

ARCH CAPITAL GROUP LTD.  
Form 424B3  
May 15, 2006

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**Subject to Completion**  
**Preliminary Prospectus Supplement dated May 15, 2006**

**The information in this prospectus supplement and the accompanying prospectus is not complete and may be changed. This prospectus supplement and the accompanying prospectus are not an offer to sell securities and are not soliciting an offer to buy securities 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 is not permitted.**

**PROSPECTUS SUPPLEMENT**  
**(to prospectus dated August 25, 2004)**

## Shares

### **% Non-Cumulative Preferred Shares, Series B**

Arch Capital Group Ltd. is offering \_\_\_\_\_ shares of its \_\_\_\_\_ % Non-Cumulative Preferred Shares, Series B, \$25 liquidation preference per share (the "Series B Non-Cumulative Preferred Shares").

Holders of Series B Non-Cumulative Preferred Shares will be entitled to receive dividend payments only when, as and if declared by our board of directors or a duly authorized committee of the board. Any such dividends will be payable from the date of original issue on a non-cumulative basis, quarterly in arrears on the 15th day of February, May, August and November of each year (each, a "dividend payment date"), commencing on August 15, 2006, at an annual rate of \_\_\_\_\_ %.

Dividends on the Series B Non-Cumulative Preferred Shares are not cumulative. Accordingly, in the event dividends are not declared on the Series B Non-Cumulative Preferred Shares for payment on any dividend payment date, then those dividends will not accrue and will not be payable. If we have not declared a dividend before the dividend payment date for any dividend period, we will have no obligation to pay dividends for that dividend period, whether or not dividends on the Series B Non-Cumulative Preferred Shares are declared for any future dividend period.

So long as any Series B Non-Cumulative Preferred Shares remain outstanding, no dividend shall be paid or declared on our common shares or any of our other securities ranking junior to the Series B Non-Cumulative Preferred Shares (other than a dividend payable solely in common shares or in such other junior securities), unless the full dividends for the latest completed dividend period on all outstanding Series B Non-Cumulative Preferred Shares and any parity shares have been declared and paid or provided for. In the past, we have not paid dividends on our common shares.

Except in specified circumstances relating to certain tax or corporate events, the Series B Non-Cumulative Preferred Shares are not redeemable prior to \_\_\_\_\_, 2011. On and after that date, the Series B Non-Cumulative Preferred Shares will be redeemable at our option, in whole or in part, at a redemption price of \$25 per Series B Non-Cumulative Preferred Share, plus any declared and unpaid dividends, without accumulation of any undeclared dividends. See "Description of the Series B Non-Cumulative Preferred Shares Redemption" and "Tax Redemption." Our ability to redeem the Series B Non-Cumulative Preferred Shares is subject to certain restrictions described under "Description of the Series B Non-Cumulative Preferred Shares Redemption."

The Series B Non-Cumulative Preferred Shares will not have voting rights, except as set forth under "Description of the Series B Non-Cumulative Preferred Shares Voting Rights."

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See "Risk Factors" beginning on page S-8 of this prospectus supplement and on page 2 of the accompanying prospectus to read about important factors you should consider before investing in the Series B Non-Cumulative Preferred Shares.

Neither the Securities and Exchange Commission nor any state securities commission has approved or disapproved of these securities or determined if this prospectus supplement or the accompanying prospectus are truthful or complete. Any representation to the contrary is a criminal offense.

	<u>Per Series B Preferred Share</u>	<u>Total</u>
Public offering price	\$	\$
Underwriting discount(1)	\$	\$
Proceeds, before expenses, to ACGL(1)	\$	\$

(1) With respect to sales made by the underwriters to certain institutions, the underwriting discount will be \$ \_\_\_\_\_ per Series B Non-Cumulative Preferred Share and, with respect to such sales only, the total underwriting discount will be less than the amount set forth in the table above and the proceeds to us will be greater than the amount set forth in the table above.

We intend to apply to have the Series B Non-Cumulative Preferred Shares approved for listing on the New York Stock Exchange ("NYSE").

The underwriters expect to deliver the Series B Non-Cumulative Preferred Share in book entry form only, through the facilities of The Depository Trust Company against payment in New York, New York on or about \_\_\_\_\_, 2006.

*Joint Book-Running Managers*

**Merrill Lynch & Co.**

**Citigroup**

**JPMorgan**

**Wachovia Securities**

**Credit Suisse**

**UBS Investment Bank**

The date of this prospectus supplement is \_\_\_\_\_, 2006.

