under our credit facilities. See Management s Discussion and Analysis of Financial Condition and Results of Operations Contractual Obligations and Commercial Commitments Letter of Credit and Revolving Credit Facilities for a discussion of our credit facilities.

The loss of our key employees or our inability to retain them could negatively impact our business.

Our success has been, and will continue to be, dependent on our ability to retain the services of our existing key executive officers and to attract and retain additional qualified personnel in the future. The pool of talent from which we actively recruit is limited. Although, to date, we have not experienced difficulties in attracting and retaining key personnel, the inability to attract and retain qualified personnel when available and the loss of services of key personnel could have a material adverse effect on our financial condition and results of operations. In addition, our underwriting staff is critical to our success in the production of business. While we do not consider any of our key executive officers or underwriters to be irreplaceable, the loss of the services of our key executive officers or underwriters or the inability to hire and retain other highly qualified personnel in the future could delay or prevent us from fully implementing our business strategy which could affect our financial performance. We are not aware of any intentions of any of our key personnel that would cause them no longer to provide their professional services to us in the near future.

The preparation of our financial statements requires us to make many estimates and judgments, which are even more difficult than those made in a mature company since limited historical information has been reported to us through December 31, 2006.

The preparation of consolidated financial statements requires us to make many estimates and judgments that affect the reported amounts of assets, liabilities (including reserves), revenues and expenses, and related disclosures of contingent liabilities. On an ongoing basis, we evaluate our estimates, including those related to revenue recognition, insurance and other reserves, reinsurance recoverables, investment valuations, intangible assets, bad debts, income taxes, contingencies and litigation. We base our estimates on historical experience, where possible, and on various other assumptions that we believe to be reasonable under the circumstances, which form the basis for our judgments about the carrying values of assets and liabilities that are not readily apparent from other sources. Estimates and judgments 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. Instead, our current loss reserves are primarily based on estimates involving actuarial and statistical projections of our expectations of the ultimate settlement and administration costs of claims incurred but not yet reported. We utilize actuarial models as well as historical insurance industry loss development patterns to establish loss reserves. Accordingly, actual claims and claim expenses paid may deviate, perhaps substantially, from the reserve estimates reflected in our financial statements.

The Warburg Pincus funds and the Hellman & Friedman funds together own approximately 31.7% of our voting shares, and these shareholders have the right to have directors on our board; their interests may materially differ from the interests of the holders of our other securities.

The Warburg Pincus funds and the Hellman & Friedman funds own 25.4% and 6.3% of our outstanding voting shares, respectively, as of December 31, 2006. These shareholders are not subject to the voting limitation contained in our bye-laws. We have agreed (until 2011) not to declare any dividend or make any other distribution on our common shares, and not to repurchase any common shares, until we have repurchased from the Warburg Pincus funds and the Hellman & Friedman funds, pro rata, on the basis of the amount of these shareholders investments in us at the time of such repurchase, common shares (which were issued pursuant to the conversion of all of the outstanding preference shares in the 2005 fourth quarter) having an aggregate value of $250 million, at a per share price acceptable to these shareholders. No such shares have yet been repurchased.

In addition, the Warburg Pincus funds and the Hellman & Friedman funds are entitled (until 2011) to nominate a prescribed number of directors based on the respective retained percentages of their equity securities purchased in November 2001. Currently, our board consists of ten members, which includes three directors nominated by the Warburg Pincus funds and two directors nominated by the Hellman & Friedman funds. As long as the Warburg Pincus funds retain at least 75% of their original investment and the Hellman & Friedman funds retain at least 60% of their original investment, these shareholders will be entitled to nominate six and three directors, respectively. Together they have the right to nominate a majority of directors to our board.

By reason of their ownership and the shareholders agreement between us and the Warburg Pincus funds and the Hellman & Friedman funds, the Warburg Pincus funds and the Hellman & Friedman funds, individually or together, are able to strongly influence or effectively control actions to be taken by us, or our shareholders. The interests of these shareholders may differ materially from the interests of the holders of our other securities, and these shareholders could take actions or make decisions that are not in the interests of the holders of our other securities generally.

The price of our common shares may be volatile.

There has been significant volatility in the market for equity securities. During 2005 and 2006, the price of our common shares fluctuated from a low of $36.56 to a high of $57.65 and from a low of $52.00 to a high of $70.59, respectively. On February 15, 2007, our common shares closed at a price of $66.01. The price of our common shares may not remain at or exceed current levels. The following factors may have an adverse impact on the market price of our common stock:

- actual or anticipated variations in our quarterly results of operations, including as a result of catastrophes;
- changes in market valuation of companies in the insurance and reinsurance industry;
- changes in expectations of future financial performance or changes in estimates of securities analysts;
- fluctuations in stock market process and volumes;
- issuances or sales of common shares or other securities in the future;
- the addition or departure of key personnel; and
- announcements by us or our competitors of acquisitions, investments or strategic alliances.

Stock markets in the United States often experience price and volume fluctuations. Market fluctuations, as well as general political and economic conditions such as recession or interest rate or currency rate fluctuations, could adversely affect the market price of our stock.

Our business is dependent upon insurance and reinsurance brokers, and the loss of important broker relationships could materially adversely affect our ability to market our products and services.

We market our insurance and reinsurance products primarily through brokers. We derive a significant portion of our business from a limited number of brokers. During 2006, approximately 18.8% and 15.4% of our gross premiums written were generated from or placed by Marsh & McLennan Companies and its subsidiaries and AON Corporation and its subsidiaries, respectively. No other broker and no one insured or reinsured accounted for more than 10% of gross premiums written for the year ended December 31, 2006. Some of our competitors have had longer term relationships with the brokers we use than we have, and the brokers may promote products offered by companies that may offer a larger variety of products than we do. Loss of all or a substantial portion of the business provided by these brokers could have a material adverse effect on us.

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.

In program business conducted by our insurance group, following our underwriting, financial, claims and information technology due diligence reviews, we authorize managing general agents, general agents and other producers to write business on our behalf within underwriting authorities prescribed by us. Once a program incepts, we must rely on the underwriting controls of these agents to write business within the underwriting authorities provided by us. Although we monitor our programs on an ongoing basis, our monitoring efforts may not be adequate or our agents may exceed their underwriting authorities or otherwise breach obligations owed to us. We have experienced breaches by certain of our agents, all of which have been resolved favorably for us. To the extent that our agents exceed their authorities or otherwise breach obligations owed to us in the future, our financial condition and results of operations could be materially adversely affected.

Our investment performance may affect our financial results and ability to conduct business.

Our operating results depend in part on the performance of our investment portfolio. A significant portion of our cash and invested assets consists of fixed maturities (83.0% as of December 31, 2006). Although 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. In addition, although we did not experience any significant defaults by issuers during 2006, we are subject to risks inherent in particular securities or types of securities, as well as sector concentrations. We may not be able to realize our investment objectives, which could reduce our net income significantly. In the event that we are unsuccessful in correlating our investment portfolio with our expected insurance and reinsurance liabilities, we may be forced to liquidate our investments at times and prices that are not optimal, which could have a material adverse effect on our financial results and ability to conduct our business.

We may be adversely affected by interest rate changes.

Our operating results are affected, in part, by the performance of our investment portfolio. Our investment portfolio contains interest rate-sensitive-instruments, such as bonds, which may be adversely affected by changes in interest rates. Changes in interest rates could also have an adverse effect on our investment income and results of operations. For example, if interest rates increase, the value of our investment portfolio may decline.

In addition, our investment portfolio includes mortgage-backed securities. As of December 31, 2006, mortgage-backed securities (excluding commercial mortgage backed securities) constituted approximately 12.7% of our cash and invested assets. As with other fixed income investments, the fair value of these securities fluctuates depending on market and other general economic conditions and the interest rate environment. Changes in interest rates can expose us to prepayment risks on these investments. In periods of declining interest rates, mortgage prepayments generally increase and mortgage-backed securities are prepaid more quickly, requiring us to reinvest the proceeds at the then current market rates.

Interest rates are highly sensitive to many factors, including governmental monetary policies, domestic and international economic and political conditions and other factors beyond our control. Although we attempt to take measures to manage the risks of investing in a changing interest rate environment, we may not be able to mitigate interest rate sensitivity effectively. Despite our mitigation efforts, an increase in interest rates could have a material adverse effect on our book value.

We may require additional capital in the future, which may not be available or only available on unfavorable terms.

We monitor our capital adequacy on a regular basis. The capital requirements of our business depend on many factors, including our ability to write new business successfully and to establish premium rates and reserves at levels sufficient to cover losses. Our ability to underwrite is largely dependent upon the quality of our claims paying and financial strength ratings as evaluated by independent rating agencies. To the extent that our existing capital is insufficient to fund our future operating requirements and/or cover claim losses, we may need to raise additional funds through financings or limit our growth. Any equity or debt financing, if available at all, may be on terms that are unfavorable to us. In the case of equity financings, dilution to our shareholders could result, and, in any case, such securities may have rights, preferences and privileges that are senior to those of our outstanding securities. If we are not able to obtain adequate capital, our business, results of operations and financial condition could be adversely affected. See Management s Discussion and Analysis of Financial Condition and Results of Operations Liquidity and Capital Resources.

We sold our prior reinsurance operations in May 2000 and may have liability to the purchaser and continuing liability from those reinsurance operations if the purchaser should fail to make payments on the reinsurance liabilities it assumed.

On May 5, 2000, we sold our prior reinsurance operations to Folksamerica Reinsurance Company (Folksamerica). The Folksamerica transaction was structured as a transfer and assumption agreement (and not reinsurance), and, accordingly, the loss reserves (and any related reinsurance recoverables) relating to the transferred business are not included as assets or liabilities on our balance sheet. In addition, in connection with that asset sale, we made extensive representations and warranties about us and our reinsurance operations, some of which survived the closing of the asset sale. Breach of these representations and warranties could result in liability to us. In the event that Folksamerica refuses or is unable to make payment for reserved losses transferred to it by us in the May 2000 sale and the notice given to reinsureds is found not to be an effective release by such reinsureds, we would be liable for such claims. In June 2006, A.M. Best Company downgraded the financial strength rating of Folksamerica to A- (Excellent) from A (Excellent). Folksamerica reported policyholders surplus of $1.12 billion at September 30, 2006.

We sold our non-standard automobile insurance operations and merchant banking operations in 2004 and may have liability to the purchasers.

In 2004, we sold our non-standard automobile insurance operations and merchant banking operations to third party purchasers. In connection with such sales, we made representations and warranties about us and our transferred businesses, some of which survived the closing of such sales. Breach of these representations and warranties could result in liability to us.

Any future acquisitions may expose us to operational risks.

We may in the future make strategic acquisitions, either of other companies or selected blocks of business. Any future acquisitions may expose us to operational challenges and risks, including:

- integrating financial and operational reporting systems;
- establishing satisfactory budgetary and other financial controls;
- funding increased capital needs and overhead expenses;
- obtaining management personnel required for expanded operations;
- funding cash flow shortages that may occur if anticipated sales and revenues are not realized or are delayed, whether by general economic or market conditions or unforeseen internal difficulties;
- the value of assets acquired may be lower than expected or may diminish due to credit defaults or changes in interest rates and liabilities assumed may be greater than expected;
- the assets and liabilities we may acquire may be subject to foreign currency exchange rate fluctuation; and
- financial exposures in the event that the sellers of the entities we acquire are unable or unwilling to meet their indemnification, reinsurance and other obligations to us.

Our failure to manage successfully these operational challenges and risks may impact our results of operations.

Some of the provisions of our bye-laws and our shareholders agreement may have the effect of hindering, delaying or preventing third party takeovers or changes in management initiated by shareholders. These provisions may also prevent our shareholders from receiving premium prices for their shares in an unsolicited takeover.

Some provisions of our bye-laws could have the effect of discouraging unsolicited takeover bids from third parties or changes in management initiated by shareholders. These provisions may encourage companies interested in acquiring the Company to negotiate in advance with our board of directors, since the board has the authority to overrule the operation of several of the limitations.

Among other things, our bye-laws provide:

- for a classified board of directors, in which the directors of the class elected at each annual general meeting holds office for a term of three years, with the term of each class expiring at successive annual general meetings of shareholders;

- that the number of directors is determined by the board from time to time by a vote of the majority of our board;

- that directors may only be removed for cause, and cause removal shall be deemed to exist only if the director whose removal is proposed has been convicted of a felony or been found by a court to be liable for gross negligence or misconduct in the performance of his or her duties;

- that our board has the right to fill vacancies, including vacancies created by an expansion of the board;

- for limitations on shareholders right to call special general meetings and to raise proposals or nominate directors at general meetings; and

- that shareholders may act by written consent only if such consent is unanimous among all shareholders entitled to vote.

Our bye-laws provide that certain provisions which may have anti-takeover effects may be repealed or altered only with prior board approval and upon the affirmative vote of holders of shares representing at least 65% of the total voting power of our shares entitled generally to vote at an election of directors.

The bye-laws also contain a provision limiting the rights of any U.S. person (as defined in section 7701(a)(30) of the Internal Revenue Code of 1986, as amended (the Code)), that owns shares of ACGL, directly, indirectly or constructively (within the meaning of section 958 of the Code), representing more than 9.9% of the voting power of all shares entitled to vote generally at an election of directors. The votes conferred by such shares of such U.S. person will be reduced by whatever amount is necessary so that after any such reduction the votes conferred by the shares of such person will constitute 9.9% of the total voting power of all shares entitled to vote generally at an election of directors. Notwithstanding this provision, the board may make such final adjustments to the aggregate number of votes conferred by the shares of any U.S. person that the board considers fair and reasonable in all circumstances to ensure that such votes represent 9.9% of the aggregate voting power of the votes conferred by all shares of ACGL entitled to vote generally at an election of directors. ACGL will assume that all shareholders (other than the Warburg Pincus funds and the Hellman & Friedman funds) are U.S. persons unless we receive assurance satisfactory to us that they are not U.S. persons.

Moreover, most states, including states in which our subsidiaries are domiciled, have laws and regulations that require regulatory approval of a change in control of an insurer or an insurer s holding company. Where such laws apply to us and our subsidiaries, there can be no effective change in our control unless the person seeking to acquire control has filed a statement with the regulators and has obtained prior approval for the proposed change from such regulators. The usual measure for a presumptive change in control pursuant to these laws is the acquisition of 10% or more of the voting power of the insurance company or its parent, although this presumption is rebuttable. Consequently, a person may not acquire 10% or more of our common shares without the prior approval of insurance regulators in the state in which our subsidiaries are domiciled.

The bye-laws also provide that the affirmative vote of 80% of our outstanding shares (including a majority of the outstanding shares held by shareholders other than holders (and such holders affiliates) of 10% or more (10% holders) of the outstanding shares) shall be required (the extraordinary vote) for the following corporate actions:

- merger or consolidation of the Company into a 10% holder;
- sale of any or all of our assets to a 10% holder;
- the issuance of voting securities to a 10% holder; or
- amendment of these provisions;

provided, however, the extraordinary vote will not apply to any transaction approved by the board, so long as a majority of those board members voting in favor of the transaction were duly elected and acting members of the board prior to the time the 10% holder became a 10% holder.

The provisions described above may have the effect of making more difficult or discouraging unsolicited takeover bids from third parties. To the extent that these effects occur, shareholders could be deprived of opportunities to realize takeover premiums for their shares and the market price of their shares could be depressed. In addition, these provisions could also result in the entrenchment of incumbent management.

Our operating insurance and reinsurance subsidiaries are subject to regulation in various jurisdictions, and material changes in the regulation of their operations could adversely affect our results of operations.

Our insurance and reinsurance subsidiaries are subject to government regulation in each of the jurisdictions in which they are licensed or authorized to do business. Governmental agencies have broad administrative power to regulate many aspects of the insurance business, which may include trade and claim practices, accounting methods, premium rates, marketing practices, claims practices, advertising, policy forms, and capital adequacy. These agencies are concerned primarily with the protection of policyholders rather than shareholders. Moreover, insurance laws and regulations, among other things:

- establish solvency requirements, including minimum reserves and capital and surplus requirements;
- limit the amount of dividends, tax distributions, intercompany loans and other payments our insurance subsidiaries can make without prior regulatory approval;
- impose restrictions on the amount and type of investments we may hold;
- require assessments through guaranty funds to pay claims of insolvent insurance companies; and
- require participation in state-assigned risk plans which may take the form of reinsuring a portion of a pool of policies or the direct issuance of policies to insureds.

The National Association of Insurance Commissioners (NAIC) continuously examines existing laws and regulations in the United States. We cannot predict the effect that any NAIC recommendations or proposed or future legislation or rule making in the United States or elsewhere may have on our financial condition or operations.

Our Bermuda insurance and reinsurance subsidiary, Arch Re Bermuda, conducts its business from its offices in Bermuda and is not licensed or admitted to do business in any jurisdiction except Bermuda. Arch Re Swiss Branch conducts only reinsurance activities and is therefore not required to be licensed by the Swiss insurance regulator authorities. We do not believe that Arch Re Bermuda is subject to the insurance laws of any state in the United States; however, recent scrutiny of the insurance and reinsurance industry in the U.S. and other countries could subject Arch Re Bermuda to additional regulation. Our U.S. reinsurance subsidiary, Arch Re U.S., and our U.S. insurance subsidiaries, Arch Insurance, Arch Specialty, Arch E&S and Western Diversified, write reinsurance and insurance in the United States. These subsidiaries are subject to extensive regulation under state statutes which delegate regulatory, supervisory and administrative powers to state insurance commissioners. Such regulation generally is designed to protect policyholders rather than investors.

Arch-Europe, our European subsidiary, conducts its business from its offices in London and Germany. Arch-Europe is licensed to write insurance in the U.K., as well as several other European Union countries, and is subject to insurance laws in the U.K. and, to a limited extent, the other European Union countries where it writes insurance. Arch-Europe also has branch licenses to underwrite insurance in Italy and Spain. In 2006, Arch-Europe was approved as an excess and surplus lines insurer in seven states in the U.S. In addition, the Canadian branch of Arch Insurance writes insurance in Canada and is subject to federal, as well as provincial and territorial, regulation in Canada.

Our U.S., Bermuda and U.K. insurance and reinsurance subsidiaries and the Canadian branch of Arch Insurance are required to maintain minimum capital and surplus as mandated by their respective jurisdictions of incorporation and, in some cases, by the jurisdictions in which those subsidiaries write business. Arch-Europe is required to maintain minimum capital surplus as mandated by the NAIC and certain states where it is approved as an excess and surplus lines insurer. All of our subsidiaries are currently in compliance with these capital and surplus requirements.

We periodically review our corporate structure in the United States so that we can optimally deploy our capital. Changes in that structure require regulatory approval. Delays or failure in obtaining any of these approvals could limit the amount of insurance that we can write in the United States.

If ACGL or any of our subsidiaries were to become subject to the laws of a new jurisdiction in which such entity is not presently admitted, ACGL or such subsidiary may not be in compliance with the laws of the new jurisdiction. Any failure to comply with applicable laws could result in the imposition of significant restrictions on our ability to do business, and could also result in fines and other sanctions, any or all of which could adversely affect our financial condition and results of operations.

ACGL is a holding company and is dependent on dividends and other payments from its operating subsidiaries, which are subject to dividend restrictions, to make payments, including the payment of debt service obligations and operating expenses we may incur and any payments of dividends, redemption amounts or liquidation amounts with respect to our preferred shares and common shares.

ACGL is a holding company whose assets primarily consist of the shares in our subsidiaries. Generally, ACGL depends on its available cash resources, liquid investments and dividends or other distributions from subsidiaries to make payments, including the payment of debt service obligations and operating expenses it may incur and any payments of dividends, redemption amounts or liquidation amounts with respect to our preferred shares and common shares. For the years ended December 31, 2006, 2005 and 2004, ACGL received dividends of $22.1 million, $22.1 million and $11.0 million from Arch Re Bermuda. Such amounts were used to pay interest on ACGL s senior notes.

The ability of our regulated insurance and reinsurance subsidiaries to pay dividends or make distributions is dependent on their ability to meet applicable regulatory standards. Under Bermuda law, Arch Re Bermuda is required to maintain a minimum solvency margin (i.e., the amount by which the value of its general business assets must exceed its general business liabilities) equal to the greatest of (1) $100 million, (2) 50% of net premiums written (being gross premiums written by us less any premiums ceded by us, but we may not deduct more than 25% of gross premiums when computing net premiums written) and (3) 15% of loss and other insurance reserves. Arch Re Bermuda is prohibited from declaring or paying any dividends during any financial year if it is not in compliance with its minimum solvency margin or minimum liquidity ratio. In addition, Arch Re Bermuda is prohibited from declaring or paying in any financial year dividends of more than 25% of its total statutory capital and surplus (as shown on its previous financial year s statutory balance sheet) unless it files, at least seven days before payment of such dividends, with the Bermuda Monetary Authority an affidavit stating that it will continue to meet the required margins. In addition, Arch Re Bermuda is prohibited, without prior approval of the Bermuda Monetary Authority, from reducing by 15% or more its total statutory capital, as set out in its previous year s statutory financial statements. At December 31, 2006, as determined under Bermuda law, Arch Re Bermuda had statutory capital of $1.98 billion and statutory capital and surplus of $3.32 billion. Such amounts include interests in U.S. insurance and reinsurance subsidiaries. Accordingly, Arch Re Bermuda can pay approximately $830.9 million to ACGL during 2007 without providing an affidavit to the Bermuda Monetary Authority, as discussed above. Our U.S. insurance and reinsurance subsidiaries can pay approximately $117.5 million in dividends or distributions to Arch-U.S., our U.S. holding company, which is owned by Arch Re Bermuda, during 2007 without prior regulatory approval. Such dividends or distributions may be subject to applicable withholding or other taxes. Arch-Europe can pay approximately £4.5 million, or $8.8 million, in dividends to ACGL during 2007 without prior notice and approval by the FSA.

In addition, the ability of our insurance and reinsurance subsidiaries to pay dividends could be constrained by our dependence on financial strength ratings from independent rating agencies. Our ratings from these agencies depend to a large extent on the capitalization levels of our insurance and reinsurance subsidiaries.

We believe that ACGL has sufficient cash resources and available dividend capacity to service its indebtedness and other current outstanding obligations.

If our Bermuda reinsurance subsidiary is unable to provide collateral to ceding companies, its ability to conduct business could be significantly and negatively affected.

Arch Re Bermuda is a registered Bermuda insurance company and is not licensed or admitted as an insurer in any jurisdiction in the United States. Because insurance regulations in the United States do not permit insurance companies to take credit for reinsurance obtained from unlicensed or non-admitted insurers on their statutory financial statements unless security is posted, Arch Re Bermuda s contracts generally require it to post a letter of credit or provide other security. Although, to date, Arch Re Bermuda has not experienced any difficulties in providing collateral when required, if we are unable to post security in the form of letters of credit or trust funds when required, the operations of Arch Re Bermuda could be significantly and negatively affected.

We may become subject to taxes in Bermuda after March 28, 2016, which may have a material adverse effect on our results of operations.

Under current Bermuda law, we are not subject to tax on income or capital gains. Furthermore, we have obtained from the Minister of Finance of Bermuda 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 tax, then the imposition of the tax will not be applicable to us or our operations until March 28, 2016. We could be subject to taxes in Bermuda after that date. This assurance does not, however, prevent the imposition of taxes on any person ordinarily resident in Bermuda or any company in respect of its ownership of real property or leasehold interests in Bermuda.

Foreign currency exchange rate fluctuation may adversely affect our financial results.

We write business on a worldwide basis, and our results of operations may be affected by fluctuations in the value of currencies other than the U.S. Dollar. The primary foreign currencies in which we operate are the Euro, the British Pound Sterling and the Canadian Dollar. Changes in foreign currency exchange rates can reduce our revenues and increase our liabilities and costs. We may therefore suffer losses solely as a result of exchange rate fluctuations. In order to mitigate the impact of exchange rate fluctuations, we have invested and expect to continue to invest in securities denominated in currencies other than the U.S. Dollar. Net foreign exchange losses, recorded in the statement of income, for the year ended December 31, 2006 were $23.9 million, compared to net foreign exchange gains for the year ended December 31, 2005 of $22.2 million. We hold investments in foreign currencies which are intended to mitigate our exposure to foreign currency fluctuations in our net insurance liabilities. However, changes in the value of such investments due to foreign currency rate movements are reflected as a direct increase to shareholders equity and are not included in the statement of income. We have chosen not to hedge the currency risk on the capital contributed to Arch-Europe in May 2004, which is held in British Pounds Sterling. However, we intend to match Arch-Europe s projected liabilities in foreign currencies with investments in the same currencies. There can be no assurances that such arrangements will mitigate the negative impact of exchange rate fluctuations, and we may suffer losses solely as a result of exchange rate fluctuations. From inception through December 31, 2006, and based on currency spot rates at December 31, 2006, Arch Re Bermuda has recorded net premiums written of approximately $560 million from Euro-denominated contracts, $380 million from British Pound Sterling-denominated contracts and $200 million from Canadian Dollar-denominated contracts. In addition, Arch-Europe writes business in British Pound Sterling and Euros, and the Canadian branch of Arch Insurance writes business in Canadian Dollars.