## TABLE OF CONTENTS

	<u>Page</u>
<b>Prospectus Supplement</b>	
Prospectus Supplement Summary	S-1
Risk Factors	S-8
Use of Proceeds	S-28
Ratio of Earnings to Fixed Charges and Preference Share Dividends	S-29
Capitalization	S-30
Description of the Series B Non-Cumulative Preferred Shares	S-32
Certain Income Tax Considerations	S-43
Underwriting	S-51
Legal Matters	S-56
Experts	S-56
Cautionary Note Regarding Forward-Looking Statements	S-57
Where You Can Find Additional Information	S-58
	<u>Page</u>
<b>Prospectus</b>	
Arch Capital Group Ltd.	1
Arch Capital Group (U.S.) Inc.	1
Risk Factors.	2
Ratio of Earnings to Fixed Charges and Preference Share Dividends	20
Use of Proceeds	21
General Description of the Offered Securities	21
Description of Arch Capital Share Capital	21
Description of Arch Capital Common Shares	22
Description of Arch Capital Preference Shares	23
Description of Arch Capital Debt Securities	26
Description of Arch Capital Depositary Shares	40
Description of Arch Capital Warrants to Purchase Common Shares or Preference Shares	43
Description of Arch Capital Warrants to Purchase Debt Securities	45
Description of Arch Capital Share Purchase Contracts and Share Purchase Units	46
Description of Arch Capital Group (U.S.) Senior Debt Securities	47
Plan of Distribution	60
Where You Can Find More Information	62
Incorporation of Documents by Reference	63
About This Prospectus	64
Cautionary Note Regarding Forward-Looking Statements	64
Legal Matters	66
Experts	66
Enforcement of Civil Liabilities Under United States Federal Securities Laws	67

You should rely only on the information contained or incorporated by reference in this prospectus supplement and the accompanying prospectus. We have not, and the underwriters have not, authorized any other person to provide you with different information. If anyone provides you with different or inconsistent information, you should not rely on it. We are not, and the underwriters are not, making an offer to sell these securities in any jurisdiction where the offer or sale is not permitted. You should assume that the information appearing in this prospectus supplement, the accompanying prospectus and the documents incorporated by reference herein and in the accompanying prospectus is accurate only

as of their respective dates. Our business, financial condition, results of operations and prospects may have changed since those dates.

In this prospectus supplement and in the accompanying prospectus, unless the context requires otherwise: (a) "ACGL" and "Arch Capital" refer to Arch Capital Group Ltd., (b) "we," "us," "our" and "the Company" refer to ACGL and its subsidiaries, (c) "Arch Re Bermuda" refers only to our wholly owned Bermuda reinsurance subsidiary, Arch Reinsurance Ltd., (d) "Arch Re U.S." refers only to our wholly owned U.S. reinsurance subsidiary, Arch Reinsurance Company, (e) (i) "Arch Specialty" refers to Arch Specialty Insurance Company, (ii) "Arch E&S" refers to Arch Excess & Surplus Insurance Company and (iii) "Western Diversified" refers to Western Diversified Casualty Insurance Company, which along with Arch Insurance Company ("Arch Insurance") are our wholly owned U.S. insurance subsidiaries, and (f) "Arch-Europe" refers to our wholly-owned U.K. insurance subsidiary, Arch Insurance Company (Europe) Limited. The terms "Warburg Pincus funds" and "Hellman & Friedman funds" refer to investment funds affiliated with Warburg Pincus LLC and investment funds led by Hellman & Friedman LLC, respectively.

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Securities may be offered or sold in Bermuda only in compliance with the provisions of the Investment Business Act of 2003 of Bermuda, which regulates the sale of securities in Bermuda. In addition, the Bermuda Monetary Authority (the "BMA") must approve all issuances and transfers of securities of a Bermuda exempted company. The BMA has issued its permission for the free issuance and transferability of our securities, as long as any of our shares are listed on an appointed stock exchange, which includes the NYSE, to and among persons who are non-residents of Bermuda for exchange control purposes. The issue and transfer of in excess of 20% of the common shares to and among persons who are residents of Bermuda for exchange control purposes requires prior authorization from the BMA. Any other transfers remain subject to approval by the BMA. In addition, this prospectus supplement and the accompanying prospectus will be filed with the Registrar of Companies in Bermuda in accordance with Bermuda law. The BMA and the Registrar of Companies accept no responsibility for the financial soundness of any proposal or for the correctness of any of the statements made or opinions expressed in this prospectus supplement or in the accompanying prospectus.