Certain employees of our Bermuda operations are required to obtain work permits before engaging in a gainful occupation in Bermuda. Required work permits may not be granted or may not remain in effect.

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 on the continued services of key employees in Bermuda. A work permit may be granted or renewed 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 s policy places a six-year term limit on individuals with work permits, subject to certain exemptions for key employees. A work permit is issued with an expiry date (up to five years) and no assurances can be given that any work permit will be issued or, if issued, renewed upon the expiration of the relevant term. We consider our key officers in Bermuda to be Constantine Iordanou, our President and Chief Executive Officer (work permit expires November 12, 2009), Marc Grandisson, Chairman and Chief Executive Officer of Arch Worldwide Reinsurance Group (work permit expires May 12, 2010), John D. Vollaro, our Executive Vice President and Chief Financial Officer (work permit expires July 25, 2010) and Nicolas Papadopoulo, President and Chief Executive Officer of Arch Re Bermuda (work permit expires March 31, 2010). We also have other key positions in Bermuda held by persons who hold work permits subject to renewal. If work permits are not obtained or renewed for our principal employees, we could lose their services, which could materially affect our business.

The enforcement of civil liabilities against us may be difficult.

We are a Bermuda company and in the future some of our officers and directors may be residents of various jurisdictions outside the United States. All or a substantial portion of our assets and of those persons may be located outside the United States. As a result, it may be difficult for you to effect service of process within the United States upon those persons or to enforce in United States courts judgments obtained against those persons.

We have appointed National Registered Agents, Inc., New York, New York, as our agent for service of process with respect to actions based on offers and sales of securities made in the United States. We have been advised by our Bermuda counsel, Conyers Dill & Pearman, that the United States and Bermuda do not currently have a treaty providing for reciprocal recognition and enforcement of judgments of U.S. courts in civil and commercial matters and that a final judgment for the payment of money rendered by a court in the United States based on civil liability, whether or not predicated solely upon the U.S. federal securities laws, would, therefore, not be automatically enforceable in Bermuda. We also have been advised by Conyers Dill & Pearman that a final and conclusive judgment obtained in a court in the United States under which a sum of money is payable as compensatory damages (i.e., not being a sum claimed by a revenue authority for taxes or other charges of a similar nature by a governmental authority, or in respect of a fine or penalty or multiple or punitive damages) may be the subject of an action on a debt in the Supreme Court of Bermuda under the common law doctrine of obligation. Such an action should be successful upon proof that the sum of money is due and payable, and without having to prove the facts supporting the underlying judgment, as long as:

- the court which gave the judgment had proper jurisdiction over the parties to such judgment;
- such court did not contravene the rules of natural justice of Bermuda;
- such judgment was not obtained by fraud;
- the enforcement of the judgment would not be contrary to the public policy of Bermuda;
- no new admissible evidence relevant to the action is submitted prior to the rendering of the judgment by the courts of Bermuda; and
- there is due compliance with the correct procedures under Bermuda law.

A Bermuda court may impose civil liability on us or our directors or officers in a suit brought in the Supreme Court of Bermuda against us or such persons with respect to a violation of U.S. federal securities laws, provided that the facts surrounding such violation would constitute or give rise to a cause of action under Bermuda law.

Risk Relating to our Preferred Shares

General market conditions and unpredictable factors could adversely affect market prices for our outstanding preferred shares.

There can be no assurance about the market prices for any series of our preferred shares. Several factors, many of which are beyond our control, will influence the market value of such series of preferred shares. Factors that might influence the market value of any series of our preferred shares include, but are not limited to:

- whether dividends have been declared and are likely to be declared on any series of our preferred shares from time to time;
- our creditworthiness, financial condition, performance and prospects;

- whether the ratings on any series of our preferred shares provided by any ratings agency have changed;
- the market for similar securities; and
- economic, financial, geopolitical, regulatory or judicial events that affect us and/or the insurance or financial markets generally.

Dividends on our preferred shares are non-cumulative.

Dividends on our preferred shares are non-cumulative and payable only out of lawfully available funds of ACGL under Bermuda law. Consequently, if ACGL s board of directors (or a duly authorized committee of the board) does not authorize and declare a dividend for any dividend period with respect to any series of our preferred shares, holders of such preferred shares would not be entitled to receive any such dividend, and such unpaid dividend will not accrue and will never be payable. ACGL will have no obligation to pay dividends for a dividend period on or after the dividend payment date for such period if its board of directors (or a duly authorized committee of the board) has not declared such dividend before the related dividend payment date; if dividends on any series of our preferred shares are authorized and declared with respect to any subsequent dividend period, ACGL will be free to pay dividends on any other series of preferred shares and/or our common shares. In the past, we have not paid dividends on our common shares.

Our preferred shares are equity and are subordinate to our existing and future indebtedness.

Our preferred shares are equity interests and do not constitute indebtedness. As such, our preferred shares will rank junior to all of our indebtedness and other non-equity claims with respect to assets available to satisfy our claims, including in our liquidation. As of December 31, 2006, our total consolidated long-term debt was $300.0 million. We may incur additional debt in the future. Our existing and future indebtedness may restrict payments of dividends on our preferred shares. Additionally, unlike indebtedness, where principal and interest would customarily be payable on specified due dates, in the case of preferred shares like our preferred shares, (1) dividends are payable only if declared by the board of directors of ACGL (or a duly authorized committee of the board) and (2) as described above under Risks Relating to Our Company ACGL is a holding company and is dependent on dividends and other payments from its operating subsidiaries, which are subject to dividend restrictions, to make payments, including the payment of debt service obligations and operating expenses we may incur and any payments of dividends, redemption amounts or liquidation amounts with respect to our preferred shares and common shares, we are subject to certain regulatory and other constraints affecting our ability to pay dividends and make other payments.

The voting rights of holders of our preferred shares are limited.

Holders of our preferred shares have no voting rights with respect to matters that generally require the approval of voting shareholders. The limited voting rights of holders of our preferred shares include the right to vote as a class on certain fundamental matters that affect the preference or special rights of our preferred shares as set forth in the certificate of designations relating to each series of preferred shares. In addition, if dividends on any series of our preferred shares have not been declared or paid for the equivalent of six dividend payments, whether or not for consecutive dividend periods, holders of the outstanding preferred shares of any series will be entitled to vote for the election of two additional directors to our board of directors subject to the terms and to the limited extent as set forth in the certificate of designations relating to such series of preferred shares.

There is no limitation on our issuance of securities that rank equally with or senior to our preferred shares.

We may issue additional securities that rank equally with or senior to our preferred shares without limitation. The issuance of securities ranking equally with or senior to our preferred shares may reduce the amount available for dividends and the amount recoverable by holders of such series in the event of a liquidation, dissolution or winding-up of ACGL.

A classification of any series of preferred shares by the NAIC may impact U.S. insurance companies that purchase such series.

The NAIC, may from time to time, in its discretion, classify securities in insurers portfolios as either debt, preferred equity or common equity instruments. The NAIC s written guidelines for classifying securities as debt, preferred equity or common equity include subjective factors that require the relevant NAIC examiner to exercise substantial judgment in making a classification. There is therefore a risk that any series of preferred shares may be classified by NAIC as common equity instead of preferred equity. The NAIC classification determines the amount of risk based capital (RBC) charges incurred by insurance companies in connection with an investment in a security. Securities classified as common equity by the NAIC carry RBC charges that can be significantly higher than the RBC requirement for debt or preferred equity. Therefore, any classification of any series of preferred shares as common equity may adversely affect U.S. insurance companies that hold such series. In addition, a determination by the NAIC to classify such series as common equity may adversely impact the trading of such series in the secondary market.

Risks Relating to Taxation

We and our non-U.S. subsidiaries may become subject to U.S. federal income taxation.

ACGL and its non-U.S. subsidiaries intend to operate their business in a manner that will not cause them to be treated as engaged in a trade or business in the United States and, thus, 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 certain U.S. source investment income) on their income. However, because there is uncertainty as to the activities which constitute being engaged in a trade or business in the United States, there can be no assurances that the U.S. Internal Revenue Service will not contend successfully that ACGL or its non-U.S. subsidiaries are engaged in a trade or business in the United States. If ACGL or any of its non-U.S. subsidiaries were subject to U.S. income tax, our shareholders equity and earnings could be adversely affected. Certain of our U.S. subsidiaries have been personal holding companies, but did not have undistributed personal holding company income.

Congress has been considering legislation intended to eliminate certain perceived tax advantages of Bermuda insurance companies and U.S. insurance companies having Bermuda affiliates, including perceived tax benefits resulting principally from reinsurance between or among U.S. insurance companies and their Bermuda affiliates. Some U.S. insurance companies have also been lobbying Congress recently to pass such legislation. In this regard, the American Jobs Creation Act of 2004 (the Jobs Act) permits the United States Internal Revenue Service (IRS) to re-allocate, re-characterize or adjust items of income, deduction or certain other items related to a reinsurance agreement between related parties to reflect the proper source, character and amount for each item (in contrast to prior law, which only covered source and character). The Jobs Act also eliminated the tax benefits available to a U.S. company that, after March 4, 2003, changed its legal domicile to a non-U.S. jurisdiction, a transaction commonly known as an inversion. We changed our legal domicile from the U.S. to Bermuda, but were not affected by the anti-inversion rule because our change in domicile occurred in November 2000. The Senate version of the Small Business and Work Opportunity Act of 2007 would make the Jobs Act anti-inversion rule applicable retroactively to inversions that occurred after March 20, 2002. Although this modification would not affect ACGL, no assurance can be given that the final 2007 bill will not make the Jobs Act anti-inversion rule applicable retroactively to inversions that occurred on an earlier date, in which case ACGL could be adversely affected. We also understand that hearings on corporate inversions might be held soon in the House of Representatives. Additional legislation, if passed, and other changes in U.S. tax laws, regulations and interpretations thereof to address these issues could adversely affect us.

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.

We believe that we and our non-U.S. subsidiaries currently might be controlled foreign corporations (CFCs), although our bye-laws are designed to preclude any U.S. person from adverse tax consequences as a result of our CFC status. We do not believe that we are a passive foreign investment company. Since these determinations and beliefs are based upon legal and factual conclusions, no assurances can be given that the U.S. Internal Revenue Service or a court would concur with our conclusions. If they were not to so concur, U.S. persons who hold our common shares or preferred shares may suffer adverse tax consequences.

Reduced tax rate for qualified dividend income received by individuals and other non-corporate holders may not be available in the future.

Dividends received by individuals and other non-corporate United States persons on our common shares or preferred shares in taxable years beginning on or before December 31, 2010 may constitute qualified dividend income that is subject to U.S. federal income tax at the rate applicable for long-term capital gains, rather than the higher rates applicable to ordinary income, provided that certain holding period requirements and other conditions are met. For taxable years beginning after December 31, 2010, qualified dividend income will no longer be taxed at the rate applicable for long-term capital gains unless legislation is enacted providing otherwise.

Our non-U.S. companies may be subject to U.K. tax that may have a material adverse effect on our results of operations.

We intend to operate in such a manner so that none of our companies, other than Arch-Europe and Arch-U.K., should be resident in the U.K. for tax purposes or have a permanent establishment in the U.K. Accordingly, we do not expect that any companies other than Arch-Europe and Arch-U.K. should be subject to U.K. taxation. However, since applicable law and regulations do not conclusively define the activities that constitute conducting business in the U.K. through a permanent establishment, the U.K. Inland Revenue might contend successfully that one or more of our companies, in addition to Arch-Europe and Arch-U.K., is conducting business in the U.K. through a permanent establishment in the U.K. and, therefore, subject to U.K. tax, which could have a material adverse effect on us.

ITEM 1B. UNRESOLVED STAFF COMMENTS

None.

ITEM 2. PROPERTIES

Our reinsurance group leases a total of approximately 9,100 square feet in Hamilton, Bermuda under a lease expiring in 2012, and approximately 19,200 square feet in Morristown, New Jersey under a lease expiring in 2011.

Our insurance group leases approximately 8,750 square feet in Hamilton, Bermuda for our Bermuda insurance operations. The principal U.S. office of our insurance group is located at One Liberty Plaza, New York, New York where we lease approximately 118,400 square feet. Such lease expires in 2014, with the exception of a portion of that lease for approximately 28,390 square feet that expires in 2010. Our insurance group also leases a total of approximately 206,200 square feet for its other primary U.S. offices and its office in Canada.

Arch-Europe leases approximately 10,770 square feet in London and 1,550 square feet in Germany. Arch-Europe has signed a lease for approximately 18,900 square feet in London which will replace its current offices in 2007. ACGL leases approximately 1,500 square feet in Bermuda. In addition, Arch Capital Services Inc., a subsidiary of ACGL which provides certain financial, legal and other administrative support services for ACGL and its subsidiaries, leases approximately 16,730 square feet in White Plains, New York.

For the years ended December 31, 2006, 2005 and 2004, our rental expense, net of income from subleases, was approximately $12.9 million, $11.1 million and $12.4 million, respectively. Our future minimum rental charges for the remaining terms of our existing leases, exclusive of escalation clauses and maintenance costs and net of rental income, will be approximately $83.0 million. We believe that the above described office space is adequate for our needs. However, as we continue to develop our business, we may open additional office locations during 2007.

ITEM 3. LEGAL PROCEEDINGS

We, in common with the insurance industry in general, are subject to litigation and arbitration in the normal course of our business. As of December 31, 2006, we were not a party to any material litigation or arbitration other than as a part of the ordinary course of business in relation to claims and reinsurance recoverable matters, none of which is expected by management to have a significant adverse effect on our results of operations and financial condition and liquidity.

In 2003, the former owners of American Independent Insurance Holding Company (American Independent) commenced an action against ACGL, American Independent and certain of American Independent s directors and officers and others seeking unspecified damages relating to the reorganization agreement pursuant to which we acquired American Independent in 2001. The plaintiffs filed a new pleading in October 2005. ACGL and the other defendants again moved to dismiss all claims, and those motions were granted in an Opinion and Order dated September 20, 2006, in which the court dismissed all counts of the second amended complaint with prejudice. The plaintiffs did not appeal from this Order, and their time for doing so has expired.

ITEM 4. SUBMISSION OF MATTERS TO A VOTE OF SECURITY HOLDERS

None.

PART II

ITEM 5. MARKET FOR REGISTRANT S COMMON EQUITY, RELATED STOCKHOLDER MATTERS AND ISSUER PURCHASES OF EQUITY SECURITIES

MARKET INFORMATION

Our common shares are traded on the NASDAQ Stock Market under the symbol ACGL. For the periods presented below, the high and low sales prices and closing prices for our common shares as reported on the NASDAQ Stock Market were as follows:

	Three Months Ended December 31, 2006	September 30, 2006	June 30, 2006	March 31, 2006
High	$ 70.59	$ 63.90	$ 62.60	$ 58.07
Low	62.71	56.46	55.42	52.00
Close	67.61	63.49	59.46	57.74

	Three Months Ended December 31, 2005	September 30, 2005	June 30, 2005	March 31, 2005
High	$ 57.65	$ 49.99	$ 45.40	$ 42.20
Low	45.89	43.01	39.55	36.56
Close	54.75	49.59	45.05	40.04

On February 15, 2007 the high and low sales prices and the closing price for our common shares as reported on the NASDAQ Stock Market were $66.11, $65.55 and $66.01, respectively.

HOLDERS

As of February 15, 2007, and based on information provided to us by our transfer agent and proxy solicitor, there were approximately 138 holders of record of our common shares and approximately 43,000 beneficial holders of our common shares.

DIVIDENDS

Any determination to pay dividends on ACGL s series A and series B non-cumulative preferred shares or common shares will be at the discretion of ACGL s board of directors (or a duly authorized committee of the board of directors) and will be dependent upon its results of operations, financial condition and other factors deemed relevant by ACGL s board of directors. As a holding company, ACGL will depend on future dividends and other permitted payments from its subsidiaries to pay dividends to its shareholders. ACGL s subsidiaries ability to pay dividends, as well as its ability to pay dividends, is subject to regulatory, contractual, rating agency and other constraints. So long as any series A or series B non-cumulative preferred shares remain outstanding for any dividend period, unless the full dividends for the latest completed dividend period on all outstanding series A and series B non-cumulative preferred shares and parity shares have been declared and paid (or declared and a sum sufficient for the payment thereof has been set aside), (a) no dividend may be paid or declared on ACGL s common shares or any of its other securities ranking junior to the series A and series B non-cumulative preferred shares (other than a dividend payable solely in common shares or in such other junior securities) and (b) no common shares or other junior shares may be purchased, redeemed or otherwise acquired for consideration by ACGL, directly or indirectly (other than (i) as a result of a reclassification of junior shares for or into other junior shares, or the exchange or conversion of one junior share for or into another junior share, (ii) through the use of the proceeds of a substantially contemporaneous sale of junior shares and (iii) as permitted by the bye-laws of ACGL in effect on the date of issuance of the series A and series B non-cumulative preferred shares.

In addition, pursuant to a shareholders agreement, ACGL has agreed (until 2011) not to declare any dividend or make any other distribution on its common shares, and not to repurchase any common shares, until it has repurchased from the Warburg Pincus funds and the Hellman & Friedman funds, pro rata, on the basis of the amount of those shareholders investments in us at the time of such repurchase, common shares (which were issued pursuant to the conversion of all outstanding preference shares in the 2005 fourth quarter) having an aggregate value of $250 million, at a per share price acceptable to those shareholders. No such shares have yet been repurchased.

SECURITIES AUTHORIZED FOR ISSUANCE UNDER EQUITY COMPENSATION PLANS

In June 2005, following shareholder approval, we adopted the 2005 Long Term Incentive and Share Award Plan (the 2005 Plan). The 2005 Plan is intended to provide for competitive compensation opportunities, to encourage long-term service, to recognize individual contributions and reward achievement of performance goals and to promote the creation of long-term value for eligible employees by aligning the interests of such persons with those of our shareholders. The 2005 Plan will provide for the grant to eligible employees and directors stock options, stock appreciation rights, restricted shares, restricted share units payable in common shares or cash, share awards in lieu of cash awards, dividend equivalents and other share-based awards (the Awards). The 2005 Plan also will provide our non-employee directors with the opportunity to receive the annual retainer fee for Board service in common shares. A maximum of up to 2,000,000 common shares was reserved for issuance under the 2005 Plan, subject to anti-dilution adjustments in the event of certain changes in our capital structure. At December 31, 2006, approximately 1,528,878 shares are available for grant under the 2005 Plan.

Our shareholders approved the 2002 Long Term Incentive and Share Award Plan (2002 Plan) on June 27, 2002. The 2002 Plan provides for grants of stock options, stock appreciation rights, restricted shares, restricted units payable in common shares or cash, share awards in lieu of cash awards, dividend equivalents and other share-based awards of common shares to our new employees, existing employees and members of our board of directors. As of December 31, 2006, approximately 26,726 shares are available for grant under the 2002 Plan. We also adopted, and our shareholders approved, the 1995 Long Term Incentive and Share Award Plan (1995 Plan) and the 1999 Long Term Incentive and Share Award Plan (1999 Plan) in 1996 and 1999, respectively. In addition, our shareholders approved the 1995 Employee Stock Purchase Plan in 1996, but this plan was suspended in December 2002. All of the shares reserved for issuance under the 1995 Plan and the 1999 Plan have been granted pursuant to existing awards.

In October 2001, we adopted the Long Term Incentive Plan for New Employees (New Employee Plan) to provide incentives to attract and motivate new hires in connection with the launch of our underwriting initiative. A total of 3,634,170 of such share awards were granted under the New Employee Plan. As eligibility under the New Employee Plan was restricted to new hires, none of the shares under the New Employee Plan were available for grants to directors or existing employees. As a result, in order to be in a position to provide long-term incentive compensation for our employees and directors, in June 2002, following shareholder approval, we adopted the 2002 Plan, and the New Employee Plan was terminated. In addition, in October 2001, we awarded an aggregate of 2,455,575 shares under certain individual award agreements, of which substantially all were approved by shareholders in June 2002. For information about our equity compensation plans, see note 13, Share Capital, of the notes accompanying our consolidated financial statements.

The following information is as of December 31, 2006:

Plan Category	**Number of securities to be issued upon exercise of outstanding options (1), warrants and rights** ***(a)***	**Weighted-average exercise price of outstanding options (1), warrants and rights** ***(b)***	**Number of securities remaining available for future issuance under equity compensation plans (excluding securities reflected in column (a))** ***(c)***
Equity compensation plans approved by security holders	3,911,614	34.67	1,555,604
Equity compensation plans not approved by security holders	1,758,380	22.75	
Total	5,669,994	30.97	1,555,604

(1) Includes all vested and unvested options.

The following table summarizes our purchases of our common shares for the year ended December 31, 2006:

Issuer Purchases of Equity Securities

Period	**Total Number of Shares Purchased (1)**	**Average Price Paid per Share**	**Total Number of Shares Purchased as Part of Publicly Announced Plans or Programs**	**Maximum Number of Shares that May Yet be Purchased Under the Plan or Programs**
1/1/2006-1/31/2006				
2/1/2006-2/28/2006	11,514	$ 56.23		
3/1/2006-3/31/2006				
4/1/2006-4/30/2006				
5/1/2006-5/31/2006	186	$ 58.19		
6/1/2006-6/30/2006				
7/1/2006-7/31/2006				
8/1/2006-8/31/2006	1,957	$ 60.44		
9/1/2006-9/30/2006	8,038	$ 62.52		
10/1/2006-10/31/2006	225	$ 65.20		
11/1/2006-11/30/2006	1,035	$ 67.57		
12/1/2006-12/31/2006	4,297	$ 68.43		
Total	27,252	$ 60.83		

(1) ACGL repurchases shares, from time to time, from employees in order to facilitate the payment of withholding taxes on restricted shares granted. We purchased these shares at their fair market value, as determined by reference to the closing price of our common shares on the day the restricted shares vested.

PERFORMANCE GRAPH

The following graph compares the cumulative total shareholder return on our common shares for each of the last five years through December 31, 2006 to the cumulative total return, assuming reinvestment of dividends, of (1) Standard & Poor s (S&P) 500 Composite Stock Index (S&P 500 Index) and (2) the S&P 500 Property & Casualty Insurance Index. The share price performance presented below is not necessarily indicative of future results.

CUMULATIVE TOTAL SHAREHOLDER RETURN (1)(2)(3)

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(1) Stock price appreciation plus dividends.

(2) The above graph assumes that the value of the investment was $100 on December 31, 2001. The closing price for our common shares on December 31, 2006 (*i.e.*, the last trading day in 2006) was $67.61.

(3) This graph is not soliciting material, is not deemed filed with the SEC and is not to be incorporated by reference in any filing by us under the Securities Act of 1933, as amended or the Securities and Exchange Act of 1934, whether made before or after the date hereof and irrespective of any general incorporation language in any such filing.

ITEM 6. SELECTED FINANCIAL DATA

The following table sets forth summary historical consolidated financial and operating data for the five-year period ended December 31, 2006 and should be read in conjunction with Management s Discussion and Analysis of Financial Condition and Results of Operations and our financial statements and the related notes.

	Years Ended December 31, 2006	2005	2004	2003	2002
	(U.S. dollars in thousands except share data)				
Statement of Income Data:					
Revenues:					
Net premiums written	$ 3,017,418	$ 3,138,772	$ 2,980,032	$ 2,738,415	$ 1,261,627
Net premiums earned	3,081,665	2,977,716	2,915,882	2,212,599	654,976
Net investment income	380,205	232,902	143,705	80,992	51,249
Net realized gains (losses)	(19,437)	(53,456)	30,237	25,317	(839)
Total revenues	3,452,678	3,167,529	3,104,050	2,343,737	721,769
Income before income taxes and extraordinary item	739,893	285,435	343,127	306,500	54,540
Income before extraordinary item	713,214	256,486	316,899	279,775	55,096
Extraordinary gain excess of fair value of acquired net assets over cost (net of $0 tax)(1)				816	3,886
Net income	713,214	256,486	316,899	280,591	58,982
Preferred dividends	(20,655)				
Net income available to common shareholders	$ 692,559	$ 256,486	$ 316,899	$ 280,591	$ 58,982
Weighted average common shares and common share equivalents outstanding:					
Basic(2)	73,212,432	35,342,650	31,560,737	26,264,055	20,095,698
Diluted(2)	76,246,725	74,709,858	72,519,045	67,777,794	59,662,178
Net income (loss) per common share data:					
Basic(2):					
Income before extraordinary item	$ 9.46	$ 7.26	$ 10.04	$ 10.65	$ 2.74
Extraordinary gain(1)				0.03	0.19
Net income available to common shareholders	$ 9.46	$ 7.26	$ 10.04	$ 10.68	$ 2.93
Diluted(2):					
Income before extraordinary item	$ 9.08	$ 3.43	$ 4.37	$ 4.13	$ 0.92
Extraordinary gain(1)				0.01	0.07
Net income available to common shareholders	$ 9.08	$ 3.43	$ 4.37	$ 4.14	$ 0.99
Cash dividends per share					

	Years Ended December 31, 2006	2005	2004	2003	2002
	(U.S. dollars in thousands except share data)				
Balance Sheet Data:					
Total investments and cash(3)	$ 9,319,148	$ 7,119,450	$ 5,835,515	$ 3,717,147	$ 1,985,898
Premiums receivable	749,961	672,902	520,781	477,032	343,716
Unpaid losses and loss adjustment expenses recoverable	1,552,157	1,389,768	617,607	369,080	211,100
Total assets	14,312,467	11,488,436	8,218,754	5,585,321	2,991,328
Reserves for losses and loss adjustment expenses:					
Before unpaid losses and loss adjustment expenses recoverable	6,463,041	5,452,826	3,492,759	1,911,596	592,432
Net of unpaid losses and loss adjustment expenses recoverable	4,910,884	4,063,058	2,875,152	1,542,516	381,332
Unearned premiums:					
Before prepaid reinsurance premiums	1,791,922	1,699,691	1,518,162	1,378,654	748,203
Net of prepaid reinsurance premiums	1,321,784	1,377,256	1,219,795	1,166,937	641,119
Senior notes	300,000	300,000	300,000		
Revolving credit agreement borrowings				200,000	
Total liabilities	10,721,848	9,007,909	5,976,848	3,874,592	1,580,084
Common shareholders equity	3,265,619	2,480,527	2,241,906	1,710,729	1,411,244
Preferred shareholders equity	325,000				
Total shareholders equity	3,590,619	2,480,527	2,241,906	1,710,729	1,411,244
Book value:					
Per common share(4)	$ 43.97	$ 33.82	$ 41.76	$ 31.74	$ 21.48
Diluted(5)	$ 43.97	$ 33.82	$ 31.03	$ 25.52	$ 21.20
Shares outstanding:					
Basic	74,270,466	73,334,870	34,902,923	28,200,372	27,725,334
Diluted(5)	74,270,466	73,334,870	72,251,073	67,045,037	66,569,999

(1) On November 30, 2002, we acquired PSIC and recorded an extraordinary gain of $3.9 million for the year ended December 31, 2002. The extraordinary gain represents the excess of the fair value of acquired net assets of $6.4 million over the purchase price of $2.5 million. In 2003, we recorded an additional extraordinary gain of $0.8 million representing an adjustment to the fair value of PSIC due to the recognition of deferred tax assets as part of the acquisition.

(2) Net income per share is based on the basic and diluted weighted average number of common shares and common share equivalents outstanding.

(3) 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.

(4) Book value per common share at December 31, 2004, 2003 and 2002 was determined by dividing (i) the difference between total shareholders equity and the aggregate liquidation preference of the series A convertible preference shares of $784.3 million, $815.7 million and $815.7 million, respectively, by (ii) the number of common shares outstanding. All outstanding series A convertible preference shares were converted to common shares in 2005.

(5) Book value per share excludes the effects of stock options and, in periods prior to 2005, class B warrants. Diluted shares outstanding and diluted book value per share as of December 31, 2001 have been adjusted on a pro forma basis to reflect the issuance of additional series A convertible preference shares on June 28, 2002 and December 16, 2002 pursuant to post-closing purchase price adjustment mechanisms under the Subscription Agreement.

ITEM 7. MANAGEMENT S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

The following discussion and analysis contains forward-looking statements which involve inherent risks and uncertainties. All statements other than statements of historical fact are forward-looking statements. These statements are based on our current assessment of risks and uncertainties. Actual results may differ materially from those expressed or implied in these statements and, therefore, undue reliance should not be placed on them. Important factors that could cause actual events or results to differ materially from those indicated in such statements are discussed in this report, including the sections entitled Cautionary Note Regarding Forward Looking Statements, and Risk Factors.

This discussion and analysis should be read in conjunction with our audited consolidated financial statements and notes thereto presented under Item 8.

General

Overview

Arch Capital Group Ltd. (ACGL and, together with its subsidiaries, we or us) is a Bermuda public limited liability company with approximately $3.9 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. 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.

The worldwide insurance and reinsurance industry is highly competitive and has traditionally been subject to an underwriting cycle in which a hard market (high premium rates, restrictive underwriting standards, as well as terms and conditions, and underwriting gains) is eventually followed by a soft market (low premium rates, relaxed underwriting standards, as well as broader terms and conditions, and underwriting losses). Insurance market conditions may affect, among other things, the demand for our products, our ability to increase premium rates, the terms and conditions of the insurance policies we write, changes in the products offered by us or changes in our business strategy.

The financial results of the insurance and reinsurance industry are influenced by factors such as the frequency and/or severity of claims and losses, including natural disasters or other catastrophic events, variations in interest rates and financial markets, changes in the legal, regulatory and judicial environments, inflationary pressures and general economic conditions. These factors influence, among other things, the demand for insurance or reinsurance, the supply of which is generally related to the total capital of competitors in the market.

In general, market conditions improved during 2002 and 2003 in the insurance and reinsurance marketplace. This reflected improvement in pricing, terms and conditions following significant industry losses arising from the events of September 11th, as well as the recognition that intense competition in the late 1990s led to inadequate pricing and overly broad terms, conditions and coverages. Such industry developments resulted in poor financial results and erosion of the industry s capital base. Consequently, many established insurers and reinsurers reduced their participation in, or exited from, certain markets and, as a result, premium rates escalated in many lines of business. These developments provided relatively new insurers and reinsurers, like us, with an opportunity to provide needed underwriting capacity. Beginning in late 2003 and continuing through 2006, additional capacity emerged in many classes of business and, consequently, premium rate increases have decelerated significantly and, in many classes of business, premium rates have decreased. However, we believe that we are still able to write insurance and reinsurance business at what we believe to be attractive rates.

In addition, the weather-related catastrophic events that occurred in the second half of 2005 have resulted in substantial improvements in market conditions in property and certain marine business. We have increased our writings in these lines of business and, as a result, these lines, which are volatile, will represent a larger proportion of our overall book of business in future periods, which may increase the volatility in our results of operations. In order to support this expansion, we sold $325 million of non-cumulative preferred shares in 2006 and signed a quota-share reinsurance treaty with Flatiron Re Ltd., a dedicated reinsurance vehicle, which has allowed us to increase our participation in property and marine lines without significantly increasing our probable maximum loss. The treaty with Flatiron Re Ltd. provides for a profit commission based on the reported underwriting results on a cumulative basis. We record such profit commission based on underwriting experience recorded each quarter. The profit commission arrangement with Flatiron Re Ltd. may increase the volatility of our reported results of operations on both a quarterly and annual basis. As a result, our writings in the property and marine lines of business in 2006 represented a larger proportion of our overall book of business than in 2005.

History

We commenced operations in September 1995 following the completion of the initial public offering of our predecessor, Arch Capital Group (U.S.) Inc. (Arch-U.S.). Arch-U.S. is a Delaware company formed in March 1995 under the original name of Risk Capital Holdings, Inc. From that time until May 2000, we provided reinsurance and other forms of capital to insurance companies. On May 5, 2000, we sold our prior reinsurance book of business to Folksamerica Reinsurance Company (Folksamerica) in an asset sale, but retained our surplus and our U.S.-licensed reinsurance platform. On November 8, 2000, following shareholder approval, we changed our legal domicile to Bermuda in order to benefit from Bermuda s favorable business, regulatory, tax and financing environment.

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.

In October 2001, we launched an underwriting initiative to meet current and future demand in the global insurance and reinsurance markets that included the recruitment of new insurance and reinsurance management teams and an equity capital infusion of $763.2 million in the form of convertible preference shares. In April 2002, we completed an offering of common shares and received net proceeds of $179.2 million and, in September 2002, we received proceeds of $74.3 million from the exercise of class A warrants by our principal shareholders and certain other investors. In March 2004, we completed a public offering of common shares and received net proceeds of $179.3 million and, in May 2004, we completed a public offering of $300 million principal amount of 7.35% senior notes due May 1, 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 2006, we issued $325.0 million of non-cumulative preferred shares in public offerings and received net proceeds of $314.4 million.

In the 2005 fourth quarter, all remaining outstanding convertible preference shares were converted to common shares. Since the preference shares were treated as common share equivalents in our reported financial results, the conversion had no impact on diluted earnings per share or diluted book value per share. However, the convertible preference shares were not included in basic calculations prior to their conversion to common shares and, due to the timing of the conversions, basic average shares outstanding and basic earnings per share for 2005 only reflect the impact of the preference share conversion for a small portion of the year. Management does not believe that the comparison of basic earnings per share is meaningful for the 2006, 2005 or 2004 periods presented and such amounts have not been presented or discussed herein.

Revenues

We derive our revenues primarily from the issuance of insurance policies and reinsurance contracts. Insurance and reinsurance premiums are driven by the volume and classes of business of the policies and contracts that we write which, in turn, are related to prevailing market conditions. The premium we charge for the risks assumed is also based on many assumptions. We price these risks well before our ultimate costs are known, which may extend many years into the future. In addition, our revenues include fee income and income we generate from our investment portfolio. Our investment portfolio is comprised primarily of fixed income investments that are classified as available for sale. Under our basis of accounting, GAAP, these investments are carried at fair value and unrealized gains and losses on the investments are not included in our statement of income. These unrealized gains and losses are included in accumulated other comprehensive income or loss as a separate component of shareholders equity in our balance sheet.

Costs and Expenses

Our costs and expenses primarily consist of losses and loss adjustment expenses, acquisition expenses and other operating expenses. Losses and loss adjustment expenses include management s best estimate of the ultimate cost of claims incurred during a reporting period. Such costs consist of three components: paid losses, changes in estimated amounts for known losses (case reserves), and changes in reserves for incurred but not reported (IBNR) losses. See Critical Accounting Policies, Estimates and Recent Accounting Pronouncements Reserves for Losses and Loss Adjustment Expenses for further discussion. Acquisition expenses, net of ceding commissions received from unaffiliated reinsurers, consist primarily of commissions, brokerage and taxes paid to obtain our business. A significant portion of such costs is paid based on a percentage of the premium written and will vary for each class or type of business that we underwrite. Other operating expenses consist primarily of certain company costs necessary to support our worldwide insurance and reinsurance operations. A large portion of such costs are compensation-related and include share-based compensation.

Critical Accounting Policies, Estimates and Recent Accounting Pronouncements

The preparation of consolidated financial statements in accordance with GAAP requires us to make many estimates and judgments that affect the reported amounts of assets, liabilities (including reserves), revenues and expenses, and related disclosures of contingent liabilities. On an ongoing basis, we evaluate our estimates, including those related to revenue recognition, insurance and other reserves, reinsurance recoverables, allowance for doubtful accounts, investment valuations, intangible assets, bad debts, income taxes, contingencies and litigation. We base our estimates on historical experience, where possible, and on various other assumptions that we believe to be reasonable under the circumstances, which form the basis for our judgments about the carrying values of assets and liabilities that are not readily apparent from other sources. Estimates and judgments 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. Actual results will differ from these estimates and such differences may be material. We believe that the following critical accounting policies require our more significant judgments and estimates used in the preparation of our consolidated financial statements.

Reserves for Losses and Loss Adjustment Expenses

We are required by applicable insurance laws and regulations and GAAP to establish reserves for losses and loss adjustment expenses (Loss Reserves) that arise from the business we underwrite. Loss Reserves for our insurance and reinsurance operations are balance sheet liabilities representing estimates of future amounts required to pay losses and loss adjustment expenses for insured or reinsured events which have occurred at or before the balance sheet date. Loss Reserves do not reflect contingency reserve allowances to account for future loss occurrences. Losses arising from future events will be estimated and recognized at the time the losses are incurred and could be substantial.

At December 31, 2006 and 2005, our Loss Reserves, net of unpaid losses and loss adjustment expenses recoverable, by type and by operating segment were as follows:

	December 31, 2006	**2005**
	(U.S. dollars in thousands)	
Insurance:		
Case reserves.	$ 619,981	$ 421,131
IBNR reserves	1,795,510	1,413,243
Total net reserves	$ 2,415,491	$ 1,834,374
Reinsurance:		
Case reserves.	$ 605,113	$ 488,593
Additional case reserves	74,181	116,788
IBNR reserves	1,816,099	1,623,303
Total net reserves	$ 2,495,393	$ 2,228,684
Total:		
Case reserves.	$ 1,225,094	$ 909,724
Additional case reserves	74,181	116,788
IBNR reserves	3,611,609	3,036,546
Total net reserves	$ 4,910,884	$ 4,063,058

Insurance Operations

Loss Reserves for our insurance operations are comprised of (1) case reserves for claims reported and (2) reserves for losses that have occurred but for which claims have not yet been reported, referred to as IBNR reserves. For our insurance operations, generally, claims personnel determine whether to establish a case reserve for the estimated amount of the ultimate settlement of individual claims. The estimate reflects the judgment of claims personnel based on general corporate reserving practices, the experience and knowledge of such personnel regarding the nature and value of the specific type of claim and, where appropriate, advice of counsel. Our insurance operations also contract with a number of outside third party administrators in the claims process who, in certain cases, have limited authority to establish case reserves. The work of such administrators is reviewed and monitored by our claims personnel. Loss Reserves are also established to provide for loss adjustment expenses (LAE) and represent the estimated expense of settling claims, including legal and other fees and the general expenses of administering the claims adjustment process. Periodically, adjustments to the reported or case reserves may be made as additional information regarding the claims is reported or payments are made. IBNR reserves are established to provide for incurred claims which have not yet been reported to an insurer or reinsurer at the balance sheet date as well as to adjust for any projected variance in case reserving. IBNR reserves are derived by subtracting paid losses and LAE and case reserves from estimates of ultimate losses and loss adjustment expenses. Actuaries estimate ultimate losses and LAE using various generally accepted actuarial methods applied to known losses and other relevant information. Like case reserves, IBNR reserves are adjusted as additional information becomes known or payments are made. The process of estimating reserves involves a considerable degree of judgment by management and, as of any given date, is inherently uncertain.

Ultimate losses and LAE are generally determined by extrapolation of claim emergence and settlement patterns observed in the past that can reasonably be expected to persist into the future. In forecasting ultimate losses and LAE with respect to any line of business, past experience with respect to that line of business is the primary resource, developed through both industry and company experience, but cannot be relied upon in isolation. Uncertainties in estimating ultimate losses and LAE are magnified by the time lag between when a claim actually occurs and when it is reported and settled. This time lag is sometimes referred to as the claim-tail . The claim-tail for most property coverages is typically short (usually several months up to a few years). The claim-tail for certain professional liability, executive assurance and healthcare coverages, which are generally written on a claims-made basis, is typically longer than property coverages but shorter than casualty lines. The claim-tail for liability/casualty coverages, such as general liability, products liability, multiple peril coverage, and workers compensation, may be especially long as claims are often reported and ultimately paid or settled years, even decades, after the related loss events occur. During the long claims reporting and settlement period, additional facts regarding coverages written in prior accident years, as well as about actual claims and trends, may become known and, as a result, our insurance operations may adjust their reserves. If management determines that an adjustment is appropriate, the adjustment is recorded in the accounting period in which such determination is made in accordance with GAAP. Accordingly, should Loss Reserves need to be increased or decreased in the future from amounts currently established, future results of operations would be negatively or positively impacted, respectively.

In determining ultimate losses and LAE, the cost to indemnify claimants, provide needed legal defense and other services for insureds and administer the investigation and adjustment of claims are considered. These claim costs are influenced by many factors that change over time, such as expanded coverage definitions as a result of new court decisions, inflation in costs to repair or replace damaged property, inflation in the cost of medical services and legislated changes in statutory benefits, as well as by the particular, unique facts that pertain to each claim. As a result, the rate at which claims arose in the past and the costs to settle them may not always be representative of what will occur in the future. The factors influencing changes in claim costs are often difficult to isolate or quantify and developments in paid and incurred losses from historical trends are frequently subject to multiple and conflicting interpretations. Changes in coverage terms or claims handling practices may also cause future experience and/or development patterns to vary from the past. A key objective of actuaries in developing estimates of ultimate losses and LAE, and resulting IBNR reserves, is to identify aberrations and systemic changes occurring within historical experience and accurately adjust for them so that the future can be projected reliably. Because of the factors previously discussed, this process requires the substantial use of informed judgment and is inherently uncertain.

At December 31, 2006 and 2005, Loss Reserves for our insurance operations by major line of business, net of unpaid losses and loss adjustment expenses recoverable, were as follows:

	December 31,	
	2006	2005
	(U.S. dollars in thousands)	
Casualty	$ 564,959	$ 420,113
Programs	345,490	323,527
Construction and surety	385,149	267,569
Executive assurance	344,881	222,949
Professional liability	335,104	226,815
Property, marine and aviation.	304,004	259,686
Healthcare	125,913	104,464
Other	9,991	9,251
Total net reserves	$ 2,415,491	$ 1,834,374

The reserving method for our insurance operations to date has been, to a large extent, the expected loss method, which is commonly applied when limited loss experience exists. 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 our insurance operations through December 31, 2006. See below for a discussion of the key assumptions in our insurance operations reserving process.

Although Loss Reserves are initially determined based on underwriting and pricing analysis, our insurance operations apply several generally accepted actuarial methods, as discussed below, on a quarterly basis to evaluate their Loss Reserves, in addition to the expected loss method, in particular for Loss Reserves from more mature accident years (the year in which a loss occurred). As noted below, beginning in 2005, our insurance operations began to give a relatively small amount of weight to their own experience following reviews of open claims on lines of business written on a claims-made basis for which they developed a reasonable level of credible data. Each quarter, as part of the reserving process, actuaries at our insurance operations reaffirm that the assumptions used in the reserving process continue to form a sound basis for the projection of liabilities. If actual loss activity differs substantially from expectations based on historical information, an adjustment to loss reserves may be supported. As time passes, estimated Loss Reserves for a given accident year will be based more on historical loss activity and patterns than on the initial assumptions based on pricing indications. Our insurance operations place more or less reliance on a particular actuarial method based on the facts and circumstances at the time the estimates of Loss Reserves are made. These methods generally fall into one of the following categories or are hybrids of one or more of the following categories:

- *Expected loss methods* these methods are based on the assumption that ultimate losses vary proportionately with premiums. Expected loss and LAE ratios are typically developed based upon the information derived by underwriters and actuaries during the initial pricing of the business, supplemented by industry data available from organizations, such as statistical bureaus and consulting firms, where appropriate. These ratios consider, among other things, rate increases and changes in terms and conditions that have been observed in the market. Expected loss methods are useful for estimating ultimate losses and LAE in the early years of long-tailed lines of business, when little or no paid or incurred loss information is available, and is commonly applied when limited loss experience exists for a company.

- *Historical incurred loss development methods* these methods assume that the ratio of losses in one period to losses in an earlier period will remain constant in the future. These methods use incurred losses (i.e., the sum of cumulative historical loss payments plus outstanding case reserves) over discrete periods of time to estimate future losses. Historical incurred loss development methods may be preferable to historical paid loss development methods because they explicitly take into account open cases and the claims adjusters evaluations of the cost to settle all known claims. However, historical incurred loss development methods necessarily assume that case reserving practices are consistently applied over time. Therefore, when there have been significant changes in how case reserves are established, using incurred loss data to project ultimate losses may be less reliable than other methods.

- *Historical paid loss development methods* these methods, like historical incurred loss development methods, assume that the ratio of losses in one period to losses in an earlier period will remain constant. These methods use historical loss payments over discrete periods of time to estimate future losses and necessarily assume that factors that have affected paid losses in the past, such as inflation or the effects of litigation, will remain constant in the future. Because historical paid loss development methods do not use incurred losses to estimate ultimate losses, they may be more reliable than the other methods that use incurred losses in situations where there are significant changes in how incurred losses are established by a company s claims adjusters. However, historical paid loss development methods are more leveraged (meaning that small changes in payments have a larger impact on estimates of ultimate losses) than actuarial methods that use incurred losses because cumulative loss payments take much longer to equal the expected ultimate losses than cumulative incurred amounts. In addition, and for similar reasons, historical paid loss development methods are often slow to react to situations when new or different factors arise than those that have affected paid losses in the past.

- *Adjusted historical paid and incurred loss development methods* these methods take traditional historical paid and incurred loss development methods and adjust them for the estimated impact of changes from the past in factors such as inflation, the speed of claim payments or the adequacy of case reserves. Adjusted historical paid and incurred loss development methods are often more reliable methods of predicting ultimate losses in periods of significant change, provided the actuaries can develop methods to reasonably quantify the impact of changes. As such, these methods utilize more judgment than historical paid and incurred loss development methods.

- *Bornhuetter-Ferguson (B-F) paid and incurred loss methods* these methods utilize actual paid and incurred losses and expected patterns of paid and incurred losses, taking the initial expected ultimate losses into account to determine an estimate of expected ultimate losses. The B-F paid and incurred loss methods are useful when there are few reported claims and a relatively less stable pattern of reported losses.

- *Additional analyses* other methodologies are often used in the reserving process for specific types of claims or events, such as catastrophic or other specific major events. These include vendor catastrophe models, which are typically used in the estimation of Loss Reserves at the early stage of known catastrophic events before information has been reported to an insurer or reinsurer, and analyses of specific industry events, such as large lawsuits or claims.

In the initial reserving process for casualty business, primarily consisting of primary and excess exposures written on an occurrence basis, our insurance operations primarily rely on the expected loss method. The development of our insurance operations casualty business may be unstable due to its long-tail nature and the occurrence of high severity events, as a portion of our insurance operations casualty business is in high excess layers. As time passes, for a given accident year, additional weight is given to the paid and incurred B-F loss development methods and historical paid and incurred loss development methods in the reserving process. Our insurance operations make a number of key assumptions in reserving for casualty business, including that the pricing loss ratio is the best estimate of the ultimate loss ratio at the time the policy is entered into, that our insurance operations loss development patterns, which are based on industry loss development patterns and adjusted to reflect differences in our insurance operations mix of business, are reasonable and that our insurance operations claims personnel and underwriters analyses of our exposure to major events are assumed to be our best estimate of our exposure to the known claims on those events. As noted earlier, due to the long claims reporting and settlement period for casualty business, additional facts regarding coverages written in prior accident years, as well as about actual claims and trends may become known and, as a result, our insurance operations may be required to adjust their casualty reserves. The expected loss ratios used in the initial reserving process for our insurance operations casualty business for recent accident years have not varied significantly from earlier accident years due to the long-tail nature of the business written and the limited number of years of historical experience available for use in projecting loss experience using standard actuarial methods. As the credibility of historical experience for earlier accident years increases, the experience from these accident years will be given a greater weighting in the actuarial analysis to determine future accident year expected loss ratios, adjusted for changes in pricing, loss trends, terms and conditions and reinsurance structure.

In the initial reserving process for property, marine and aviation business, which are primarily short-tail exposures, our insurance operations primarily rely on the expected loss method. For catastrophe-exposed business, our insurance operations reserving process also includes the usage of catastrophe models for known events and a heavy reliance on analysis of individual catastrophic events and management judgment. The development of property losses can be unstable, especially for policies characterized by high severity, low frequency losses. As time passes, for a given accident year, additional weight is given to the paid and incurred B-F loss development methods and historical paid and incurred loss development methods in the reserving process. Our insurance operations make a number of key assumptions in their reserving process, including that historical paid and reported development patterns are stable, catastrophe models provide useful information about our exposure to catastrophic events that have occurred and our underwriters judgment as to potential loss exposures can be relied on. The expected loss ratios used in the initial reserving process for our insurance operations property business have varied over time due to changes in pricing, reinsurance structure, estimates of catastrophe losses, policy changes (such as attachment points, class and limits) and geographical distribution. As a result of the weather-related catastrophic events in the second half of 2005 (and to a lesser extent in 2004), there has been a substantial improvement in rates and market conditions in property lines. As losses in property lines are reported relatively quickly, expected loss ratios are selected for the current accident year based upon actual attritional loss ratios for earlier accident years, adjusted for rate changes, inflation, changes in reinsurance programs and expected attritional losses based on modeling. Due to the short-tail nature of property business, reported loss experience emerges quickly and ultimate losses are known in a reasonably short period of time.