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**PROSPECTUS SUPPLEMENT SUMMARY**

*This summary is not complete and does not contain all the information you should consider. You should read this entire prospectus supplement and the accompanying prospectus carefully, including without limitation, the documents incorporated by reference in this prospectus supplement or the accompanying prospectus, the sections entitled "Risk Factors" in this prospectus supplement and in the accompanying prospectus and the section entitled "Cautionary Note Regarding Forward-Looking Statements."*

**Our Company**

Arch Capital Group Ltd. is a Bermuda public limited liability company with approximately \$3.05 billion in capital at March 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.

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 lines of business. We are seeking to increase our writings in the property and marine lines of business and, as a result, these lines, which are more volatile, may represent a larger proportion of our overall book of business in future periods, which may increase the volatility in our results of operations. In order to take advantage of these current opportunities, we sold \$200 million of non-cumulative preferred shares in early 2006 to enable us to write additional business and signed a quota-share reinsurance treaty with Flatiron Re Ltd., a dedicated reinsurance vehicle, which will allow us to increase our participation in property and marine lines without significantly increasing our probable maximum loss. In response to current market conditions, our gross and net writings in the property and marine lines of business in

the 2006 first quarter represented a larger proportion of our overall book of business than in the 2005 first quarter.

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

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

*Principal Executive Office*

Our registered office is located at Clarendon House, 2 Church Street, Hamilton HM 11, Bermuda (telephone number: (441) 295-1422), and our principal executive offices are located at Wessex House, 45 Reid Street, Hamilton HM 12, Bermuda (telephone number: (441) 278-9250). We maintain a website at <http://www.archcapgroup.bm>. The information contained on our website is not incorporated herein by reference and does not form a part of this prospectus supplement or the accompanying prospectus.

**THE OFFERING**

The following is a brief summary of certain terms of this offering. For a more complete description of the terms of Series B Non-Cumulative Preferred Shares, see "Description of the Series B Non-Cumulative Preferred Shares" in this prospectus supplement.

Issuer	Arch Capital Group Ltd.
Securities offered	shares of % Non-Cumulative Preferred Shares, Series B (or "Series B Non-Cumulative Preferred Shares"), \$0.01 par value per share, with a liquidation preference of \$25 per share, of Arch Capital. We may from time to time elect to issue additional Series B Non-Cumulative Preferred Shares, and all the additional shares would be deemed to form a single series with the Series B Non-Cumulative Preferred Shares.
Dividends	<p>Dividends on the Series B Non-Cumulative Preferred Shares, when, as and if declared by the board of directors of Arch Capital or a duly authorized committee of the board, will accrue and be payable on the liquidation preference amount from the original issue date, on a non-cumulative basis, quarterly in arrears on each dividend payment date, at an annual rate of %. Any such dividends will be distributed to holders of the Series B Non-Cumulative Preferred Shares in the manner described under "Description of the Series B Non-Cumulative Preferred Shares Dividends" in this prospectus supplement. Dividends will be computed on the basis of a 360-day year consisting of twelve 30-day months. Dividends on the Series B Non-Cumulative Preferred Shares are not cumulative. Accordingly, in the event dividends are not declared on the Series B Non-Cumulative Preferred Shares and any parity shares for payment on any dividend payment date, then such dividends will not accrue and will not be payable. If the board of directors of Arch Capital or a duly authorized committee of the board has not declared a dividend before the dividend payment date for any dividend period, we will have no obligation to pay dividends for such dividend period after the dividend payment date for that dividend period, whether or not dividends on the Series B Non-Cumulative Preferred Shares are declared for any future dividend period.</p> <p>We believe that the dividends paid on the Series B Non-Cumulative Preferred Shares should qualify as "qualified dividend income" if, as is intended, the Series B Non-Cumulative Preferred Shares are approved for listing on the NYSE. Qualified dividend income paid in taxable years beginning on or before December 31, 2008 to certain shareholders is subject to tax at long-term capital gain rates. Congress has passed a bill which would extend this benefit to taxable years beginning on or before December 31, 2010. Dividends paid on the Series B Non-Cumulative Preferred Shares to U.S. corporate shareholders will not be eligible for the dividends-received deduction. There is a risk that dividends, if any, paid prior to the listing of the Series B Non-Cumulative Preferred Shares on the NYSE may not constitute qualified dividend income. See "Certain Income Tax Considerations Taxation of Shareholders United States Taxation Taxation of Dividends" in this prospectus supplement.</p>

Dividend Payment Dates	The 15th day of February, May, August and November of each year, commencing on August 15, 2006. If any date on which dividends would otherwise be payable is not a business day, then the dividend payment date will be the next succeeding business day with the same force and effect as if made on the original dividend payment date. Dividends on the Series B Non-Cumulative Preferred Shares will not be mandatory.
Payment of Additional Amounts and Tax Redemption	Subject to certain limitations, we will pay additional amounts to holders of the Series B Non-Cumulative Preferred Shares, as additional dividends, to make up for any deduction or withholding for any taxes or other charges imposed on amounts we must pay with respect to the Series B Non-Cumulative Preferred Shares, so that the net amounts paid will be equal to the amounts we would otherwise be required to pay had no such withholding or deduction been required. See "Description of the Series B Non-Cumulative Preferred Shares Payment of Additional Amounts" in this prospectus supplement. If we become obligated to pay any additional amounts as a result of a change in tax law, we will also have the option to redeem the Series B Non-Cumulative Preferred Shares, at any time in whole or in part from time to time, at a redemption price of \$25 per share plus declared and unpaid dividends, if any, to the date of redemption. See "Description of the Series B Non-Cumulative Preferred Shares Tax Redemption" in this prospectus supplement.
Redemption	<p>On and after _____, 2011, the Series B Non-Cumulative Preferred Shares will be redeemable at our option, in whole or in part, at a redemption price equal to \$25 per Series B Non-Cumulative Preferred Share, plus any declared and unpaid dividends, without accumulation of any undeclared dividends. We may not redeem the Series B Non-Cumulative Preferred Shares before _____, 2011, except as described under "Description of the Series B Non-Cumulative Preferred Shares Tax Redemption" in this prospectus supplement, and except that we may redeem all but not less than all of the Series B Non-Cumulative Preferred Shares before that date at a redemption price of \$26 per share, plus any declared and unpaid dividends, to the date of redemption, if we</p> <p>submit a proposal to our holders of common shares concerning an amalgamation, consolidation, merger, arrangement, reconstruction, reincorporation, de-registration or other similar transaction involving us that requires a vote of the holders of our Series B Non-Cumulative Preferred Shares, voting separately as a single class (alone or with one or more classes or series of preferred shares); or</p>



submit any proposal for any other matter that, as a result of any change in Bermuda law after the date of this prospectus supplement (whether by enactment or official interpretation), requires a vote of the holders of our Series B Non-Cumulative Preferred Shares, voting separately as a single class (alone or with one or more classes or series of preferred shares).

Our ability to redeem the Series B Non-Cumulative Preferred Shares as described above or pursuant to certain tax events may be limited by covenants contained in our credit facilities and by the provisions of other agreements we may enter into.

The Series B Non-Cumulative Preferred Shares will not be subject to any sinking fund or other obligation of ours to redeem, purchase or retire the Series B Non-Cumulative Preferred Shares.

Under Bermuda law, no redemption of the Series B Non-Cumulative Preferred Shares may be effected if, on the date that the redemption is to be effected, we have reasonable grounds for believing that we are, or after the redemption would be, unable to pay our liabilities as they become due.

Ranking

The Series B Non-Cumulative Preferred Shares:

will rank senior to our junior shares with respect to the payment of dividends and distributions upon our liquidation, dissolution or winding-up. Junior shares includes our common shares and any other class of shares that rank junior to the Series B Non-Cumulative Preferred Shares either as to the payment of dividends or as to the distribution of assets upon liquidation, dissolution or winding-up; and

will rank at least equally with each other series of shares ranking on parity with the Series B Non-Cumulative Preferred Shares as to dividends and distributions upon any liquidation or dissolution or winding-up of Arch Capital, which we refer to as parity shares.

On February 1, 2006, we issued \$200 million aggregate liquidation preference of our 8.00% Non-Cumulative Preferred Shares, Series A (the "Series A Non-Cumulative Preferred Shares"). As of the date of this prospectus supplement, the Series A Non-Cumulative Preferred Shares are our only outstanding shares or series of shares that are on parity with the Series B Non-Cumulative Preferred Shares with respect to the payment of dividends and the distribution of assets upon a liquidation, dissolution or winding-up of Arch Capital.

During any dividend period, so long as any Series B Non-Cumulative Preferred Shares remain outstanding, unless the full dividends for the latest completed dividend period on all outstanding Series B Non-Cumulative Preferred Shares have been declared and paid:

no dividend shall be paid or declared on our common shares or other junior shares, other than a dividend payable solely in junior shares; and no common shares or other junior shares shall be purchased, redeemed or otherwise acquired for consideration by us, 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 Arch Capital in effect on the date of issuance of the Series B Non-Cumulative Preferred Shares).