In addition to the assumptions and development characteristics noted above for casualty and property business, our insurance operations authorize managing general agents, general agents and other producers to write program business on their behalf within prescribed underwriting authorities. This adds additional complexity to the reserving process. To monitor adherence to the underwriting guidelines given to such parties, our insurance operations periodically perform claims due diligence reviews. In the initial reserving process for program business, consisting of property and liability exposures which are primarily written on an occurrence basis, our insurance operations primarily rely on the expected loss method. As time passes, for a given accident year, additional weight is given to the paid and incurred B-F loss development methods and historical paid and incurred loss development methods in the reserving process. The expected loss ratios used in the initial reserving process for our insurance operations program business have varied over time depending on the type of exposures written (casualty or property) and changes in pricing, loss trends, reinsurance structure and changes in the underlying business.

In the initial reserving process for executive assurance, professional liability and healthcare business, primarily consisting of medium-tail exposures written on a claims-made basis, our insurance operations primarily rely on the expected loss method. As time passes, for a given accident year, additional weight is given to the paid and incurred B-F loss development methods and historical paid and incurred loss development methods in the reserving process. Beginning in 2005, our insurance operations began to give a relatively small amount of weight to their own experience following reviews of open claims, in particular for lines of business written on a claims-made basis for which they developed a reasonable level of credible data. In general, the expected loss ratios for executive assurance, professional liability and healthcare business for recent accident years have not varied significantly from earlier accident years since this business is primarily written on a claims-made basis and is subject to high severity, low frequency losses. In addition, only a limited number of years of historical experience is available for use in projecting loss experience using standard actuarial methods. As the credibility of historical experience for earlier accident years increases, the experience from these accident years will be given a greater weighting in the actuarial analysis to determine future accident year expected loss ratios, adjusted for the occurrence or lack of large losses, changes in pricing, loss trends, terms and conditions and reinsurance structure.

In the initial reserving process for construction and surety business, consisting of primary and excess casualty and contract surety coverages written on an occurrence and claims-made basis, our insurance operations primarily rely on the expected loss method. Such business is subject to the assumptions and development characteristics noted above for casualty business. As time passes, for a given accident year, additional weight is given to the paid and incurred B-F loss development methods and historical paid and incurred loss development methods in the reserving process. The expected loss ratios used in the initial reserving process for our insurance operations construction and surety business for recent accident years have not varied significantly from earlier accident years due to the medium-tail nature of the business written and the limited number of years of historical experience available for use in actuarial methods. As the credibility of historical experience for earlier accident years increases, the experience from these accident years will be given a greater weighting in the actuarial analysis to determine future accident year expected loss ratios, adjusted for anticipated changes in the regulatory environment, pricing, loss trends, terms and conditions and reinsurance structure.

For the years ended December 31, 2004 to 2006, on average, our insurance segment has reported approximately $16 million of estimated net favorable development in prior year Loss Reserves, or approximately 1.4% of average beginning Loss Reserves. Of such amount, approximately $19 million came from long-tail lines, or 4.1% of average beginning Loss Reserves, and $6 million from medium-tail lines, or 1.1% of beginning Loss Reserves, offset partially by adverse development on $9 million from short-tail lines, or 5% of average beginning Loss Reserves. The average adverse development on short-tail lines resulted from $31 million of adverse development recorded in 2006 on the 2005 catastrophic events. For the year ended December 31, 2006, estimated net favorable development in prior year Loss Reserves was $8 million, or 0.5% of beginning Loss Reserves. Such amount consisted of approximately $32 million from long-tail lines, or 4.5% of beginning Loss Reserves, and $20 million from medium-tail lines, or 2.5% of beginning Loss Reserves, partially offset by adverse development of $44 million from short-tail lines (which included $31 million of adverse development on the 2005 catastrophic events), or 14.2% of beginning Loss Reserves. For informational purposes, based on historical results, applying the 1.4% average estimated net favorable development in average beginning Loss Reserves for the years ended December 31, 2004 to 2006 to our insurance segment s net Loss Reserves of $2.42 billion at December 31, 2006 would result in an increase in income before income taxes of approximately $33 million, or $0.43 per diluted share, and applying the 0.5% of estimated net favorable development in beginning Loss Reserves for the year ended December 31, 2006 to such Loss Reserves would result in an increase in income before income taxes of approximately $11 million, or $0.14 per diluted share. The amounts noted above are informational only and should not be considered projections of future events. Future favorable or adverse development in our insurance segment s Loss Reserves is subject to numerous factors, and no assurances can be given that we will experience favorable development in our Loss Reserves or that our ultimate losses will not be significantly different than the amounts shown above, and such differences could directly and significantly impact earnings favorably or unfavorably in the period they are determined. Because of our insurance segment s limited operating history, the sensitivity analysis above is one way to gauge the impact of changes in the assumptions in our reserving process. For another estimate of potential variability in our insurance segment s Loss Reserves, see Simulation Results. Refer to Results of Operations for a discussion on net favorable or adverse development of our insurance operations prior year Loss Reserves.

Reinsurance Operations

Loss Reserves for our reinsurance operations are comprised of (1) case reserves for claims reported, (2) additional case reserves (ACRs) and (3) IBNR reserves. Our reinsurance operations receive reports of claims notices from ceding companies and record case reserves based upon the amount of reserves recommended by the ceding company. Case reserves on known events may be supplemented by ACRs, which are often estimated by our reinsurance operations claims personnel ahead of official notification from the ceding company, or when our reinsurance operations judgment regarding the size or severity of the known event differs from the ceding company. In certain instances, our reinsurance operations establish ACRs even when the ceding company does not report any liability on a known event. In addition, specific claim information reported by ceding companies or obtained through claim audits can alert our reinsurance operations to emerging trends such as changing legal interpretations of coverage and liability, claims from unexpected sources or classes of business, and significant changes in the frequency or severity of individual claims. Such information is often used in the process of estimating IBNR reserves.

The estimation of Loss Reserves for our reinsurance operations is subject to the same risk factors as the estimation of Loss Reserves for our insurance operations. In addition, the inherent uncertainties of estimating such reserves are even greater for reinsurers, due primarily to: (1) the claim-tail for reinsurers is generally longer because claims are first reported to the ceding company and then to the reinsurer through one or more intermediaries, (2) the reliance on premium estimates, where reports have not been received from the ceding company, in the reserving process, (3) the potential for writing a number of reinsurance contracts with different ceding companies with the same exposure to a single loss event, (4) the diversity of loss development patterns among different types of reinsurance treaties or facultative contracts, (5) the necessary reliance on the ceding companies for information regarding reported claims and (6) the differing reserving practices among ceding companies.

As with our insurance operations, the process of estimating Loss Reserves for our reinsurance operations involves a considerable degree of judgment by management and, as of any given date, is inherently uncertain. As discussed above, such uncertainty is greater for reinsurers compared to insurers. As a result, our reinsurance operations obtain information from numerous sources to assist in the process. Pricing actuaries from our reinsurance operations devote considerable effort to understanding and analyzing a ceding company s operations and loss history during the underwriting of the business, using a combination of ceding company and industry statistics. Such statistics normally include historical premium and loss data by class of business, individual claim information for larger claims, distributions of insurance limits provided, loss reporting and payment patterns, and rate change history. This analysis is used to project expected loss ratios for each treaty during the upcoming contract period.

As mentioned above, there can be a considerable time lag from the time a claim is reported to a ceding company to the time it is reported to the reinsurer. The lag can be several years in some cases and may be attributed to a number of reasons, including the time it takes to investigate a claim, delays associated with the litigation process, the deterioration in a claimant s physical condition many years after an accident occurs, the case reserving approach of the ceding company, etc. In the reserving process, our reinsurance operations assume that such lags are predictable, on average, over time and therefore the lags are contemplated in the loss reporting patterns used in their actuarial methods. This means that our reinsurance operations must rely on estimates for a longer period of time than does an insurance company.

Backlogs in the recording of assumed reinsurance can also complicate the accuracy of loss reserve estimation. As of December 31, 2006, there were no significant backlogs related to the processing of assumed reinsurance information at our reinsurance operations.

Our reinsurance operations rely heavily on information reported by ceding companies, as discussed above. In order to determine the accuracy and completeness of such information, underwriters, actuaries, and claims personnel at our reinsurance operations often perform audits of ceding companies and regularly review information received from ceding companies for unusual or unexpected results. Material findings are usually discussed with the ceding companies. Our reinsurance operations sometime encounter situations where it determines that a claim presentation from a ceding company is not in accordance with contract terms. In these situations, our reinsurance operations attempt to resolve the dispute with the ceding company. Most situations are resolved amicably and without the need for litigation or arbitration. However, in the infrequent situations where a resolution is not possible, our reinsurance operations will vigorously defend their position in such disputes.

At December 31, 2006 and 2005, Loss Reserves for our reinsurance operations by major line of business, net of unpaid losses and loss adjustment expenses recoverable, were as follows:

	December 31, 2006	2005
	(U.S. dollars in thousands)	
Casualty	$1,545,363	$1,308,657
Property excluding property catastrophe	306,990	264,949
Other specialty.	239,132	266,600
Marine and aviation	176,144	175,375
Property catastrophe	147,031	103,200
Other	80,733	109,903
Total net reserves	$2,495,393	$2,228,684

The reserving method for our reinsurance operations to date has been, to a large extent, the expected loss method, which is commonly applied when limited loss experience exists. 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 our reinsurance operations through December 31, 2006. See below for a discussion of the key assumptions in our reinsurance operations reserving process.

Although Loss Reserves are initially determined based on underwriting and pricing analysis, our reinsurance operations apply several generally accepted actuarial methods, as discussed above, on a quarterly basis to evaluate their Loss Reserves in addition to the expected loss method, in particular for Loss Reserves from more mature underwriting years (the year in which business is underwritten). Each quarter, as part of the reserving process, actuaries at our reinsurance operations reaffirm that the assumptions used in the reserving process continue to form a sound basis for projection of liabilities. If actual loss activity differs substantially from expectations based on historical information, an adjustment to loss reserves may be supported. As time passes, for a given underwriting year, the reserving process to estimate Loss Reserves will be based more on actual loss activity and historical patterns than on initial assumptions based on pricing indications. Our reinsurance operations place more or less reliance on a particular actuarial method based on the facts and circumstances at the time the estimates of Loss Reserves are made.

In the initial reserving process for medium-tail and long-tail lines, consisting of casualty, other specialty, marine and aviation and other exposures, our reinsurance operations primarily rely on the expected loss method. The development of medium-tail and long-tail business may be unstable, especially if there are high severity major events, with business written on an excess of loss basis typically having a longer tail than business written on a pro rata basis. As time passes, for a given underwriting year, additional weight is given to the paid and incurred B-F loss development methods and historical paid and incurred loss development methods in the reserving process. Our reinsurance operations make a number of key assumptions in reserving for medium-tail and long-tail lines, including that the pricing loss ratio is the best estimate of the ultimate loss ratio at the time the contract is entered into, historical paid and reported development patterns are stable and our reinsurance operations claims personnel and underwriters analyses of our exposure to major events are assumed to be our best estimate of our exposure to the known claims on those events. The expected loss ratios used in our reinsurance operations initial reserving process for medium-tail and long-tail contracts have varied over time due to changes in pricing, terms and conditions and reinsurance structure. As the credibility of historical experience for earlier underwriting years increases, the experience from these underwriting years will be used in the actuarial analysis to determine future underwriting year expected loss ratios, adjusted for changes in pricing, loss trends, terms and conditions and reinsurance structure.

The process of estimating Loss Reserves for our reinsurance operations involves a considerable degree of judgment by management and, as of any given date, is inherently uncertain. The inherent uncertainties of estimating such reserves are even greater for reinsurers than for insurers due to the longer claim-tail for reinsurers, the reliance on premium estimates in the reserving process, the diversity and instability of loss development patterns, the necessary reliance on the ceding companies for information regarding reported claims and the differing reserving practices among ceding companies. In addition, as a result of the start up nature of our reinsurance operations in 2002 and 2003, the assumptions used in the initial loss estimates were subject to greater uncertainty than for an established company, especially for casualty reinsurance exposures (which have a longer claim-tail and involve a higher degree of judgment by management than short-tail lines). In the reserving process in 2002 and 2003, our reinsurance operations recognized that there is a possibility that the assumptions made could prove to be inaccurate due to the factors discussed above related to the start up nature of their operations in both periods.

In response to such factors, and their impact on the credibility of the initial loss estimates for casualty reinsurance exposures, a provision was included in establishing our reinsurance operations net Loss Reserves in 2002 and 2003 on casualty losses occurring prior to each balance sheet date. As of December 31, 2003, the provision, included in IBNR, was $49.0 million (or 5.0% of our reinsurance operations net Loss Reserves). Due to the additional data our reinsurance operations had gained on its existing book of business by the end of 2003, it was determined that it was no longer necessary to continue to include a provision in the reserving process beginning in 2004. Based on the recommendation of an independent actuarial firm, our reinsurance operations adopted a methodology to evaluate the existing provision by comparing actual claims experience to a schedule of expected claims experience prepared by the independent actuarial firm. If the actual claims experience is in line with the expected claims experience, a reduction of the provision is made based on the schedule established in the review. For the years ended December 31, 2006, 2005 and 2004, following reviews of actual and expected claims experience, our reinsurance operations reduced the provision by $7.7 million, $12.1 million and $7.3 million, respectively. At December 31, 2006, the remaining provision included in our reinsurance operations Loss Reserves was $21.9 million (or 0.9% of our reinsurance operations net Loss Reserves), compared to $29.6 million (or 1.3% of our reinsurance operations net Loss Reserves) at December 31, 2005.

In the initial reserving process for short-tail lines, consisting of property excluding property catastrophe and property catastrophe exposures, our reinsurance operations primarily rely on the expected loss method. For known catastrophic events, our reinsurance operations reserving process also includes the usage of catastrophe models and a heavy reliance on analysis which includes ceding company inquiries and management judgment. The development of property losses may be unstable, especially where there is high catastrophic exposure, may be characterized by high severity, low frequency losses for excess and catastrophe-exposed business and may be highly correlated across contracts. As time passes, for a given underwriting year, additional weight is given to the paid and incurred B-F loss development methods and historical paid and incurred loss development methods in the reserving process. Our reinsurance operations make a number of key assumptions in reserving for short-tail lines, including that historical paid and reported development patterns are stable, catastrophe models provide useful information about our exposure to catastrophic events that have occurred and our underwriters judgment and guidance received from ceding companies as to potential loss exposures may be relied on. The expected loss ratios used in the initial reserving process for our reinsurance operations property exposures have varied over time due to changes in pricing, reinsurance structure, estimates of catastrophe losses, terms and conditions and geographical distribution. As losses in property lines are reported relatively quickly, expected loss ratios are selected for the current underwriting year incorporating the experience for earlier underwriting years, adjusted for rate changes, inflation, changes in reinsurance programs, expectations about present and future market conditions and expected attritional losses based on modeling. Due to the short-tail nature of property business, reported loss experience emerges quickly and ultimate losses are known in a reasonably short period of time.

For the years ended December 31, 2004 to 2006, on average, our reinsurance segment has reported approximately $82 million of estimated net favorable development in prior year Loss Reserves, or 5.1% of average beginning Loss Reserves. Of such amount, approximately $66 million came from short-tail lines, or 10.6% of average beginning Loss Reserves, and $16 million came from medium-tail and long-tail lines, or 1.6% of average beginning Loss Reserves. For the year ended December 31, 2006, estimated net favorable development in prior year Loss Reserves was $69 million, or 3.1% of beginning Loss Reserves. Of such amount, approximately $37 million came from short-tail lines, or 5.3% of beginning Loss Reserves, and $32 million came from medium-tail and long-tail lines, or 2.1% of beginning Loss Reserves. The $69 million of estimated net favorable development during 2006 reflected approximately $38 million of adverse development on the 2005 catastrophic events, primarily in short-tail lines. For informational purposes, based on our reinsurance segment s historical results, applying the 5.1% average estimated net favorable development in average beginning Loss Reserves for the years ended December 31, 2004 to 2006 to our reinsurance segment s net Loss Reserves of $2.5 billion at December 31, 2006 would result in an increase in income before income taxes of approximately $126 million, or $1.66 per diluted share, while using the 3.1% of estimated net favorable development in beginning Loss Reserves for the year ended December 31, 2006 to such Loss Reserves would result in an increase in income before income taxes of approximately $77 million, or $1.01 per diluted share. The amounts noted above are informational only and should not be considered projections of future events. Future favorable or adverse development in our reinsurance segment s Loss Reserves is subject to numerous factors, and no assurances can be given that we will experience favorable development in our Loss Reserves or that our ultimate losses will not be significantly different than the amounts shown above, and such differences could directly and significantly impact earnings favorably or unfavorably in the period they are determined. Because of our reinsurance segment s limited operating history, the sensitivity analysis above is one way to gauge the impact of changes in the assumptions in our reserving process. For another estimate of potential variability in our reinsurance segment s Loss Reserves, see Simulation Results. Refer to Results of Operations for additional discussion on net favorable or adverse development of our reinsurance operations prior year Loss Reserves.

Simulation Results

Generally, due to the insufficient amount of historical loss data for our insurance and reinsurance operations in many lines of business, we do not produce a range of estimates in calculating reserves. As described above, we primarily use the expected loss method to calculate our initial Loss Reserves, and such amounts represent management s best estimate of our ultimate liabilities. As the loss data has developed, other actuarial methods have been given more weight in our reserving process for certain lines of business. In order to illustrate the potential volatility in our reserves for losses and loss adjustment expenses, we used a statistical model to simulate a range of results based on various probabilities. Both the probabilities and related modeling are subject to inherent uncertainties. The simulation relies on a significant number of assumptions, such as the potential for multiple entities to react similarly to external events, and includes other statistical assumptions.

Our recorded estimate of reserves for losses and loss adjustment expenses, net of unpaid losses and loss adjustment expenses recoverable, by operating segment at December 31, 2006, along with the results of the simulation are as follows:

	December 31, 2006		
	Insurance	Reinsurance	Total
	(U.S. dollars in thousands)		
Total net reserves	$ 2,415,491	$ 2,495,393	$ 4,910,884
Simulation results:			
90th percentile(1)	$ 2,899,813	$ 3,188,911	$ 5,884,245
10th percentile(2)	$ 1,971,686	$ 1,895,242	$ 4,027,167

(1) Simulation results indicate that a 90 percent probability exists that the net reserves for losses and loss adjustment expenses will not exceed the indicated amount.

(2) Simulation results indicate that a 10 percent probability exists that the net reserves for losses and loss adjustment expenses will be at or below the indicated amount.

The simulation results shown for each segment do not add to the total simulation results, as the individual segment simulation results do not reflect the diversification effects across our segments. For informational purposes, based on the total simulation results, a change in our Loss Reserves to the amount indicated at the 90th percentile would result in a decrease in income before income taxes of approximately $973 million, or $12.77 per diluted share, while a change in our Loss Reserves to the amount indicated at the 10th percentile would result in an increase in income before income taxes of approximately $884 million, or $11.59 per diluted share. The simulation results noted above are informational only, and no assurance can be given that our ultimate losses will not be significantly different than the simulation results shown above, and such differences could directly and significantly impact earnings favorably or unfavorably in the period they are determined.

We do not have significant exposure to pre-2002 liabilities, such as asbestos-related illnesses and other long-tail liabilities and, to date, we have experienced a relatively low level of reported claims activity in many lines of business, particularly in longer-tailed lines such as primary and excess casualty and executive assurance, which have longer time periods during which claims are reported and paid. Our limited history does not provide meaningful trend information for such lines of business.

Ceded Reinsurance

In the normal course of business, our insurance operations cede a substantial portion of their premium through pro rata, excess of loss and facultative reinsurance agreements. Our reinsurance operations also obtain reinsurance whereby another reinsurer contractually agrees to indemnify it for all or a portion of the reinsurance risks underwritten by our reinsurance operations. Such arrangements, where one reinsurer provides reinsurance to another reinsurer, are usually referred to as retrocessional reinsurance arrangements. In addition, our reinsurance subsidiaries participate in common account retrocessional arrangements for certain pro rata treaties. Such arrangements reduce the effect of individual or aggregate losses to all companies participating on such treaties, including the reinsurers, such as our reinsurance operations, and the ceding company. Reinsurance recoverables are recorded as assets, predicated on the reinsurers ability to meet their obligations under the reinsurance agreements. If the reinsurers are unable to satisfy their obligations under the agreements, our insurance or reinsurance operations would be liable for such defaulted amounts.

The availability and cost of reinsurance and retrocessional protection is subject to market conditions, which are beyond our control. Although we believe that our insurance and reinsurance operations have been successful in obtaining reinsurance and retrocessional protection since the commencement of our underwriting initiative in October 2001, it is not certain that they will be able to continue to obtain adequate protection at cost effective levels. As a result of such market conditions and other factors, our insurance and reinsurance operations may not be able successfully to mitigate risk through reinsurance and retrocessional arrangements and may lead to increased volatility in our results of operations in future periods. See 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.

In addition to the use of individual per risk and inuring reinsurance contracts to limit exposure, our insurance operations had in force during 2005 a catastrophe reinsurance program which provides coverage for certain property catastrophe-related losses occurring during the contract period equal to a maximum of 95% of the first $200 million in excess of a $50 million retention per occurrence of such losses. Estimated losses related to Hurricane Katrina and Hurricane Wilma have exceeded the per occurrence retention. Based on current estimates, our insurance operations has recorded recoverables of approximately $122.4 million through such coverage for Hurricane Katrina and $6.9 million for Hurricane Wilma with approximately $53.1 million of remaining available coverage for Hurricane Katrina and $183.1 million of remaining available coverage for Hurricane Wilma should the actual amount of losses ultimately attributable to such events exceed current estimates. Amounts shown for Hurricane Katrina are net of reinstatement premiums.

Estimates for our insurance operations related to Hurricanes Katrina, Rita and Wilma and other catastrophic events that occurred in the second half of 2005 are based on currently available information derived from modeling techniques, industry assessments of exposure, claims information obtained from its clients and brokers to date and a review of its in-force contracts. Actual losses from these events may vary materially from the insurance operations estimates due to the inherent uncertainties in making such determinations resulting from several factors, including the preliminary nature of available information, the potential inaccuracies and inadequacies in the data provided by clients and brokers, the modeling techniques and the application of such techniques, the contingent nature of business interruption exposures, the effects of any resultant demand surge on claims activity and attendant coverage issues. In addition, actual losses may increase if reinsurers dispute or fail to meet their obligations to our insurance operations or the reinsurance protections purchased by our insurance operations are exhausted or are otherwise unavailable.

Our insurance operations had in effect during 2006 a reinsurance program which provided coverage equal to a maximum of 92% of the first $325 million in excess of a $75 million retention per occurrence for certain property catastrophe-related losses occurring during 2006. In the 2007 first quarter, our insurance operations renewed its reinsurance program which provides coverage for certain property-catastrophe related losses occurring during 2007 equal to a maximum of 88% of the first $325 million in excess of a $75 million retention per occurrence. The cost of the coverage in 2007 was higher than in 2006.

On December 29, 2005, Arch Re Bermuda entered into a quota share reinsurance treaty with Flatiron Re Ltd., a newly-formed Bermuda reinsurance company, pursuant to which Flatiron Re Ltd. is assuming a 45% quota share (the Flatiron Treaty) of certain lines of property and marine business underwritten by Arch Re Bermuda for unaffiliated third parties for the 2006 and 2007 underwriting years (January 1, 2006 to December 31, 2007). The quota share is subject to decrease by Arch Re Bermuda under certain circumstances. In addition, in certain circumstances, Flatiron Re Ltd. may extend at its option the coverage provided by the Flatiron Treaty to Arch Re Bermuda s 2008 underwriting year. 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 does not incept beyond September 30, 2006. The ceding percentage for all business bound outside of this period will continue to be 45%, subject to adjustment as provided under the Flatiron Treaty. Arch Re Bermuda pays to Flatiron Re Ltd. a reinsurance premium in the amount of the ceded percentage of the original gross written premium on the business reinsured with Flatiron Re Ltd. less a ceding commission, which includes a reimbursement of direct acquisition expenses as well as a commission to Arch Re Bermuda for generating the business. The Flatiron Treaty also provides for a profit commission to Arch Re Bermuda based on the underwriting results for the 2006 and 2007 underwriting years on a cumulative basis. Arch Re Bermuda records such profit commission based on underwriting experience recorded each quarter. As a result, the profit commission arrangement with Flatiron Re Ltd. may increase the volatility of our reported results of operations on both a quarterly and annual basis.

Our reinsurance operations previously purchased a catastrophe reinsurance program which provides up to $55 million of coverage in excess of certain deductibles for any one occurrence and $110 million in the aggregate annually, for certain catastrophe-related losses worldwide occurring during the period from May 2005 through April 2006. Based on current estimates, our reinsurance operations have recorded recoverables of approximately $82.2 million, net of reinstatement premiums, related to the 2005 catastrophic events. The recovery represents full usage of the available coverage under the reinsurance program, and the coverage was not renewed upon expiration. Estimates for our reinsurance operations related to Hurricanes Katrina, Rita and Wilma and other catastrophic events that occurred in the second half of 2005 are based on currently available information derived from modeling techniques, industry assessments of exposure, claims information obtained from its clients and brokers to date and a review of its in-force contracts. Actual losses from these events may vary materially from our reinsurance operations estimates due to the inherent uncertainties in making such determinations resulting from several factors, including the preliminary nature of available information, the potential inaccuracies and inadequacies in the data provided by clients and brokers, the modeling techniques and the application of such techniques, the contingent nature of business interruption exposures, the effects of any resultant demand surge on claims activity and attendant coverage issues. In addition, actual losses may increase if reinsurers dispute or fail to meet their obligations to our reinsurance operations or the reinsurance protections purchased by our reinsurance operations are otherwise unavailable. While our reinsurance operations purchase industry loss warranty contracts and other reinsurance which is intended to limit their exposure, the non-renewal of the catastrophe reinsurance program increases the risk retention of our reinsurance operations and, as a result, may increase the volatility in our results of operations in future periods.

Premium Revenues and Related Expenses

Insurance premiums written are generally recorded at the policy inception and are primarily earned on a pro rata basis over the terms of the policies for all products, usually twelve months. Premiums written include estimates in most of our insurance operations lines of business. The amount of such insurance premium estimates included in premiums receivable and other assets at December 31, 2006 and 2005 was $76.4 million and $25.9 million, respectively. Such premium estimates are derived from multiple sources which include the historical experience of the underlying business, similar business and available industry information. Unearned premium reserves represent the portion of premiums written that relates to the unexpired terms of in-force insurance policies.

Reinsurance premiums written include amounts reported by brokers and ceding companies, supplemented by our own estimates of premiums where reports have not been received or in cases where the amounts reported by brokers and ceding companies are adjusted to reflect management s best judgments and expectations. Premium estimates are derived from multiple sources which include our underwriters, the historical experience of the underlying business, similar business and available industry information. Premiums written are recorded based on the type of contracts we write. Premiums on our excess of loss and pro rata reinsurance contracts are estimated when the business is underwritten. For excess of loss contracts, the minimum premium, as defined in the contract, is generally recorded as an estimate of premiums written as of the inception date of the treaty. Estimates of premiums written under pro rata contracts are recorded in the period in which the underlying risks are expected to incept and are based on information provided by the brokers and the ceding companies. For multi-year reinsurance treaties which are payable in annual installments, generally, only the initial annual installment is included as premiums written at policy inception due to the ability of the reinsured to commute or cancel coverage during the term of the policy. The remaining annual installments are included as premiums written at each successive anniversary date within the multi-year term.

Reinstatement premiums for our insurance and reinsurance operations are recognized at the time a loss event occurs, where coverage limits for the remaining life of the contract are reinstated under pre-defined contract terms. Reinstatement premiums, if obligatory, are fully earned when recognized. The accrual of reinstatement premiums is based on an estimate of losses and loss adjustment expenses, which reflects management s judgment, as described above in Reserves for Losses and Loss Adjustment Expenses.

The amount of reinsurance premium estimates included in premiums receivable and the amount of related acquisition expenses by type of business were as follows at December 31, 2006 and 2005:

	December 31, 2006			2005		
	Gross Amount	Acquisition Expenses	Net Amount	Gross Amount	Acquisition Expenses	Net Amount
	(U.S. dollars in thousands)					
Casualty	$ 191,842	($52,382)	$ 139,460	$ 241,801	($68,603)	$ 173,198
Property excluding property catastrophe	110,996	(26,653)	84,343	103,238	(23,118)	80,120
Other specialty	85,886	(26,166)	59,720	94,177	(24,971)	69,206
Marine and aviation	76,167	(19,440)	56,727	62,472	(16,981)	45,491
Property catastrophe	23,079	(3,694)	19,385	6,005	(1,084)	4,921
Other	1,554	(101)	1,453	6,787	(1,887)	4,900
Total	$ 489,524	($128,436)	$ 361,088	$ 514,480	($136,644)	$ 377,836

Premium estimates are reviewed by management at least quarterly. Such review includes a comparison of actual reported premiums to expected ultimate premiums along with a review of the aging and collection of premium estimates. Based on management s review, the appropriateness of the premium estimates is evaluated, and any adjustment to these estimates is recorded in the period in which it becomes known. Adjustments to premium estimates could be material and such adjustments could directly and significantly impact earnings favorably or unfavorably in the period they are determined because the estimated premium may be fully or substantially earned.

A significant portion of amounts included as premiums receivable, which represent estimated premiums written, net of commissions, are not currently due based on the terms of the underlying contracts. Based on currently available information, management believes that the premium estimates included in premiums receivable will be collectible and, therefore, no provision for doubtful accounts has been recorded on the premium estimates at December 31, 2006.

Reinsurance premiums assumed, irrespective of the class of business, are generally earned on a pro rata basis over the terms of the underlying policies or reinsurance contracts. Contracts and policies written on a losses occurring basis cover claims that may occur during the term of the contract or policy, which is typically 12 months. Accordingly, the premium is earned evenly over the term. Contracts which are written on a risks attaching basis cover claims which attach to the underlying insurance policies written during the terms of such contracts. Premiums earned on such contracts usually extend beyond the original term of the reinsurance contract, typically resulting in recognition of premiums earned over a 24-month period.

Certain of our reinsurance contracts include provisions that adjust premiums or acquisition expenses based upon the experience under the contracts. Premiums written and earned, as well as related acquisition expenses, are recorded based upon the projected experience under such contracts.

We also write certain business that is intended to provide insurers with risk management solutions that complement traditional reinsurance. Under these contracts, we assume a measured amount of insurance risk in exchange for an anticipated margin, which is typically lower than on traditional reinsurance contracts. The terms and conditions of these contracts may include additional or return premiums based on loss experience, loss corridors, sublimits and caps. Examples of such business include aggregate stop-loss coverages, financial quota share coverages and multi-year retrospectively rated excess of loss coverages. If these contracts are deemed to transfer risk, they are accounted for as reinsurance.

Certain assumed reinsurance contracts, which pursuant to Statement of Financial Accounting Standards No. 113 (SFAS No. 113), Accounting and Reporting for Reinsurance of Short-Duration and Long-Duration Contracts, issued by the Financial Accounting Standards Board (FASB), are deemed not to transfer insurance risk, are accounted for using the deposit method of accounting as prescribed in Statement of Position 98-7 (SOP 98-7), Deposit Accounting: Accounting for Insurance and Reinsurance Contracts That Do Not Transfer Insurance Risk. However, it is possible that we could incur financial losses on such contracts. Management exercises significant judgment in the assumptions used in determining whether assumed contracts should be accounted for as reinsurance contracts under SFAS No. 113 or deposit insurance contracts under SOP 98-7. Under SOP 98-7, for those contracts that contain an element of underwriting risk, the estimated profit margin is deferred and amortized over the contract period and such amount is included in our underwriting results. When the estimated profit margin is explicit, the margin is reflected as fee income and any adverse financial results on such contracts are reflected as incurred losses. When the estimated profit margin is implicit, the margin is reflected as an offset to paid losses and any adverse financial results on such contracts are reflected as incurred losses. For those contracts that do not transfer an element of underwriting risk, the projected profit is reflected in earnings over the estimated settlement period using the interest method and such profit is included in investment income. Additional judgments are required when applying the accounting guidance set forth in SOP 98-7 with respect to the revenue recognition criteria for contracts deemed not to transfer insurance risk.

Retroactive reinsurance reimburses a ceding company for liabilities incurred as a result of past insurable events covered by the underlying policies reinsured. In certain instances, reinsurance contracts cover losses both on a prospective basis and on a retroactive basis and, accordingly, we bifurcate the prospective and retrospective elements of these reinsurance contracts and account for each element separately. Underwriting income generated in connection with retroactive reinsurance contracts is deferred and amortized into income over the settlement period while losses are charged to income immediately. Subsequent changes in estimated or actual cash flows under such retroactive reinsurance contracts are accounted for by adjusting the previously deferred amount to the balance that would have existed had the revised estimate been available at the inception of the reinsurance transaction, with a corresponding charge or credit to income.

Acquisition expenses and other expenses that vary with, and are directly related to, the acquisition of business in our underwriting operations are deferred and amortized over the period in which the related premiums are earned. Acquisition expenses, net of ceding commissions received from unaffiliated reinsurers, consist primarily of commissions, brokerage and taxes paid to obtain our business. Other operating expenses also include expenses that vary with, and are directly related to, the acquisition of business. Deferred acquisition costs, which are based on the related unearned premiums, are carried at their estimated realizable value and take into account anticipated losses and loss adjustment expenses, based on historical and current experience, and anticipated investment income.

Collection of Insurance-Related Balances and Provision for Doubtful Accounts

For purposes of managing risk, we reinsure a portion of our exposures, paying to reinsurers a part of the premiums received on the policies we write, and we may also use retrocessional protection. Ceded premiums written represented approximately 29.5% of gross premiums written for 2006, compared to 21.8% for 2005 and 18.8% for 2004.

The availability and cost of reinsurance and retrocessional protection is subject to market conditions, which are beyond our control. Although we believe that our insurance subsidiaries have been successful in obtaining reinsurance protection since the commencement of our underwriting initiative in October 2001, it is not certain that we will be able to obtain adequate protection at cost effective levels. As a result of such market conditions and other factors, we may not be able to successfully mitigate risk through reinsurance and retrocessional arrangements. Further, we are subject to credit risk with respect to our reinsurers and retrocessionaires 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. We are also subject to risks based upon the possibility that loss payments could occur earlier than the receipt of related reinsurance recoverables. 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.

We monitor the financial condition of our reinsurers and attempt to place coverages only with substantial, financially sound carriers. At December 31, 2006 and 2005, approximately 92.3% and 92.6%, respectively, of our reinsurance recoverables on paid and unpaid losses (not including prepaid reinsurance premiums) of $1.67 billion and $1.47 billion, respectively, were due from carriers which had an A.M. Best rating of A- or better. At December 31, 2006 and 2005, the largest reinsurance recoverables from any one carrier were less than 5.1% and 5.6%, respectively, of our total shareholders equity.

The following table details our reinsurance recoverables at December 31, 2006:

	% of Total		A.M. Best Rating(1)
Everest Reinsurance Company	10.8	%	A+
Lloyd s of London syndicates(2)	9.3	%	A
Munich Reinsurance America, Inc.	7.8	%	A
Allied World Assurance Company Ltd.	5.4	%	A
Endurance Reinsurance Corp. of America	5.1	%	A-
Odyssey America Reinsurance Corporation(3)	4.6	%	A
Swiss Reinsurance America Corporation	4.5	%	A+
ACE Property & Casualty Insurance Company	3.3	%	A+
Platinum Underwriters Reinsurance Inc.	3.2	%	A
Flatiron Re Ltd.(4)	3.1	%	NR
Max Re Ltd.	3.1	%	A-
Transatlantic Reinsurance Company	3.1	%	A+
Sentry Insurance a Mutual Company(5)	3.1	%	A+
Federal Insurance Company	2.9	%	A++
GE Frankona Reinsurance Ltd.	2.5	%	A-
All other(6)	28.2	%	
Total	100.0	%	

(1) The financial strength ratings are as of January 30, 2007 and were assigned by A.M. Best based on its opinion of the insurer s financial strength as of such date. An explanation of the ratings listed in the table follows: the ratings of A++ and A+ are designated Superior ; the A and A- ratings

are designated Excellent ; and the rating of B++ is designated Very Good. Additionally, A.M. Best has five classifications within the Not Rated or NR category. Reasons for an NR rating being assigned by A.M. Best include insufficient data, size or operating experience, companies which are in run-off with no active business writings or are dormant, companies which disagree with their rating and request that a rating not be published or insurers that request not to be formally evaluated for the purposes of assigning a rating opinion.

(2) The A.M. Best group rating of A (Excellent) has been applied to all Lloyd s of London syndicates.

(3) Approximately 63% of amounts due from Odyssey America Reinsurance Corporation are collateralized through a reinsurance trust.

(4) Flatiron Re Ltd. is required to contribute funds into a trust for the benefit of Arch Re Bermuda. The recoverable from Flatiron Re Ltd. was fully collateralized through such trust at December 31, 2006. See note 11, Commitments and Contingencies, of the notes accompanying our consolidated financial statements for further details on the Flatiron Treaty.

(5) In connection with our acquisition of Arch Specialty in February 2002, the seller, Sentry, agreed to reinsure and guarantee all liabilities arising out of Arch Specialty s business prior to the closing of the acquisition. In addition to the guarantee provided by Sentry, substantially all of the recoverable from Sentry is still subject to the original reinsurance agreements inuring to Arch Specialty and, to the extent Sentry fails to comply with its payment obligations to us, we may seek reimbursement from the third party reinsurers under such agreements.

(6) The following table provides a breakdown of the All other category by A.M. Best rating:

Companies rated A- or better	23.6 %
Companies rated B++	0.2 %
Companies not rated(7)	4.4 %
Total	28.2 %

(7) A substantial portion of such amount is collateralized through reinsurance trusts or letters of credit.

If the financial condition of our reinsurers or retrocessionaires deteriorates, resulting in an impairment of their ability to make payments, we will provide for probable losses resulting from our inability to collect amounts due from such parties, as appropriate. We evaluate the credit worthiness of all the reinsurers to which we cede business. If our analysis indicates that there is significant uncertainty regarding the collectibility of amounts due from reinsurers, managing general agents, brokers and other clients, we will record a provision for doubtful accounts. At December 31, 2006, approximately 83.5% of premiums receivable of $750.0 million represented amounts not yet due, while amounts in excess of 90 days overdue were 1.9% of the total. At December 31, 2005, approximately 78.6% of premiums receivable of $672.9 million represented amounts not yet due, while amounts in excess of 90 days overdue were 1.6% of the total. Approximately 19.6% of the $122.1 million of paid losses and loss adjustment expenses recoverable were in excess of 90 days overdue at December 31, 2006, compared to 1.1% of the $80.9 million of paid losses and loss adjustment expenses recoverable at December 31, 2005. At December 31, 2006 and 2005, our reserves for doubtful accounts were approximately $12.0 million and $2.1 million, respectively. The increase in reserves for doubtful accounts at December 31, 2006 was due to the higher level of paid losses and loss adjustment expenses recoverable in excess of 90 days overdue at December 31, 2006.

We are also subject to credit risk from our alternative market products, such as rent-a-captive risk-sharing programs, which allow a client to retain a significant portion of its loss exposure without the administrative costs and capital commitment required to establish and operate its own captive. In certain of these programs, we participate in the operating results by providing excess reinsurance coverage and earn commissions and management fees. In addition, we write program business on a risk-sharing basis with managing general agents or brokers, which may be structured with commissions which are contingent on the underwriting results of the program. While we attempt to obtain collateral from such parties in an amount sufficient to guarantee their projected financial obligations to us, there is no guarantee that such collateral will be sufficient to secure their actual ultimate obligations.

Income Taxes

Deferred income taxes reflect the net tax effect of temporary differences between the carrying amounts of assets and liabilities for financial reporting purposes and amounts used for income tax purposes. A valuation allowance is recorded if it is more likely than not that some or all of a deferred income tax asset may not be realized. We consider future taxable income and feasible tax planning strategies in assessing the need for a valuation allowance. In the event we determine that we will not be able to realize all or part of our deferred income tax assets in the future, an adjustment to the deferred income tax assets would be charged to income in the period in which such determination is made. In addition, if we subsequently assess that the valuation allowance is no longer needed, a benefit would be recorded to income in the period in which such determination is made.

Investments

We currently classify all of our fixed maturity investments, short-term investments and other investments as available for sale and, accordingly, they are carried at estimated fair value. The fair value of fixed maturity securities is generally determined from quotations received from a nationally recognized pricing service. Short-term investments comprise securities due to mature within one year of the date of issue. Short-term investments include certain cash equivalents which are part of our investment portfolios under the management of external and internal investment managers. Other investments are carried at estimated fair value. Fair value is initially considered to be equal to the cost of such investment until the investment is revalued based on substantive events or other factors which could indicate a diminution or appreciation in value.

Other investments are classified as available for sale and include alternative investments, which are funds with underlying ownership structures that may be limited partnerships (LPs) or limited liability companies (LLCs), equity securities such as investments in mutual funds and privately held securities. For those investments in which the underlying ownership structure is an LP or an LLC (*i.e.,* when the LLC meets specific criteria requiring it to be treated similar to an LP) we use the equity method to account for such investments. Under the equity method, investments are initially recorded at cost and are subsequently adjusted for changes in our proportionate share of net income or loss or other changes in capital of the investee. Changes in the carrying value of such investments are recorded in net investment income or other income. Investments in equity securities are carried at estimated fair value in accordance with SFAS No. 115. The estimated fair value of investments in privately held securities, other than those carried under the equity method, is initially equal to the cost of such investments until the investments are revalued based principally on substantive events or other factors which could indicate a diminution or appreciation in value, such as an arm s-length third party transaction justifying an increased valuation or adverse development of a significant nature requiring a write-down.

In accordance with SFAS No. 115, Accounting for Certain Investments in Debt and Equity Securities, FASB Staff Position Nos. FAS115-1 and FAS124-1, The Meaning of Other-Than-Temporary Impairment and Its Application to Certain Investments and Securities and Exchange Commission Staff Accounting Bulletin No. 59, Other-Than-Temporary Impairment of Certain Investments in Debt and Equity Securities, we review our investments each quarter to determine whether a decline in fair value below the amortized cost basis is other-than-temporary. Our process for identifying declines in the fair value of investments that are other-than-temporary involves consideration of several factors. These factors include (i) the time period in which there has been a significant decline in value, (ii) an analysis of the liquidity, business prospects and overall financial condition of the issuer, (iii) the significance of the decline and (iv) our intent and ability to hold the investment for a sufficient period of time for the value to recover. Where our analysis of the above factors results in the conclusion that declines in fair values are other-than-temporary, the cost of the securities is written down to fair value and is reflected as a realized loss. In periods subsequent to the recognition of an other-than-temporary impairment on fixed maturities, we account for such securities as if they had been purchased on the measurement date of the other-than-temporary impairment and the provision for other-than-temporary impairment (reflected as a discount or reduced premium based on the new cost basis) is amortized into net investment income over the remaining life of the fixed maturities, or until such securities are sold.

In general, we consider twelve months to be the threshold for the time period in which there has been a significant decline in value in order to consider such security s value to be other-than-temporarily impaired. Securities which are in an unrealized loss position for more than twelve months are considered other-than-temporarily impaired, while securities in an unrealized loss position for less than twelve months are evaluated for other-than-temporary impairment if such unrealized loss is in excess of 20% of the security s cost basis. With respect to securities where the decline in value is determined to be temporary because we concluded that the investment was impaired for a minor length of time or to a minor extent and the security s value is not written down, a subsequent decision may be made to sell that security and realize a loss. Such sale would not contradict our determination that the decline was temporary because subsequent decisions to sell a security are made within the context of overall risk management, new information and the assessment of such security s value relative to comparable securities. While our internal and external investment managers may, at a given point in time, believe the preferred course of action is to hold securities until such losses are recovered, the dynamic nature of portfolio management may result in a subsequent decision by us to sell the security and realize the loss, based upon a change in market and other factors discussed above. We believe these subsequent decisions are consistent with the classification of our investment portfolio as available for sale. See note 7, Investment Information, of the notes accompanying our consolidated financial statements.

Under SFAS No. 133, Accounting for Derivative Instruments and Hedging Activities (SFAS No. 133), as amended on January 1, 2001, all derivative financial instruments, including embedded derivative instruments, are required to be recognized as either assets or liabilities in the consolidated balance sheets and measured at fair value. The accounting for gains and losses associated with changes in the fair value of a derivative and the effect on the consolidated financial statements depends on whether it has been designated and qualifies as part of a hedging relationship and whether the hedge is highly effective in achieving offsetting changes in the fair value of the asset or liability hedged.

Our investment strategy allows for the use of derivative instruments. We utilize various derivative instruments such as futures contracts as part of the management of our stock index fund investments and to replicate equity investment positions. Derivative instruments may be used to enhance investment performance, replicate investment positions or manage market exposures and duration risk that would be allowed under our investment guidelines if implemented in other ways. Pursuant to SFAS No. 133, these instruments, which have no hedging designation, are recognized as assets and liabilities in our balance sheet at fair value and changes in fair value are included in net realized gains and losses in our results of operations. See note 7, Investment Information Investment-Related Derivatives, of the notes accompanying our consolidated financial statements for more information about our use of derivative instruments.

Share-Based Compensation

On January 1, 2006, we adopted the fair value method of accounting for share-based awards using the modified prospective method of transition as described in Financial Accounting Standards Board

(FASB) Statement No. 123 (revised 2004), Share-Based Payment (SFAS No. 123(R)). Under SFAS No.123(R), the estimated grant date fair value adjusted for assumed forfeitures of share-based compensation related to stock option awards is recognized as compensation expense over the requisite service period of the grant. Under the fair value method of accounting pursuant to SFAS No. 123(R), the fair value of restricted share and unit awards is measured by the grant date price of our shares. No value is attributed to awards that employees forfeit because they fail to satisfy vesting conditions. As such, the number of shares granted is reduced by assumed forfeitures and adjusted based on actual forfeitures until vesting. Such expense is amortized over the requisite service period of the related awards. The share-based compensation expense associated with awards that have graded vesting features and vest based on service conditions only (i) granted after the effective date of adoption is calculated on a straight-line basis over the requisite service periods of the related awards and (ii) granted prior to the effective date of adoption and that remain unvested as of the date of adoption is calculated on a graded-vesting basis as prescribed under FASB Interpretation No. 28, Accounting for Stock Appreciation Rights and Other Variable Stock Option or Award Plans an interpretation of APB Opinions No. 15 and 25, over the remaining requisite service periods of the related awards.

Under the modified prospective method of transition, compensation expense is recognized beginning with the effective date of adoption for all share-based payments (i) granted after the effective date of adoption and (ii) granted prior to the effective date of adoption and that remain unvested on the date of adoption. Under the modified prospective method of transition, we are not required to restate our prior period financial statements to reflect expensing of share-based compensation under SFAS No.123(R). Therefore, the results for the year ended December 31, 2006 are not comparable to results for the 2005 and 2004 periods.

Under SFAS No. 123(R), we use the Black-Scholes option pricing model to estimate the fair value of the share-based option awards as of the grant date. The Black-Scholes model, by its design, is highly complex, and requires judgment in determining key data inputs including estimating the risk free interest rate, expected life of the option and expected volatility rate. In addition, judgment is also required in estimating the amount of share-based awards that are expected to be forfeited. The primary data inputs with the greatest degree of judgment are the estimated lives of the share-based awards and the estimated volatility of our stock price. The Black-Scholes model is highly sensitive to changes in these two data inputs. In our process for estimating the fair value of stock options granted, we believe that we have made a good faith fair value estimate in accordance with the provisions of SFAS No. 123(R) as well as guidance from the SEC as contained in Staff Accounting Bulletin No. 107 in a way that is designed to take into account the assumptions that underlie the instrument s value that marketplace participants would reasonably make. If actual results differ significantly from these estimates, share-based compensation expense and our results of operations could be materially impacted.

See note 2(m), Significant Accounting Policies Share-Based Compensation, of the notes accompanying our consolidated financial statements for more information about the adoption of SFAS No. 123(R).

Reclassifications

We have reclassified the presentation of certain prior year information to conform to the current presentation. Such reclassifications had no effect on our net income, shareholders equity or cash flows.

Recent Accounting Pronouncements

See note 2(q), Significant Accounting Policies Recent Accounting Pronouncements, of the notes accompanying our consolidated financial statements.

Results of Operations

Comparison of Years Ended December 31, 2006 and 2005

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

	Years Ended December 31, 2006	2005
	(U.S. dollars in thousands, except share data)	
Net income available to common shareholders	$ 692,559	$ 256,486
Diluted net income per common share	$ 9.08	$ 3.43
Diluted weighted average common shares and common share equivalents outstanding	76,246,725	74,709,858

Net income available to common shareholders was $692.6 million for 2006, compared to $256.5 million for 2005. The improvement in our results of operations was primarily due to a lower level of catastrophic activity in 2006, as discussed in Segment Information below, and growth in investment income. Our net income available to common shareholders for 2006 represented a 24.1% annualized return on average common equity, compared to 10.9% for 2005.

The increase in diluted average shares outstanding from 2005 to 2006 was due, in part, to increases in the dilutive effects of stock options and nonvested restricted stock calculated using the treasury stock method and the exercise of stock options. Under the treasury stock method, the dilutive impact of options and nonvested stock on diluted weighted average shares outstanding increases as the market price of our common shares increases.

Segment Information

We determined our reportable operating segments using the management approach described in SFAS No. 131 Disclosures about Segments of an Enterprise and Related Information, as further detailed in note 3, Segment Information, of the notes accompanying our consolidated financial statements. Management measures segment performance based on underwriting income or loss, which includes the excess or deficiency of net premiums earned for each reporting period over the combined total of expenses and losses incurred during the same period.

Insurance Segment

The following table sets forth our insurance segment s underwriting results:

	Years Ended December 31, 2006	2005
	(U.S. dollars in thousands)	
Gross premiums written	$ 2,624,757	$ 2,325,632
Net premiums written	1,652,056	1,481,300
Net premiums earned	$ 1,600,854	$ 1,392,114
Fee income	5,085	5,332
Losses and loss adjustment expenses	(1,017,263)	(949,996)
Acquisition expenses, net	(175,740)	(137,804)
Other operating expenses	(249,637)	(221,934)
Underwriting income	$ 163,299	$ 87,712
Underwriting Ratios		
Loss ratio	63.5 %	68.2 %
Acquisition expense ratio(1)	10.8 %	9.7 %
Other operating expense ratio	15.6 %	15.9 %
Combined ratio	89.9 %	93.8 %

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

88

Underwriting Income. The insurance segment s underwriting income was $163.3 million for 2006, compared to $87.7 million for 2005. The combined ratio for the insurance segment was 89.9% for 2006, compared to 93.8% for 2005. The components of the insurance segment s underwriting income are discussed below.

Premiums Written. Gross premiums written by the insurance segment were $2.62 billion for 2006, compared to $2.33 billion for 2005, and ceded premiums written were 37.1% of gross premiums written for 2006, compared to 36.3% for 2005. Net premiums written by the insurance segment were $1.65 billion for 2006, compared to $1.48 billion for 2005. Roughly half of the increase was in worldwide property business, primarily as a result of rate increases which were tempered by higher reinsurance costs. The balance of the growth was generated from increases in professional liability business, as a result of growth in policies written and a decrease in the usage of reinsurance in 2006 business, construction business, primarily due to growth in large deductible construction accounts, surety business, and in executive assurance business. This growth was partially offset by a reduction in U.S. primary casualty business in response to increasing competition. For information regarding net premiums written produced by major line of business and geographic location, refer to note 3, Segment Information, of the notes accompanying our consolidated financial statements.

On January 1, 2007, our U.S. insurance operations entered into an agreement under which they will write excess workers compensation and employers liability insurance business produced by Wexford Underwriting Managers, Inc. (Wexford), a managing general agent. As part of the transaction, our U.S. insurance operations also entered into an asset purchase agreement to acquire the operations of Wexford, including the renewal rights of the subject business, as of January 1, 2008, subject to the satisfaction of customary closing conditions. In 2006, Wexford produced approximately $74 million for the predecessor carrier on the program, although no assurances can be made as to the level of business that will be written by our U.S. insurance operations during 2007 under the arrangements with Wexford.

Net Premiums Earned. Net premiums earned for the insurance segment were $1.6 billion for 2006, compared to $1.39 billion for 2005, and generally reflect changes in net premiums written over the previous five quarters, including the mix and type of business written.

Losses and Loss Adjustment Expenses. Insurance segment losses and loss adjustment expenses incurred for 2006 were $1.02 billion, or 63.5% of net premiums earned, compared to $950.0 million, or 68.2% of net premiums earned, for 2005. The insurance segment s results for 2006 included several large property and surety individual risk losses in the 2006 fourth quarter totaling $36.6 million, while 2005 included $119.8 million related to Hurricanes Dennis, Emily, Katrina, Rita and Wilma and the European Floods. The net impact of the change in large losses and catastrophic activity resulted in a 5.2 point decrease in the 2006 loss ratio. In addition, losses incurred for 2006 included $8.3 million of estimated net favorable development in prior year loss reserves, compared to $27.8 million of estimated net favorable development in 2005. 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. As a result, the insurance segment reduced loss selections for some lines, in particular those written on a claims-made basis and for which it now has a reasonable level of credible data. The insurance segment s net favorable development in 2006 and 2005 was primarily due to reductions in reserves in medium-tailed and long-tailed lines of business resulting from such changes, 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. The net impact of the change in estimated net prior year development was a 1.2 point increase in the 2006 loss ratio.

For a discussion of the reserves for losses and loss adjustment expenses, please refer to the section above entitled Critical Accounting Policies, Estimates and Recent Accounting Pronouncements Reserves for Losses and Loss Adjustment Expenses.

Underwriting Expenses. The underwriting expense ratio for the insurance segment was 26.4% in 2006, compared to 25.6% for 2005. The acquisition expense ratio was 10.8% for 2006, compared to 9.7% for 2005. As a result of the surety losses noted above, the insurance segment reduced profit commissions that it had recorded previously by $7.7 million, or 0.5 points of the acquisition expense ratio. The remainder of the increase in the acquisition expense ratio was primarily due to changes in the mix of business. The insurance segment s other operating expense ratio was 15.6% for 2006, compared to 15.9% for 2005.

Reinsurance Segment

The following table sets forth our reinsurance segment s underwriting results:

	Years Ended December 31, 2006	2005
	(U.S. dollars in thousands)	
Gross premiums written	$ 1,703,796	$ 1,750,839
Net premiums written	1,365,362	1,657,472
Net premiums earned	$ 1,480,811	$ 1,585,602
Fee income	4,729	5,035
Losses and loss adjustment expenses	(773,286)	(1,051,953)
Acquisition expenses, net	(368,171)	(442,116)
Other operating expenses	(53,533)	(52,192)
Underwriting income	$ 290,550	$ 44,376
Underwriting Ratios		
Loss ratio	52.2 %	66.3 %
Acquisition expense ratio	24.9 %	27.9 %
Other operating expense ratio	3.6 %	3.3 %
Combined ratio	80.7 %	97.5 %

Underwriting Income. The reinsurance segment s underwriting income was $290.6 million for 2006, compared to $44.4 million for 2005. The combined ratio for the reinsurance segment was 80.7% for 2006, compared to 97.5% for 2005. The components of the reinsurance segment s underwriting income are discussed below.

Premiums Written. Gross premiums written by the reinsurance segment were $1.70 billion in 2006, compared to $1.75 billion for 2005. Gross premiums written for 2006 reflects a lower level of international casualty business in response to actual and anticipated market conditions, partially offset by growth in international property and marine lines, due to higher rates and an increase in exposure. Catastrophe-exposed property and marine lines have continued to provide attractive opportunities in the wake of the 2005 storms. As a result of the significant catastrophic activity in 2005 and the impact of such events on the insurance market, the reinsurance segment was able to write certain property (both catastrophe and non-catastrophe) and marine business in the 2005 fourth quarter, which resulted in approximately $109.2 million of gross premiums written ($100.2 million on a net basis). Such business did not contribute to the reinsurance segment s 2006 premiums written.

Ceded premiums written by the reinsurance segment were 19.9% of gross premiums written for 2006, compared to 5.3% for 2005. The higher ceded percentage in 2006 primarily resulted from the $273.2 million of premiums written ceded by Arch Re Bermuda to Flatiron Re Ltd. ($157.4 million on an earned basis) under a quota-share reinsurance treaty, as previously disclosed.

Net premiums written by the reinsurance segment were $1.37 billion for 2006, compared to $1.66 billion for 2005. Net premiums written for 2006 reflects the lower level of international casualty business

noted above, which more than offset growth in international property and marine lines, net of the amounts ceded to Flatiron Re Ltd. In addition, net premiums written in 2005 included $100.2 million of non-recurring business, as noted above. For information regarding net premiums written produced by major line and type of business and geographic location, refer to note 3, Segment Information, of the notes accompanying our consolidated financial statements.

Net Premiums Earned. Net premiums earned for our reinsurance segment were $1.48 billion for 2006, compared to $1.59 billion for 2005, and generally reflect changes in net premiums written over the previous five quarters, including the mix and type of business written.

Fee Income. The reinsurance segment recorded $4.7 million of fee income for 2006, compared to $5.0 million for 2005. The 2006 amount related to certain assumed reinsurance contracts which were deemed, under GAAP, not to transfer insurance risk, and are accounted for using the deposit method of accounting. Of the 2005 amount, $4.5 million related to an industry loss warranty contract. Under this contract, we received payment when industry-wide losses from certain natural perils exceeded a specified amount.

Losses and Loss Adjustment Expenses. Reinsurance segment losses and loss adjustment expenses incurred for 2006 were $773.3 million, or 52.2% of net premiums earned, compared to $1.05 billion, or 66.3% of net premiums earned, for 2005. The reinsurance segment s 2006 results included approximately $45.9 million related to 2006 catastrophe losses, while the 2005 results included $208.5 million related to Hurricanes Dennis, Emily, Katrina, Rita and Wilma and the European Floods and $24.0 million of other catastrophe losses. The net impact of the change in catastrophic activity resulted in a 12.6 point decrease in the 2006 loss ratio. In addition, losses incurred for 2006 included $68.5 million of estimated net favorable development in prior year loss reserves, compared to $91.2 million of estimated net favorable development in 2005. 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 impact of the change in prior year development was a 1.5 point increase in the 2006 loss ratio.

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 in the reserving process in 2004. Following reserve reviews, and based on the level of claims activity reported to date, the reinsurance segment has reduced the amount it had recorded in 2002 and 2003 by $7.7 million in 2006 and $12.1 million in 2005. Such amounts are reflected in the prior year development shown above.

The net favorable development in both periods was partially offset by increased acquisition expenses, primarily as a result of the commutation of certain treaties. Such activity resulted in an increase to acquisition expenses of approximately $7.8 million in 2006, compared to $9.0 million in 2005. The net decrease in acquisition expenses related to the commutation activity resulted in a 0.1 point decrease in the 2006 acquisition expense ratio. The remainder of the change in the loss ratio for 2006, compared to 2005, resulted from better results recorded in the reinsurance segment s property lines of business and changes in their mix of business.

For a discussion of the reserves for losses and loss adjustment expenses, please refer to the section above entitled Critical Accounting Policies, Estimates and Recent Accounting Pronouncements Reserves for Losses and Loss Adjustment Expenses.

Underwriting Expenses. The underwriting expense ratio for the reinsurance segment was 28.5% for 2006, compared to 31.2% for 2005. The acquisition expense ratio for 2006 was 24.9%, compared to 27.9%

for 2005. The reinsurance segment s 2006 results included commission income (in excess of the reimbursement of direct acquisition expenses) on the quota-share reinsurance treaty with Flatiron Re Ltd., which reduced the acquisition expense ratio by 1.6 points in 2006. The 2005 results included $13.3 million of assessments incurred as a result of the 2005 hurricane activity, which added 0.8 points to the 2005 acquisition expense ratio. The reinsurance segment s other operating expense ratio was 3.6% for 2006, compared to 3.3% for 2005.

Net Investment Income

Net investment income was $380.2 million for 2006, compared to $232.9 million for 2005. The increase in net investment income in 2006 resulted from a higher level of average invested assets primarily generated by cash flows from operations. In addition, an increase in the pre-tax investment income yield to 4.71% for 2006 from 3.68% for 2005 contributed to the growth in net investment income. These yields were calculated based on amortized cost. Yields on future investment income may vary based on financial market conditions, investment allocation decisions and other factors.

Net Realized Gains or Losses

Following is a summary of net realized gains (losses):

	Years Ended December 31, 2006	2005
	(U.S. dollars in thousands)	
Fixed maturities	$ (27,379)	$ (56,770)
Other investments	4,186	1,016
Other	3,756	2,298
Total	$ (19,437)	$ (53,456)

Total return on our portfolio under management, as reported to us by our investment advisors, for 2006 was 5.24%, compared to 2.09% for 2005. Total return is calculated on a pre-tax basis and before investment expenses. The higher total return in 2006 compared to 2005 was primarily due to movements in interest rates during the periods. The increase in interest rates in 2005 was greater than the increase in 2006 and resulted in a lower relative return compared to 2006. For 2006, net realized losses on our fixed maturities of $27.4 million included a provision of $31.6 million for declines in the fair value of investments held in our available for sale portfolio which were considered to be other-than-temporary, based on a review performed during 2006. For 2005, net realized losses on our fixed maturities of $56.8 million included a provision of $25.7 million for declines in the fair value of investments held in our available for sale portfolio which were considered to be other-than-temporary, based on a review performed during 2005. In periods subsequent to the recognition of an other-than-temporary impairment on fixed maturities, we account for such securities as if they had been purchased on the measurement date of the other-than temporary impairment and the provision for the other-than-temporary impairment (reflected as a discount or reduced premium based on the new cost basis) is amortized into net investment income over the remaining life of the fixed maturities, or until such securities are sold. The declines in fair value on such securities were primarily due to the current interest rate environment. The balance of $4.2 million in net realized gains on our fixed maturities in 2006 resulted from the sale of securities, compared to net realized losses from the sale of fixed maturities of $31.1 million for 2005. For the 2006 and 2005 periods, net realized gains or losses from the sale of fixed maturities resulted from our decisions to reduce credit exposure, changes in duration targets, relative value determinations and sales related to rebalancing the portfolio.

Other Expenses

Other expenses, which are included in our other operating expenses and part of our corporate and other segment (non-underwriting), were $29.1 million for 2006, compared to $25.8 million for 2005. Such amounts primarily represent certain holding company costs necessary to support our worldwide insurance and reinsurance operations, share based compensation expense and costs associated with operating as a publicly traded company. Other expenses for 2005 included approximately $1.9 million of costs related to an agreement entered into with Robert Clements, former Chairman of our board of directors, and approximately $4.9 million of costs related to an agreement entered into with Dwight Evans, former Chairman and Chief Executive Officer of Arch Worldwide Reinsurance Group. See note 10, Transactions with Related Parties, of the notes accompanying our consolidated financial statements.

As required by the provisions of SFAS 123(R), we recorded pre-tax share-based compensation expense related to stock options of $9.2 million in 2006. Under the modified prospective method of transition, no expense related to stock options was recorded in 2005. Therefore, results for 2006 are not comparable to 2005. See note 13, Share Capital, of the notes accompanying our consolidated financial statements and Critical Accounting Policies, Estimates and Recent Accounting Policies Share-Based Compensation for more information about the adoption of SFAS No. 123(R).

Interest Expense

Interest expense was $22.1 million for 2006, compared to $22.5 million for 2005. Such amounts primarily relate to the $300 million in 7.35% senior notes outstanding in both periods.

Net Foreign Exchange Gains or Losses

Net foreign exchange losses for 2006 of $23.9 million consisted of net unrealized losses of $27.3 million and net realized gains of $3.4 million, compared to net foreign exchange gains of $22.2 million for 2005, which consisted of net unrealized gains of $23.3 million and net realized losses of $1.1 million. For the 2006 and 2005 periods, the net unrealized foreign exchange gains or losses recorded were largely offset by changes in the value of our investments held in foreign currencies.

Income Taxes

ACGL changed its legal domicile from the United States to Bermuda in November 2000. Under current Bermuda law, we are not obligated to pay any taxes in Bermuda based upon income or capital gains. We have received a written undertaking from the Minister of Finance in Bermuda under the Exempted Undertakings Tax Protection Act of 1966 that in the event legislation is enacted in Bermuda imposing tax computed on profits, income, gain or appreciation on any capital asset, or tax in the nature of estate duty or inheritance tax, such tax will not be applicable to us or our operations until March 28, 2016.

ACGL will be subject to U.S. federal income tax only to the extent that it derives U.S. source income that is subject to U.S. withholding tax or income that is effectively connected with the conduct of a trade or business within the U.S. and is not exempt from U.S. tax under an applicable income tax treaty. ACGL will be subject to a withholding tax on dividends from U.S. investments and interest from certain U.S. taxpayers. ACGL does not consider itself to be engaged in a trade or business within the U.S. and, consequently, does not expect to be subject to direct U.S. income taxation. However, because there is uncertainty as to the activities which constitute being engaged in a trade or business within the United States, there can be no assurances that the U.S. Internal Revenue Service will not contend successfully that ACGL or its non-U.S. subsidiaries are engaged in a trade or business in the United States. If ACGL or any of its non-U.S. subsidiaries were subject to U.S. income tax, ACGL s shareholders equity and earnings could be materially adversely affected. ACGL has subsidiaries and branches that operate in various jurisdictions around the world that are subject to tax in the jurisdictions in which they operate. The significant jurisdictions in which ACGL s subsidiaries and branches are subject to tax are the United States, United Kingdom, Canada and Switzerland. See Risk Factors Risks Relating to Taxation and Business Tax Matters.

The income tax provision on income before income taxes resulted in an effective tax rate of 3.6% for 2006, compared to 10.1% for 2005. Our effective tax rate fluctuates from year to year consistent with the relative mix of income reported by jurisdiction due primarily to the varying tax rates in each jurisdiction. We currently estimate that our comparable income tax provision in 2007 will result in an effective tax rate of approximately 4.0% to 6.0%, although no assurances can be given to that effect. See note 9, Income Taxes, of the notes accompanying our consolidated financial statements for a reconciliation of the difference between the provision for income taxes and the expected tax provision at the weighted average statutory tax rate for 2006, 2005 and 2004.

At December 31, 2006 and 2005, we had a valuation allowance of $1.4 million against a deferred tax asset in one of our subsidiaries that currently does not have a business plan to produce significant future taxable income. See note 9, Income Taxes, of the notes accompanying our consolidated financial statements.

We have net operating loss carryforwards in our U.S. operating subsidiaries totaling $16.8 million at December 31, 2006. Such net operating losses are currently available to offset future taxable income of the subsidiaries. Under applicable law, the U.S. net operating loss carryforwards expire between 2018 and 2020. Full utilization of our net operating losses would reduce future taxes payable by $5.9 million. In addition, we also have a net capital loss carryforward of $1.2 million which will expire between 2010 -2011 and an alternative minimum tax (AMT) credit carryforward in the amount of $1.0 million which can be carried forward without expiration. On November 20, 2001, we underwent an ownership change for U.S. federal income tax purposes as a result of the capital raised at that time. As a result of this ownership change, limitations are imposed upon the utilization by our U.S. operating subsidiaries of existing net operating losses and the alternative minimum tax credit carryforward. Our Swiss branch has a net operating loss carryforward of $0.4 million which is available to offset income of the Swiss branch until it expires in 2013. See note 9, Income Taxes, of the notes accompanying our consolidated financial statements.

Comparison of Years Ended December 31, 2005 and 2004

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

	Years Ended December 31, 2005	2004
	(U.S. dollars in thousands except share data)	
Net income available to common shareholders	$ 256,486	$ 316,899
Diluted net income per common share	$ 3.43	$ 4.37
Diluted weighted average common shares and common share equivalents outstanding	74,709,858	72,519,045

Net income available to common shareholders was $256.5 million for 2005, compared to $316.9 million for 2004. The lower level of net income available to common shareholders was primarily due to the higher level of catastrophic activity in 2005, as discussed in Segment Information below. Our net income available to common shareholders for 2005 represented a 10.9% return on average equity, compared to 16.0% for 2004. For purposes of computing return on average equity, average equity has been calculated as the average of shareholders equity outstanding at the beginning and end of each year.

The increase in diluted average shares outstanding from 2004 to 2005 was due, in part, to increases in the dilutive effects of stock options and nonvested restricted stock calculated using the treasury stock method and the exercise of stock options. Under the treasury stock method, the dilutive impact of options and nonvested stock on diluted weighted average shares outstanding increases as the market price of our common shares increases. In addition, diluted weighted average shares outstanding for 2005 reflects the full weighting of 4.7 million common shares issued in March 2004.

Segment Information

Insurance Segment

The following table sets forth our insurance segment s underwriting results:

	Years Ended December 31, 2005	2004
	(U.S. dollars in thousands)	
Gross premiums written	$ 2,325,632	$ 2,146,188
Net premiums written	1,481,300	1,391,984
Net premiums earned	$ 1,392,114	$ 1,342,559
Fee income	5,332	18,597
Losses and loss adjustment expenses	(949,996)	(877,761)
Acquisition expenses, net	(137,804)	(155,225)
Other operating expenses	(221,934)	(214,866)
Underwriting income	$ 87,712	$ 113,304
Underwriting Ratios		
Loss ratio	68.2 %	65.4 %
Acquisition expense ratio(1)	9.7 %	10.4 %
Other operating expense ratio	15.9 %	16.0 %
Combined ratio	93.8 %	91.8 %

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

Underwriting Income. The insurance segment had underwriting income of $87.7 million and a combined ratio of 93.8% for 2005, compared to $113.3 million and 91.8% for 2004. The 2005 results included estimated pre-tax net losses in 2005 related to Hurricanes Dennis, Emily, Katrina, Rita and Wilma of $150.3 million, after reinsurance recoveries and net of reinstatement premiums. Before reinsurance recoveries, such estimated losses were $656.5 million. The 2004 results reflected estimated pre-tax net losses related to Hurricanes Charley, Frances, Ivan and Jeanne of $41.8 million, after reinsurance recoveries and net of reinstatement premiums. Before reinsurance recoveries, such estimated losses were $88.9 million. The components of the insurance segment s underwriting income are discussed below.

Premiums Written. Gross premiums written for our insurance segment were $2.33 billion for 2005, compared to $2.15 billion for 2004. The increase in gross premiums written for 2005 primarily resulted from increased contributions in the property, professional liability and executive assurance lines from the insurance segment s European operations, which became fully operational in the 2004 fourth quarter. Growth in certain U.S. specialty lines, including construction and surety and professional liability, was offset by reductions due to the sale of the insurance segment s non-standard auto insurance operations in late 2004, which contributed $96.5 million in the 2004 period, and in casualty and program business. The decrease in casualty business primarily resulted from the non-renewal of one large policy in the 2005 fourth quarter.

For purposes of managing risk, our insurance segment reinsures a portion of its exposures, paying to reinsurers a part of the premiums received on the policies it writes. For 2005, ceded premiums written represented 36.3% of gross premiums written, compared to 35.1% for 2004. The higher ceded percentage for 2005 compared to 2004 primarily resulted from increases in business ceded in the insurance segment s property and professional liability lines and an increase in program business ceded through a 30% quota share of certain programs with effective dates subsequent to March 31, 2004. Net premiums written for our insurance segment increased to $1.48 billion for 2005, compared to $1.39 billion for 2004, with the increase primarily as a result of the reasons discussed above. For information regarding net premiums written produced by major type of business and geographic location, refer to note 3, Segment Information, of the notes accompanying our consolidated financial statements.

Net Premiums Earned. Net premiums earned for our insurance segment were $1.39 billion for 2005, compared to $1.34 billion for 2004. The increase in net premiums earned in 2005 primarily reflects changes in net premiums written over the previous five quarters, including the mix and type of business written.

Fee Income. Policy-related fee income for our insurance segment was $3.4 million for 2005, compared to $15.3 million for 2004. The 2005 amounts were earned on our alternative markets business, and the 2004 amounts included a significant contribution from our non-standard automobile business, which was sold in late 2004. Other underwriting-related fee income for our insurance segment was $2.0 million for 2005, compared to $3.3 million for 2004. Other underwriting-related fee income for our insurance segment primarily relates to miscellaneous income from certain aviation business, certain service fee reimbursements received and non-recurring revenue from the insurance segment s alternative markets business.

Losses and Loss Adjustment Expenses. Insurance segment losses and loss adjustment expenses incurred for 2005 were $950.0 million, or 68.2% of net premiums earned, compared to $877.8 million, or 65.4%, for 2004. The 2005 loss ratio reflected $119.8 million related to the 2005 catastrophic events noted above, while the 2004 loss ratio reflected $41.8 million from the 2004 catastrophic events noted above. The net increase in catastrophic activity in 2005 resulted in a 5.6 point increase in the 2005 loss ratio. The loss ratio for 2005 also reflected net favorable development in prior year reserves of $27.8 million, compared to $13.4 million for 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. As a result, the insurance segment reduced loss selections for some lines, in particular those written on a claims-made basis and for which it now has a reasonable level of credible data. The insurance segment s net favorable development in 2005 was primarily due to reductions in reserves for medium-tailed and longer-tailed lines of business resulting from such changes, while the net favorable development in 2004 was primarily due to short-tail lines, mainly property. The net impact of the change in prior year development was a 1.0 point decrease in the 2005 loss ratio. The 2005 loss ratio also reflected better results recorded in the insurance segment s non-catastrophe related property and other short-tail lines of business and changes in their mix of business. For a discussion of the reserves for losses and loss adjustment expenses, please refer to the section above entitled Critical Accounting Policies, Estimates and Recent Accounting Pronouncements Reserves for Losses and Loss Adjustment Expenses.

Underwriting Expenses. The acquisition expense ratio for our insurance segment is calculated net of policy-related fee income and is affected by, among other things, (1) the amount of ceding commissions received from unaffiliated reinsurers and (2) the amount of business written on a surplus lines (non-admitted) basis. The acquisition expense ratio was 9.7% for 2005 (net of 0.2 points of policy-related fee income), compared to 10.4% for 2004 (net of 1.1 points). The other operating expense ratio for 2005 was essentially unchanged at 15.9%.

Reinsurance Segment

The following table sets forth our reinsurance segment s underwriting results:

	Years Ended December 31, 2005	2004
	(U.S. dollars in thousands)	
Gross premiums written	$ 1,750,839	$ 1,657,520
Net premiums written	1,657,472	1,588,048
Net premiums earned	$ 1,585,602	$ 1,573,323
Fee income	5,035	601
Losses and loss adjustment expenses	(1,051,953)	(998,844)
Acquisition expenses, net	(442,116)	(408,692)
Other operating expenses	(52,192)	(48,447)
Underwriting income	$ 44,376	$ 117,941
Underwriting Ratios		
Loss ratio	66.3%	63.5%
Acquisition expense ratio	27.9%	26.0%
Other operating expense ratio	3.3%	3.1%
Combined ratio	97.5%	92.6%

Underwriting Income. The reinsurance segment had underwriting income of $44.4 million and a combined ratio of 97.5% for 2005, compared to $117.9 million and 92.6% for 2004. The 2005 results included estimated pre-tax net losses in 2005 related to Hurricanes Dennis, Emily, Katrina, Rita and Wilma and the European Floods of $200.5 million, after reinsurance recoveries and net of reinstatement premiums. Before reinsurance recoveries, such estimated losses were $371.7 million. The 2004 results reflected estimated pre-tax net losses related to Hurricanes Charley, Frances, Ivan and Jeanne and Typhoon Songda of $125.4 million, after reinsurance recoveries and net of reinstatement premiums. Before reinsurance recoveries, such estimated losses were $177.0 million. The components of the reinsurance segment s underwriting income are discussed below.

Premiums Written. Gross premiums written for our reinsurance segment were $1.75 billion for 2005, compared to $1.66 billion for 2004. As a result of the significant catastrophic activity in 2005 and the impact of such events on the insurance market, the reinsurance segment was able to write certain property (both catastrophe and non-catastrophe) and marine business in the 2005 fourth quarter, which resulted in approximately $109.2 million of gross premiums written. Such business is not considered to be a recurring source of business in the future. Net premiums written for our reinsurance segment were $1.66 billion for 2005, compared to $1.59 billion for 2004. The growth was primarily attributable to the 2005 fourth quarter property and marine business discussed above. For 2005, 79.3% and 20.7% of net premiums written were generated from pro rata contracts and excess of loss treaties, compared to 71.2% and 28.8%, respectively, for 2004. Pro rata contracts are typically written at a lower loss ratio and higher expense ratio than excess of loss business. In certain cases, the reinsurance segment writes pro rata contracts where the underlying business consists of excess of loss treaties or insurance policies. Approximately 32.1% of amounts included in the pro rata contracts written are related to excess of loss treaties for 2005, compared to 32.8% for 2004. For information regarding net premiums written produced by type of business and geographic location, refer to note 3, Segment Information, of the notes accompanying our consolidated financial statements.

Net Premiums Earned. Net premiums earned for our reinsurance segment increased to $1.59 billion for 2005, compared to $1.57 billion for 2004. The increase in net premiums earned in 2005 primarily reflects changes in net premiums written over the previous five quarters, including the mix and type of

business written. For 2005, 75.7% and 24.3% of net premiums earned were generated from pro rata contracts and excess of loss treaties, respectively, compared to 73.3% and 26.7% for 2004.

Fee Income. The reinsurance segment recorded $5.0 million of fee income for 2005, compared to $0.6 million for 2004. Of the 2005 amount, $4.5 million related to an industry loss warranty contract. Under this contract, we received payment when industry-wide losses from certain natural perils exceeded a specified amount.

Losses and Loss Adjustment Expenses. Reinsurance segment losses and loss adjustment expenses incurred for 2005 were $1.05 billion, or 66.3% of net premiums earned, compared to $998.8 million, or 63.5%, for 2004. The 2005 loss ratio reflected $208.5 million related to the 2005 catastrophic events noted above and $24.0 million of other catastrophe losses, while the 2004 loss ratio reflected $131.5 million from the 2004 catastrophic events noted above and the Algerian natural gas plant explosion in January 2004. The net increase in catastrophic activity in 2005 resulted in a 6.4 point increase in the 2005 loss ratio.

The loss ratio for 2005 also reflected net favorable development in prior year reserves of $91.2 million, compared to $85.3 million for 2004. The net favorable development in both periods was primarily due to short-tail lines, mainly property, and resulted from better than anticipated loss emergence. The net impact of the change in prior year development was a 0.4 point reduction in the 2005 loss ratio, compared to the 2004 ratio. 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 in the reserving process in 2004. Following reserve reviews, and based on the level of claims activity reported to date, the reinsurance segment has reduced the amount it had recorded in 2002 and 2003 by $12.1 million in 2005 and $7.3 million in 2004. Such amounts are reflected in the prior year development shown above.

The net favorable development in both periods was partially offset by increased acquisition expenses, primarily as a result of the commutation of certain treaties. Such activity resulted in an increase to acquisition expenses of approximately $9.0 million in 2005, compared to $21.7 million in 2004. The net decrease in acquisition expenses related to the commutation activity resulted in a 0.8 point decrease in the 2005 acquisition expense ratio, compared to the 2004 ratio. The remainder of the change in the loss ratio for 2005, compared to 2004, resulted from better results recorded in the reinsurance segment s property lines of business and changes in their mix of business. For a discussion of the reserves for losses and loss adjustment expenses, please refer to the section above entitled Critical Accounting Policies, Estimates and Recent Accounting Pronouncements Reserves for Losses and Loss Adjustment Expenses.

Underwriting Expenses. The acquisition expense ratio for 2005 was 27.9%, compared to 26.0% for 2004. The increase in the 2005 acquisition ratio was due, in part, to a higher amount of property business than in 2004, $13.3 million of assessments incurred as a result of the 2005 hurricane activity, which added 0.9 points to the 2005 acquisition expense ratio, and changes in mix and type of business. Such amounts more than offset the reduction in acquisition expenses related to the commutation activity noted above. The other operating expense ratio was 3.3% for 2005, compared to 3.1% for 2004.

Net Investment Income

Net investment income was $232.9 million for 2005, compared to $143.7 million for 2004. The increase in net investment income was due, in part, to growth in average invested assets and an increase in the pre-tax investment income yield (net of investment expenses) to 3.7% for 2005, compared to 3.0% for 2004. These yields were calculated based on the amortized cost of the portfolio. Yields on future investment income may vary based on financial market conditions, investment allocation decisions and other factors. The increase in investment income yields was primarily due to higher yields available in financial markets as we reduced the average effective duration from 3.7 years at December 31, 2004 to 3.3 years at

December 31, 2005 and we maintained the average Standard & Poor s quality of our portfolio at AA+. The average yield to maturity (book yield) increased from 3.5% at December 31, 2004 to 4.2% at December 31, 2005.

Net Realized Gains (Losses)

Following is a summary of net realized gains or losses for the years ended December 31, 2005 and 2004:

	Years Ended December 31, 2005	2004
	(U.S. dollars in thousands)	
Fixed maturities	$ (56,770)	$ 22,007
Other investments	1,016	4,980
Other	2,298	3,250
Total	$ (53,456)	30,237

Currently, our portfolio is actively managed on a total return basis within certain guidelines. The effect of financial market movements will influence the recognition of net realized gains and losses as the portfolio is adjusted and rebalanced. For 2005, net realized losses on our fixed maturities of $56.8 million included a provision of $25.7 million for declines in the fair value of investments held in our available for sale portfolio which were considered to be other-than-temporary, based on a review performed during the 2005 fourth quarter. For 2004, based on our other-than-temporary impairment review process, we did not consider any declines in the fair value of investments to be other-than-temporary. The declines in fair value on such securities were primarily due to the current interest rate environment and not due to issues with credit quality. The balance of $31.1 million in net realized losses in 2005 resulted from the sale of securities, compared to net realized gains from the sale of securities of $22.0 million in 2004. Net realized gains or losses in 2005 and 2004 from the sale of securities resulted from our decisions to reduce credit exposure, changes in duration targets and from sales related to rebalancing the portfolio. For a discussion of our accounting for investments, please refer to the section above entitled Critical Accounting Policies, Estimates and Recent Accounting Pronouncements Investments.

Other Expenses

Other expenses, which are included in our other operating expenses and part of our corporate and other segment (non-underwriting), were $25.8 million for 2005, compared to $21.7 million for 2004. Such amounts primarily represent certain holding company costs necessary to support our worldwide insurance and reinsurance operations, share based compensation expense and costs associated with operating as a publicly traded company. Other expenses for 2005 include approximately $1.9 million of costs related to an agreement entered into with Robert Clements, former Chairman of our board of directors, and approximately $4.9 million of costs related to an agreement entered into with Dwight Evans, former Chairman and Chief Executive Officer of Arch Worldwide Reinsurance Group. See note 10, Transactions with Related Parties, of the notes accompanying our consolidated financial statements.

Interest Expense

Interest expense was $22.5 million for 2005, compared to $18.0 million for 2004. The increase in interest expense in 2005 is primarily due to the fact that the $300 million of 7.35% senior notes, which were issued in May 2004, were outstanding for all of 2005.

Net Foreign Exchange Gains or Losses

Net foreign exchange gains for 2005 of $22.2 million consisted of net unrealized gains of $23.3 million and net realized losses of $1.1 million, compared to net foreign exchange losses for 2004 of $17.4 million, which consisted of net unrealized losses of $16.3 million and net realized losses of $1.1 million. Net unrealized foreign exchange gains or losses result from the effects of revaluing our net insurance liabilities required to be settled in foreign currencies at each balance sheet date. We hold investments in foreign currencies which are intended to mitigate our exposure to foreign currency fluctuations in our net insurance liabilities. However, changes in the value of such investments due to foreign currency rate movements are reflected as a direct increase or decrease to shareholders equity and are not included in the statement of income. For the 2005 and 2004 periods, the net foreign exchange gains or losses recorded by us were largely offset by changes in the value of our investments held in foreign currencies.

Income Taxes

The income tax provision on income before income taxes resulted in an effective tax rate of 10.1% for 2005, compared to 7.6% for 2004. Our effective tax rate fluctuates from year to year consistent with the relative mix of income reported by jurisdiction due primarily to the varying tax rates in each jurisdiction. See note 9, Income Taxes, of the notes accompanying our consolidated financial statements for a reconciliation of the difference between the provision for income taxes and the expected tax provision at the weighted average statutory tax rate for 2005 and 2004.

Liquidity and Capital Resources

ACGL is a holding company whose assets primarily consist of the shares in its subsidiaries. Generally, ACGL depends on its available cash resources, liquid investments and dividends or other distributions from its subsidiaries to make payments, including the payment of debt service obligations and operating expenses it may incur and any dividends or liquidation amounts with respect to the series A non-cumulative and series B non-cumulative preferred shares and common shares. For the years ended December 31, 2006, 2005 and 2004, ACGL received dividends of $22.1 million, $22.1 million and $11.0 million from Arch Re Bermuda. Such amounts were used to pay interest on ACGL s senior notes.

On a consolidated basis, our aggregate cash and invested assets totaled $9.32 billion at December 31, 2006, compared to $7.12 billion at December 31, 2005. At December 31, 2006 and 2005, our fixed income portfolio, which includes fixed maturity securities and short-term investments, had an average Standard & Poor s quality rating of AAA and AA+ , respectively, and an average effective duration of 3.2 years and 3.3 years, respectively. ACGL s readily available cash, short-term investments and marketable securities, excluding amounts held by our regulated insurance and reinsurance subsidiaries, totaled $14.2 million at December 31, 2006, compared to $21.0 million at December 31, 2005.

The ability of our regulated insurance and reinsurance subsidiaries to pay dividends or make distributions or other payments to us is dependent on their ability to meet applicable regulatory standards. Under Bermuda law, Arch Reinsurance Ltd. (Arch Re Bermuda) is required to maintain a minimum solvency margin (*i.e.*, the amount by which the value of its general business assets must exceed its general business liabilities) equal to the greatest of (1) $100 million, (2) 50% of net premiums written (being gross premiums written by us less any premiums ceded by us, but we may not deduct more than 25% of gross premiums when computing net premiums written) and (3) 15% of loss and other insurance reserves. Arch Re Bermuda is prohibited from declaring or paying any dividends during any financial year if it is not in compliance with its minimum solvency margin or minimum liquidity ratio. In addition, Arch Re Bermuda is prohibited from declaring or paying in any financial year dividends of more than 25% of its total statutory capital and surplus (as shown on its previous financial year s statutory balance sheet) unless it files, at least seven days before payment of such dividends, with the Bermuda Monetary Authority an affidavit stating that it will continue to meet the required margins. In addition, Arch Re Bermuda is prohibited, without prior approval of the Bermuda Monetary Authority, from reducing by 15% or more its total statutory capital, as set out in its previous year s statutory financial statements. At December 31, 2006, as determined under Bermuda law, Arch Re Bermuda had statutory capital of $1.98 billion and statutory capital and surplus of $3.32 billion. Such amounts include ownership interests in U.S. insurance and reinsurance subsidiaries. Accordingly, Arch Re Bermuda can pay approximately $830.9 million to ACGL during 2007 without providing an affidavit to the Bermuda Monetary Authority, as discussed above. Our U.S. insurance and reinsurance subsidiaries can pay approximately $117.5 million in dividends or distributions to Arch-U.S., our U.S. holding company, which is owned by Arch Re Bermuda, during 2007 without prior regulatory approval. Such dividends or distributions may be subject to applicable withholding or other taxes. Arch-Europe can pay approximately £4.5 million, or $8.8 million, in dividends to ACGL during 2007 without prior notice and approval by the FSA. In addition, the ability of our insurance and reinsurance subsidiaries to pay dividends is also constrained by our dependence on the financial strength ratings of our insurance and reinsurance subsidiaries from independent rating agencies. The ratings from these agencies depend to a large extent on the capitalization levels of our insurance and reinsurance subsidiaries. We believe that ACGL has sufficient cash resources and available dividend capacity to service its indebtedness and other current outstanding obligations.

Our insurance and reinsurance subsidiaries are required to maintain assets on deposit, which primarily consist of fixed maturities, with various regulatory authorities to support their operations. The assets on deposit are available to settle insurance and reinsurance liabilities to third parties. Our insurance and reinsurance subsidiaries also have investments in segregated portfolios primarily to provide collateral or guarantees for letters of credit to third parties. At December 31, 2006 and 2005, such amounts approximated $1.17 billion and $1.0 billion, respectively. In addition, Arch Re Bermuda maintains assets in trust accounts as collateral for insurance and reinsurance transactions with affiliated companies. At December 31, 2006 and 2005, such amounts approximated $3.6 billion and $2.77 billion, respectively.

ACGL, through its subsidiaries, provides financial support to certain of its insurance subsidiaries and affiliates, through certain reinsurance arrangements essential to the ratings of such subsidiaries. Except as described in the preceding sentence, or where express reinsurance, guarantee or other financial support contractual arrangements are in place, each of ACGL s subsidiaries or affiliates is solely responsible for its own liabilities and commitments (and no other ACGL subsidiary or affiliate is so responsible). Any reinsurance arrangements, guarantees or other financial support contractual arrangements that are in place are solely for the benefit of the ACGL subsidiary or affiliate involved and third parties (creditors or insureds of such entity) are not express beneficiaries of such arrangements.

Our insurance and reinsurance operations provide liquidity in that premiums are received in advance, sometimes substantially in advance, of the time losses are paid. The period of time from the occurrence of a claim through the settlement of the liability may extend many years into the future. Sources of liquidity include cash flows from operations, financing arrangements or routine sales of investments.

As part of our investment strategy, we seek to establish a level of cash and highly liquid short-term and intermediate-term securities which, combined with expected cash flow, is believed by us to be adequate to meet our foreseeable payment obligations. However, due to the nature of our operations, cash flows are affected by claim payments that may comprise large payments on a limited number of claims and which can fluctuate from year to year. We believe that our liquid investments and cash flow will provide us with sufficient liquidity in order to meet our claim payment obligations. However, the timing and amounts of actual claim payments related to recorded Loss Reserves vary based on many factors, including large individual losses, changes in the legal environment, as well as general market conditions. The ultimate amount of the claim payments could differ materially from our estimated amounts. Certain lines of business written by us, such as excess casualty, have loss experience characterized as low frequency and high severity. The foregoing may result in significant variability in loss payment patterns. The impact of this variability can be exacerbated by the fact that the timing of the receipt of reinsurance recoverables owed to us may be slower than anticipated by us. Therefore, the irregular timing of claim payments can create significant variations in cash flows from operations between periods and may require us to utilize other sources of liquidity to make these payments, which may include the sale of investments or utilization of existing or new credit facilities or capital market transactions. If the source of liquidity is the sale of investments, we may be forced to sell such investments at a loss, which may be material.

Consolidated cash provided by operating activities was $1.61 billion for the year ended December 31, 2006, compared to $1.45 billion for the year ended December 31, 2005. Payments related to the 2004 and 2005 catastrophic events reduced operating cash flows by $179.8 million for the year ended December 31, 2006. Cash flow from operating activities are provided by premiums collected, fee income, investment income and collected reinsurance recoverables, offset by losses and loss adjustment expense payments, reinsurance premiums paid, operating costs and current taxes paid.

We expect that our operational needs, including our anticipated insurance obligations and operating and capital expenditure needs, for the next twelve months, at a minimum, will be met by our balance of cash, short-term investments and our credit facilities, as well as by funds generated from underwriting activities and investment income and proceeds on the sale or maturity of our investments. See Contractual Obligations and Commercial Commitments Contractual Obligations for an analysis of our contractual commitments at December 31, 2006.

We monitor our capital adequacy on a regular basis and will seek to adjust our capital base (up or down) according to the needs of our business. The future capital requirements of our business will depend on many factors, including our ability to write new business successfully and to establish premium rates and reserves at levels sufficient to cover losses. Our ability to underwrite is largely dependent upon the quality of our claims paying and financial strength ratings as evaluated by independent rating agencies. In particular, we require (1) sufficient capital to maintain our financial strength ratings, as issued by several ratings agencies, at a level considered necessary by management to enable our key operating subsidiaries to compete; (2) sufficient capital to enable our underwriting subsidiaries to meet the capital adequacy tests performed by statutory agencies in the U.S. and other key markets; and (3) letters of credit and other forms of collateral that are necessary for our non-U.S. operating companies because they are non-admitted under U.S. state insurance regulations.

As part of our capital management program, we may seek to raise additional capital or may seek to return capital to our shareholders through share repurchases, cash dividends or other methods (or a combination of such methods). Any such determination will be at the discretion of our board of directors and will be dependent upon our profits, financial requirements and other factors, including legal restrictions, rating agency requirements and such other factors as our board of directors deems relevant.

On February 28, 2007, our Board of Directors authorized us to invest up to $1 billion in ACGL s common shares through a share repurchase program. Repurchases under the program may be effected from time to time in open market or privately negotiated transactions through February 2009. The timing and amount of the repurchase transactions under this program will depend on a variety of factors, including market conditions and corporate and regulatory considerations. In connection with the repurchase program, the Warburg Pincus funds and Hellman & Friedman funds waived their rights relating to share repurchases under the shareholders agreement for all repurchases of common shares by ACGL under the repurchase program in open market transactions and certain privately negotiated transactions. See Market for Registrant s Common Equity, Related Stockholder Matters and Issuer Purchases of Equity Securities Dividends.

To the extent that our existing capital is insufficient to fund our future operating requirements or maintain such ratings, we may need to raise additional funds through financings or limit our growth. If we are not able to obtain adequate capital, our business, results of operations and financial condition could be adversely affected, which could include, among other things, the following possible outcomes: (1) potential downgrades in the financial strength ratings assigned by ratings agencies to our operating subsidiaries, which could place those operating subsidiaries at a competitive disadvantage compared to higher-rated competitors; (2) reductions in the amount of business that our operating subsidiaries are able to write in order to meet capital adequacy-based tests enforced by statutory agencies; and (3) any resultant ratings downgrades could, among other things, affect our ability to write business and increase the cost of bank credit and letters of credit.

In addition to common share capital, we depend on external sources of finance to support our underwriting activities, which can be in the form (or any combination) of debt securities, preference shares, common equity and bank credit facilities providing loans and/or letters of credit. Any equity or debt financing, if available at all, may be on terms that are unfavorable to us. In the case of equity financings, dilution to our shareholders could result, and, in any case, such securities may have rights, preferences and privileges that are senior to those of our outstanding securities.

In June 2006, ACGL and Arch-U.S. filed a universal shelf registration statement with the SEC. This registration statement allows for the possible future offer and sale by us of various types of securities, including unsecured debt securities, preference shares, common shares, warrants, share purchase contracts and units and depositary shares. The shelf registration statement enables us to efficiently access the public debt and/or equity capital markets in order to meet our future capital needs. The shelf registration statement also allows selling shareholders to resell common shares that they own in one or more offerings from time to time. We will not receive any proceeds from any shares offered by the selling shareholders. This report is not an offer to sell or the solicitation of an offer to buy nor shall there be any sale of these securities in any state in which such offer, solicitation or sale would be unlawful prior to registration or qualification under the securities laws of any such state.

In August 2006, we entered into a five-year agreement for a $300 million unsecured revolving loan and letter of credit facility and a $1.0 billion secured letter of credit facility. The $300 million unsecured loan and letter of credit facility is also available for the issuance of unsecured letters of credit up to $100 million for our U.S.-based reinsurance operation.

During 2006, ACGL completed two public offerings of non-cumulative preferred shares. On February 1, 2006, $200.0 million principal amount of 8.0% series A non-cumulative preferred shares (series A preferred shares) were issued with net proceeds of $193.5 million and, on May 24, 2006, $125.0 million principal amount of 7.875% series B non-cumulative preferred shares (series B preferred shares and together with the series A preferred shares, the preferred shares) were issued with net proceeds of $120.9 million. The net proceeds of the offerings were used to support the underwriting activities of ACGL s insurance and reinsurance subsidiaries. ACGL has the right to redeem all or a portion of each series of preferred shares at a redemption price of $25.00 per share on or after (1) February 1, 2011 for the series A preferred shares and (2) May 15, 2011 for the series B preferred shares. Dividends on the preferred shares are non-cumulative. Consequently, in the event dividends are not declared on the preferred shares for any dividend period, holders of preferred shares will not be entitled to receive a dividend for such period, and such undeclared dividend will not accrue and will not be payable. Holders of preferred shares will be entitled to receive dividend payments only when, as and if declared by ACGL s board of directors or a duly authorized committee of the board of directors. Any such dividends will be payable from the date of original issue on a non-cumulative basis, quarterly in arrears. To the extent declared, these dividends will accumulate, with respect to each dividend period, in an amount per share equal to 8.0% of the $25.00 liquidation preference per annum for the series A preferred shares and 7.875% of the $25.00 liquidation preference per annum for the series B preferred shares. For the year ended December 31, 2006, we paid $17.4 million to holders of the preferred shares and, at December 31, 2006, had declared an aggregate of $3.3 million of dividends to be paid to holders of the preferred shares.

At December 31, 2006, ACGL s capital of $3.89 billion consisted of $300.0 million of senior notes, representing 7.7% of the total, $325.0 million of preferred shares, representing 8.4% of the total, and common shareholders equity of $3.27 billion, representing the balance. At December 31, 2005, ACGL s capital of $2.78 billion consisted of senior notes of $300 million, representing 10.8% of the total, and common shareholders equity of $2.48 billion, representing the balance. The increase in capital during 2006 of $1.11 billion was primarily attributable to net income for the year ended December 31, 2006, the issuance of $325.0 million of preferred shares and an after-tax increase in the fair value of our investment portfolio during 2006 which was primarily due to a decrease in the level of interest rates in the second half of 2006.

Natural and Man-Made Catastrophic Events

We have large aggregate exposures to natural and man-made catastrophic events. Catastrophes can be caused by various events, including, but not limited to, hurricanes, floods, windstorms, earthquakes, hailstorms, explosions, severe winter weather and fires. Catastrophes can also cause losses in non-property business such as workers compensation or general liability. In addition to the nature of property business, we believe that economic and geographic trends affecting insured property, including inflation, property value appreciation and geographic concentration, tend to generally increase the size of losses from catastrophic events over time.

We have substantial exposure to unexpected, large losses resulting from future man-made catastrophic events, such as acts of war, acts of terrorism and political instability. These risks are inherently unpredictable and recent events may lead to increased frequency and severity of losses. It is difficult to predict the timing of such events with statistical certainty or estimate the amount of loss any given occurrence will generate. It is not possible to eliminate completely our exposure to unforecasted or unpredictable events and, to the extent that losses from such risks occur, our financial condition and results of operations could be materially adversely affected. Therefore, claims for natural and man-made catastrophic events could expose us to large losses and cause substantial volatility in our results of operations, which could cause the value of our common shares to fluctuate widely. In certain instances, we specifically insure and reinsure risks resulting from terrorism. Even in cases where we attempt to exclude losses from terrorism and certain other similar risks from some coverages written by us, we may not be successful in doing so. Moreover, irrespective of the clarity and inclusiveness of policy language, there can be no assurance that a court or arbitration panel will limit enforceability of policy language or otherwise issue a ruling adverse to us.

We seek to limit our loss exposure by writing a number of our reinsurance contracts on an excess of loss basis, adhering to maximum limitations on reinsurance written in defined geographical zones, limiting program size for each client and prudent underwriting of each program written. In the case of proportional treaties, we may seek per occurrence limitations or loss ratio caps to limit the impact of losses from any one or series of events. In our insurance operations, we seek to limit our exposure through the purchase of reinsurance. We cannot be certain that any of these loss limitation methods will be effective. We also seek to limit our loss exposure by geographic diversification. Geographic zone limitations involve significant underwriting judgments, including the determination of the area of the zones and the inclusion of a particular policy within a particular zone s limits. There can be no assurance that various provisions of our policies, such as limitations or exclusions from coverage or choice of forum, will be enforceable in the manner we intend. Disputes relating to coverage and choice of legal forum may also arise. Underwriting is inherently a matter of judgment, involving important assumptions about matters that are inherently unpredictable and beyond our control, and for which historical experience and probability analysis may not provide sufficient guidance. One or more catastrophic or other events could result in claims that substantially exceed our expectations, which could have a material adverse effect on our financial condition or our results of operations, possibly to the extent of eliminating our shareholders equity.

For our natural catastrophe exposed business, we seek to limit the amount of exposure we will assume from any one insured or reinsured and the amount of the exposure to catastrophe losses in any geographic zone. We monitor our exposure to catastrophic events, including earthquake and wind and periodically reevaluate the estimated probable maximum pre-tax loss for such exposures. Our estimated probable maximum pre-tax loss is determined through the use of modeling techniques, but such estimate does not represent our total potential loss for such exposures. We seek to limit the probable maximum pre-tax loss to a specific level for severe catastrophic events. Currently, we generally seek to limit the probable maximum pre-tax loss to approximately 25% of total shareholders equity for a severe catastrophic event in any geographic zone that could be expected to occur once in every 250 years, although we reserve the right to change this threshold at any time. There can be no assurances that we will not suffer pre-tax losses greater than 25% of our total shareholders equity from one or more catastrophic events due to several factors, including the inherent uncertainties in estimating the frequency and severity of such events and the margin of error in making such determinations resulting from potential inaccuracies and inadequacies in the data provided by clients and brokers, the modeling techniques and the application of such techniques or as a result of a decision to change the percentage of shareholders equity exposed to a single catastrophic event. In addition, depending on business opportunities and the mix of business that may comprise our insurance and reinsurance portfolio, we may seek to adjust our self-imposed limitations on probable maximum pre-tax loss for catastrophe exposed business. See Critical Accounting Policies, Estimates and Recent Accounting Pronouncements Ceded Reinsurance for a discussion of our catastrophe reinsurance programs.

Contractual Obligations and Commercial Commitments

Letter of Credit and Revolving Credit Facilities

On August 30, 2006, we entered into the Second Amended and Restated Credit Agreement (Credit Agreement) for a $300 million unsecured revolving loan and letter of credit facility and a $1.0 billion secured letter of credit facility, an increase of $500 million from the previous credit agreement. The $300 million unsecured revolving loan is also available for the issuance of unsecured letters of credit up to $100 million for Arch Re U.S. Borrowings of revolving loans may be made by ACGL and Arch Re U.S. at a variable rate based on LIBOR or an alternative base rate at our option. Secured letters of credit are available for issuance on behalf of our insurance and reinsurance subsidiaries.

Issuance of letters of credit and borrowings under the Credit Agreement are subject to our compliance with certain covenants and conditions, including absence of a material adverse change. These covenants require, among other things, that we maintain a debt to shareholders equity ratio of not greater than 0.35 to 1 and shareholders equity in excess of $1.95 billion plus 25% of future aggregate net income for each quarterly period (not including any future net losses) beginning after June 30, 2006 and 25% of future aggregate proceeds from the issuance of common or preferred equity and that our principal insurance and reinsurance subsidiaries maintain at least a B++ rating from A.M. Best. In addition, certain of our subsidiaries which are party to the Credit Agreement are required to maintain minimum shareholders equity levels. We were in compliance with all covenants contained in the Credit Agreement at December 31, 2006. The Credit Agreement expires on August 30, 2011.

Including the secured letter of credit portion of the Credit Agreement and another letter of credit facility (together, the LOC Facilities), we have access to letter of credit facilities for up to a total of $1.45 billion. The principal purpose of the LOC Facilities is to issue, as required, evergreen standby letters of credit in favor of primary insurance or reinsurance counterparties with which we have entered into reinsurance arrangements to ensure that such counterparties are permitted to take credit for reinsurance obtained from our reinsurance subsidiaries in United States jurisdictions where such subsidiaries are not licensed or otherwise admitted as an insurer, as required under insurance regulations in the United States, and to comply with requirements of Lloyd s of London in connection with qualifying quota share and other arrangements. The amount of letters of credit issued is driven by, among other things, the timing and payment of catastrophe losses, loss development of existing reserves, the payment pattern of such reserves, the further expansion of our business and the loss experience of such business. When issued, certain letters of credit are secured by a portion of our investment portfolio. In addition, the LOC Facilities also require the maintenance of certain covenants, which we were in compliance with at December 31, 2006. At such date, we had approximately $663.7 million in outstanding letters of credit under the LOC Facilities, which were secured by investments totaling $728.7 million. The other letter of credit facility was amended and restated in December 2006. It is anticipated that the LOC Facilities will be renewed (or replaced) on expiry, but such renewal (or replacement) will be subject to the availability of credit from banks which we utilize. In addition to letters of credit, we have established and may establish additional insurance trust accounts in the U.S. and Canada to secure our reinsurance amounts payable as required. See note 7, Investment Information, of the notes accompanying our consolidated financial statements.

Senior Notes

In May 2004, ACGL completed a public offering of $300 million principal amount of 7.35% senior notes (Senior Notes) due May 1, 2034 and received net proceeds of $296.4 million. ACGL will pay interest on the Senior Notes on May 1 and November 1 of each year. The first such payment was made on November 1, 2004. ACGL may redeem the Senior Notes at any time and from time to time, in whole or in part, at a make-whole redemption price. The Senior Notes are ACGL s senior unsecured obligations and rank equally with all of its existing and future senior unsecured indebtedness. The effective interest rate related to the Senior Notes, based on the net proceeds received, is approximately 7.46%. ACGL used $200 million of the net proceeds from the offering to repay all amounts outstanding under a revolving credit agreement and the remaining proceeds were used to support the underwriting activities of its insurance and reinsurance subsidiaries and for other general corporate purposes.

Guarantee

In the 2005 first quarter, we agreed to provide a guarantee, through the issuance of a standby letter of credit in the amount of $6.0 million (the Guarantee) for the benefit of a commercial bank, to assist the principals of an agency obtain a loan to purchase the agency from its prior owner. The agency loan is payable over a seven year term, and the amount of the Guarantee is based on the amortization schedule of the agency loan. At December 31, 2006, the Guarantee was $4.6 million. The fair value of the Guarantee included as a liability in our balance sheet was $0.2 million at December 31, 2006 and $0.3 million at December 31, 2005.

Contractual Obligations

The following table provides an analysis of our contractual commitments at December 31, 2006:

		Payment due by period			
	Total	Less than 1 year	1 - 3 years	3 - 5 years	More than 5 years
	(U.S. dollars in thousands)				
Long-term debt obligations	$ 300,000				$ 300,000
Interest expense on long-term debt obligations	606,375	22,050	44,100	44,100	496,125
Operating lease obligations	82,977	10,829	25,378	23,238	23,532
Purchase obligations	21,543	9,293	11,292	958	
Reserves for losses and loss adjustment expenses, gross(1)	6,463,041	2,003,408	2,189,003	971,857	1,298,773
Deposit accounting liabilities(2)	45,107	3,243	5,500	8,395	27,969
Securities lending collateral(3)	891,376	891,376			
Investment commitments	28,400	28,400			
Total	$ 8,438,819	$ 2,968,599	$ 2,275,273	$ 1,048,548	$ 2,146,399

(1) The estimated expected contractual commitments related to the reserves for losses and loss adjustment expenses are presented on a gross basis. It should be noted that until a claim has been presented to us, determined to be valid, quantified and settled, there is no known obligation on an individual transaction basis, and while estimable in the aggregate, the timing and amount contain significant uncertainty. Approximately 74% of our net reserves were incurred but not reported at December 31, 2006.

(2) The estimated expected contractual commitments related to deposit accounting liabilities have been estimated using projected cash flows from the underlying contracts. It should be noted that, due to the nature of such liabilities, the timing and amount contain significant uncertainty.

(3) As part of our securities lending program, we loan certain fixed income securities to third parties and receive collateral, primarily in the form of cash. The collateral received is reinvested and is reflected as short-term investment of funds received under securities lending agreements, at fair value. Such collateral is due back to the third parties at the close of the securities lending transaction.

Off-Balance Sheet Arrangements

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

On December 29, 2005, Arch Re Bermuda entered into a quota share reinsurance treaty with Flatiron Re Ltd., a newly-formed Bermuda reinsurance company, pursuant to which Flatiron Re Ltd. is assuming a 45% quota share (the Flatiron Treaty) of certain lines of property and marine business underwritten by Arch Re Bermuda for unaffiliated third parties for the 2006 and 2007 underwriting years (January 1, 2006 to December 31, 2007). The quota share is subject to decrease by Arch Re Bermuda under certain circumstances. In addition, in certain circumstances, Flatiron Re Ltd. may extend at its option the coverage provided by the Flatiron Treaty to Arch Re Bermuda s 2008 underwriting year. 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 Flatiron Treaty. As a result of the terms of the Flatiron Treaty, we determined that Flatiron Re Ltd. is a variable interest entity. However, Arch Re Bermuda is not the primary beneficiary of Flatiron Re Ltd. and, as such, we are not required to consolidate the assets, liabilities and results of operations of Flatiron Re Ltd. per FIN 46R. See note 11, Commitments and Contingencies, of the notes accompanying our consolidated financial statements for further details on the Flatiron Treaty.

Investments

The finance and investment committee of our board of directors establishes our investment policies and creates guidelines for our investment managers. The finance and investment committee reviews the implementation of the investment strategy on a regular basis. Our current approach stresses preservation of capital, market liquidity and diversification of risk.

Our cash and invested assets were as follows at December 31, 2006 and 2005:

	December 31,	
	2006	**2005**
	(U.S. dollars in thousands)	
Fixed maturities available for sale, at fair value	$ 6,876,548	$ 5,280,987
Fixed maturities pledged under securities lending agreements, at fair value(1)	860,803	862,766
Total fixed maturities	7,737,351	6,143,753
Short-term investments available for sale, at fair value	957,698	681,887
Short-term investments pledged under securities lending agreements, at fair value(1)		1,100
Cash	317,017	222,477
Other investments, at fair value	307,082	70,233
Total cash and invested assets(1)(2)	$ 9,319,148	$ 7,119,450

(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.

At December 31, 2006, our fixed income portfolio, which includes fixed maturity securities and short-term investments, had a AAA average Standard & Poor s quality rating, an average effective duration of 3.2 years, and an average yield to maturity (imbedded book yield), before investment expenses, of 4.97%. At December 31, 2005, our fixed income portfolio had a AA+ average Standard & Poor s quality rating, an average effective duration of 3.3 years, and an average yield to maturity (imbedded book yield), before investment expenses, of 4.19%.

We hired a Chief Investment Officer during 2005 to administer the investment portfolio, oversee our investment managers, formulate investment strategy in conjunction with our finance and investment committee and directly manage certain portions of our fixed income portfolio. At December 31, 2006, approximately $3.9 billion, or 42%, of our total investments and cash was internally managed, compared to $2.1 billion, or 29%, at December 31, 2005. While maintaining our emphasis on preservation of capital and liquidity, we expect our portfolio to become more diversified and, as a result, we may expand into areas which are not currently part of our investment strategy.

We participate in 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.

As part of our investment strategy, we seek to establish a level of cash and highly liquid short-term and intermediate-term securities which, combined with expected cash flow, is believed by us to be adequate to meet our foreseeable payment obligations. Our investment strategy allows for the use of derivative securities. Derivative instruments may be used to enhance investment performance, replicate investment positions or manage market exposures and duration risk that would be allowed under our investment guidelines if implemented in other ways. We began using equity futures to replicate equity investment positions in the 2006 first quarter. The fair values of those derivatives are based on quoted market prices.

The notional value of the net long position for equity futures was $78.6 million at December 31, 2006. In connection with the use of equity futures, we also began using exchange-traded Treasury note futures in the 2006 first quarter. The notional value of the net short position for Treasury note futures was $35.2 million at December 31, 2006. We recorded net realized gains of $2.1 million for the year ended December 31, 2006 related to changes in the fair value of all futures contracts. At December 31, 2006, the carrying value and fair value of all futures contracts was a liability of $0.3 million.

Our portfolio includes investments, such as mortgage-backed securities, which are subject to prepayment risk. At December 31, 2006, our investments in mortgage-backed securities, excluding commercial mortgage-backed securities, amounted to approximately $1.18 billion, or 12.7% of total investments and cash, compared to $376.8 million, or 5.3%, at December 31, 2005. Such amounts are classified as available for sale and are not held for trading purposes. In addition, our fixed maturities at December 31, 2006 include exposures to certain corporate sectors, such as the financial sector (8.0% of total investments and cash) and the industrial sector (4.8% of total investments and cash).

We expanded our investment strategy in 2005 to include other asset sectors. Alternative investment funds primarily include funds that invest in investment grade and non-investment grade fixed income securities and funds that invest in senior floating rate loans; equity securities include certain investments in mutual funds and other preferred stocks; and privately held securities include our investment in Aeolus LP. See note 10, Transactions with Related Parties, of the notes accompanying our consolidated financial statements for further details on the Company s investment in Aeolus, L.P. Our investment commitments related to other investments totaled approximately $28.4 million and $8.4 million, respectively, at December 31, 2006 and 2005.

Calculation of Book Value Per Common Share

The following presents the calculation of book value per common share for December 31, 2006 and 2005. The shares and per share numbers set forth below exclude the effects of 5,669,994 and 5,637,108 stock options and 91,514 and 93,545 restricted stock units outstanding at December 31, 2006 and 2005, respectively.

	December 31, 2006 (U.S. dollars in thousands, except share data)	2005
Total shareholders equity	$ 3,590,619	$ 2,480,527
Less preferred shareholders equity	(325,000)	
Common shareholders equity	3,265,619	$ 2,480,527
Common shares outstanding	74,270,466	73,334,870
Book value per common share	$ 43.97	$ 33.82

Market Sensitive Instruments and Risk Management

We are exposed to potential loss from various market risks, including changes in equity prices, interest rates and foreign currency exchange rates.

In accordance with the SEC s Financial Reporting Release No. 48, we performed a sensitivity analysis to determine the effects that market risk exposures could have on the future earnings, fair values or cash flows of our financial instruments as of December 31, 2006. Market risk represents the risk of changes in the fair value of a financial instrument and consists of several components, including liquidity, basis and price risks.

The sensitivity analysis performed as of December 31, 2006 presents hypothetical losses in cash flows, earnings and fair values of market sensitive instruments which were held by us on December 31, 2006 and are sensitive to changes in interest rates and equity security prices. This risk management discussion and the estimated amounts generated from the following sensitivity analysis represent forward-looking statements of market risk assuming certain adverse market conditions occur. Actual results in the future may differ materially from these projected results due to actual developments in the global financial markets. The analysis methods used by us to assess and mitigate risk should not be considered projections of future events of losses.

The focus of the SEC s market risk rules is on price risk. For purposes of specific risk analysis, we employ sensitivity analysis to determine the effects that market risk exposures could have on the future earnings, fair values or cash flows of our financial instruments. The financial instruments included in the following sensitivity analysis consist of all of our investments and cash.

Investment Market Risk

Fixed Income Securities. We invest in interest rate sensitive securities, primarily debt securities. We consider the effect of interest rate movements on the market value of our fixed maturities, fixed maturities pledged under securities lending agreements, short-term investments and certain of our other investments which invest in fixed income securities and the corresponding change in unrealized appreciation. As interest rates rise, the market value of our interest rate sensitive securities falls, and the converse is also true. The following table summarizes the effect that an immediate, parallel shift in the interest rate yield curve would have had on the portfolio at December 31, 2006 and 2005. Based on historical observations, there is a low probability that all interest rate yield curves would shift in the same direction at the same time and, accordingly, the actual effect of interest rate movements may differ materially from the amounts set forth below. For further discussion on investment activity, please refer to Investments.

	Interest Rate Shift in Basis Points				
	-100	**-50**	**0**	**50**	**100**
	(U.S. dollars in millions)				
December 31, 2006:					
Total market value	$ 9,153.8	$ 9,007.0	$ 8,862.5	$ 8,720.5	$ 8,581.2
Market value change from base	3.29 %	1.63 %		(1.60 %)	(3.17 %)
Change in unrealized value	$ 291.3	$ 144.5		($142.0)	($281.3)
December 31, 2005:					
Total market value	$ 7,090.6	$ 6,971.4	$ 6,855.5	$ 6,743.1	$ 6,634.8
Market value change from base	3.43 %	1.69 %		(1.64 %)	(3.22 %)
Change in unrealized value	$ 235.1	$ 115.9		($112.4)	($220.7)

Another method that attempts to measure portfolio risk is Value-at-Risk (VaR). VaR attempts to take into account a broad cross-section of risks facing a portfolio by utilizing relevant securities volatility data skewed towards the most recent months and quarters. VaR measures the amount of a portfolio at risk for outcomes 1.65 standard deviations from the mean based on normal market conditions over a one year time horizon and is expressed as a percentage of the portfolio s initial value. In other words, 95% of the time, should the risks taken into account in the VaR model perform per their historical tendencies, the portfolio s loss in any one year period is expected to be less than or equal to the calculated VaR, stated as a percentage of the measured portfolio s initial value. As of December 31, 2006, our portfolio s VaR was estimated to be 3.66%, compared to an estimated 3.29% at December 31, 2005.

Equities and Privately Held Securities. Our investment portfolio includes an allocation to other investments which include investments in certain stock index funds, other preferred stocks and privately held securities. At December 31, 2006 and 2005, the fair value of our investments in equities and privately held securities totaled $139.6 million and $41.5 million, respectively. These securities are exposed to price risk, which is the potential loss arising from decreases in the market value of equities. An immediate hypothetical 10% depreciation in the value of each equity position would reduce the fair value of such investments by approximately $14.0 million and $4.2 million at December 31, 2006 and 2005, respectively, and would have decreased book value per common share by approximately $0.19 and $0.06, respectively.

Investment-Related Derivatives. We began to invest in certain derivative instruments in 2006 to replicate investment positions and to manage market exposures and duration risk. The notional value of the net long position for equity futures was $78.6 million at December 31, 2006 and the notional value of the net short position for Treasury note futures was $35.2 million at December 31, 2006. A 10% depreciation of the underlying exposure to these derivative instruments at December 31, 2006 would have resulted in a reduction in net income of approximately $11.4 million and would have decreased book value per common share by $0.15.

Foreign Currency Exchange Risk

Foreign currency rate risk is the potential change in value, income and cash flow arising from adverse changes in foreign currency exchange rates. A 10% depreciation of the U.S. Dollar against other currencies under our outstanding contracts at December 31, 2006, net of unrealized appreciation on our securities denominated in currencies other than the U.S. Dollar, would have resulted in unrealized gains of approximately $3.6 million and would have increased book value per common share by approximately $0.05. A 10% depreciation of the U.S. Dollar against other currencies under our outstanding contracts at December 31, 2005, net of unrealized appreciation on our securities denominated in currencies other than the U.S. Dollar, would have resulted in unrealized losses of approximately $7.7 million and would have decreased book value per common share by approximately $0.11. Based on historical observations, there is a low probability that all foreign currency exchange rates would shift against the U.S. Dollar in the same direction and at the same time and, accordingly, the actual effect of foreign currency rate movements may differ materially from the amounts set forth above. For further discussion on foreign exchange activity, please refer to Results of Operations.

Effects of Inflation

We do not believe that inflation has had a material effect on our consolidated results of operations, except insofar as inflation may affect our reserves for losses and loss adjustment expenses and interest rates. The potential exists, after a catastrophe loss, for the development of inflationary pressures in a local economy. The anticipated effects of inflation on us are considered in our catastrophe loss models. The actual effects of inflation on our results cannot be accurately known until claims are ultimately settled.

ITEM 7A. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

Reference is made to the information appearing above under the subheading Market Sensitive Instruments and Risk Management under the caption Management s Discussion and Analysis of Financial Condition and Results of Operation, which information is hereby incorporated by reference.

ITEM 8. FINANCIAL STATEMENTS AND SUPPLEMENTARY DATA

See our consolidated financial statements and notes thereto and required financial statement schedules commencing on page F-1.

ITEM 9. CHANGES IN AND DISAGREEMENTS WITH ACCOUNTANTS ON ACCOUNTING AND FINANCIAL DISCLOSURE

None.

ITEM 9A. CONTROLS AND PROCEDURES

Evaluation of Disclosure Controls and Procedures

In connection with the filing of this Form 10-K, our management, including the Chief Executive Officer and Chief Financial Officer, conducted an evaluation, as of December 31, 2006, for the purposes set forth in the applicable rules under the Securities and Exchange Act of 1934, as amended (the Exchange Act). Based on that evaluation, the Chief Executive Officer and Chief Financial Officer concluded that the disclosure controls and procedures are effective.

We continue to enhance our operating procedures and internal controls (including the timely and successful implementation of our information technology initiatives, which include the implementation of improved computerized systems and programs to replace and support manual systems, and including controls over financial reporting) to effectively support our business and our regulatory and reporting requirements. Our management does not expect that our disclosure controls or our internal controls will prevent all errors and all fraud. A control system, no matter how well conceived and operated, can provide only reasonable, not absolute, assurance that the objectives of the control system are met. Further, the design of a control system must reflect the fact that there are resource constraints, and the benefits of controls must be considered relative to their costs. As a result of the inherent limitations in all control systems, no evaluation of controls can provide absolute assurance that all control issues and instances of fraud, if any, within the company have been detected. These inherent limitations include the realities that judgments in decision-making can be faulty, and that breakdowns can occur because of simple error or mistake. Additionally, controls can be circumvented by the individual acts of some persons or by collusion of two or more people. The design of any system of controls also is based in part upon certain assumptions about the likelihood of future events, and there can be no assurance that any design will succeed in achieving its stated goals under all potential future conditions; over time, controls may become inadequate because of changes in conditions, or the degree of compliance with the policies or procedures may deteriorate. As a result of the inherent limitations in a cost-effective control system, misstatement due to error or fraud may occur and not be detected. Accordingly, our disclosure controls and procedures are designed to provide reasonable, not absolute, assurance that the disclosure controls and procedures are met.

Management s Annual Report on Internal Control Over Financial Reporting

Our management is responsible for establishing and maintaining adequate internal control over financial reporting, as defined in Rule 13a-15(f) and 15d-15(f) under the Exchange Act. Our management assessed the effectiveness of our internal control over financial reporting as of December 31, 2006. In making this assessment, management used the criteria set forth by the Committee of Sponsoring Organizations (COSO) of the Treadway Commission in *Internal Control-Integrated Framework*.

Based on our assessment, management determined that, as of December 31, 2006, our internal control over financial reporting was effective. Our management s assessment of the effectiveness of our internal control over financial reporting as of December 31, 2006 has been audited by PricewaterhouseCoopers LLP, an independent registered public accounting firm, as stated in their report which appears on page F-2.

Changes in Internal Controls Over Financial Reporting

There have been no changes in internal control over financial reporting that occurred during the fiscal quarter ended December 31, 2006 that have materially affected, or are reasonably likely to materially affect, internal control over financial reporting.

ITEM 9B. OTHER INFORMATION

None.

PART III

ITEM 10. DIRECTORS AND EXECUTIVE OFFICERS OF THE REGISTRANT

The information required by this item is incorporated by reference from the information to be included in our definitive proxy statement (Proxy Statement) for our annual meeting of shareholders to be held in 2007, which we intend to file with the SEC before April 30, 2007. Copies of our code of ethics applicable to our chief executive officer, chief financial officer and principal accounting officer or controller are available free of charge to investors upon written request addressed to the attention of ACGL s corporate secretary, Wessex House, 45 Reid Street, Hamilton HM 12, Bermuda. In addition, our code of ethics and certain other basic corporate docu