For any dividend period in which dividends are not paid in full upon the Series B Non-Cumulative Preferred Shares and any parity shares, all dividend declared for such dividend period with respect to the Series B Non-Cumulative Preferred Shares and such parity shares shall be declared on a pro rata basis. See "Description of the Series B Non-Cumulative Preferred Shares Dividends" in this prospectus supplement.

Liquidation Rights

Upon any voluntary or involuntary liquidation, dissolution or winding-up of Arch Capital, holders of the Series B Non-Cumulative Preferred Shares and any parity shares are entitled to receive out of our assets available for distribution to shareholders, before any distribution is made to holders of common shares or other junior shares, a liquidating distribution in the amount of \$25 per Series B Non-Cumulative Preferred Share plus any declared and unpaid dividends, without accumulation of any undeclared dividends. Distributions will be made pro rata as to the Series B Non-Cumulative Preferred Shares and any parity shares and only to the extent of our assets, if any, that are available after satisfaction of all liabilities to creditors. See "Description of the Series B Non-Cumulative Preferred Shares Liquidation Rights" in this prospectus supplement.

Voting Rights

Holders of the Series B Non-Cumulative Preferred Shares will have no voting rights, except with respect to certain fundamental changes in the terms of the Series B Non-Cumulative Preferred Shares and in the case of certain dividend non-payments or as otherwise required by Bermuda law or the bye-laws of Arch Capital. See "Description of the Series B Non-Cumulative Preferred Shares Voting Rights" in this prospectus supplement.

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Maturity	The Series B Non-Cumulative Preferred Shares do not have any maturity date, and we are not required to redeem the Series B Non-Cumulative Preferred Shares. Holders of the Series B Non-Cumulative Preferred Shares will have no right to have the Series B Non-Cumulative Preferred Shares redeemed. Accordingly, the Series B Non-Cumulative Preferred Shares will remain outstanding indefinitely, unless and until we decide to redeem them.
Preemptive Rights	Holders of the Series B Non-Cumulative Preferred Shares will have no preemptive rights.
Listing	We intend to apply to have the Series B Non-Cumulative Preferred Shares approved for listing on the NYSE.
Ratings	The Series B Non-Cumulative Preferred Shares are expected to be rated BB+ by Standard & Poor's, Baa3 by Moody's Investors Service and BBB- by Fitch Ratings. The ratings of the Series B Non-Cumulative Preferred Shares should be evaluated independently from similar ratings of other securities. A rating is not a recommendation to buy, sell or hold securities and may be subject to review, revision, suspension, reduction or withdrawal at any time by the assigning rating agency.
Use of proceeds	We expect to receive approximately \$                      million in net proceeds from the sale of the Series B Non-Cumulative Preferred Shares in this offering. We intend to use the net proceeds of this offering for general corporate purposes.
Transfer Agent	American Stock Transfer & Trust Company.

S-7

## RISK FACTORS

An investment in the Series B Non-Cumulative Preferred Shares involves the following risks. You should consider carefully these risk factors and also refer to the other information provided in this prospectus supplement and the accompanying prospectus and the documents incorporated therein by reference, including our "Management's Discussion and Analysis of Financial Condition and Results of Operation" and our financial statements and the related notes which are included in our Annual Report on Form 10-K for the year ended December 31, 2005 and our Quarterly Report on Form 10-Q for the quarter ended March 31, 2006, which is incorporated by reference in this prospectus supplement, 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 the Terrorism Risk Insurance Act of 2002, as amended under the Terrorism Risk Insurance Extension Act of 2005 ("TRIA"), 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 TRIA 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. See "Our Company Regulation U.S. Insurance Regulation" contained in our Annual Report on Form 10-K for the year ended December 31, 2005 incorporated herein by reference. 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.

**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, preliminary 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 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 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 are seeking to increase our writings in the property and marine lines of business and, as a result, these lines may represent a larger proportion 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 March 31, 2006, our reserves for unpaid losses and loss adjustment expenses, net of unpaid losses and loss adjustment expenses recoverable, were approximately \$4.32 billion. Such reserves were established in accordance with applicable insurance laws and generally accepted accounting principles ("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 March 31, 2006. See Development of GAAP Reserves table included under "Business Reserves" contained in our Annual Report on Form 10-K for the year ended December 31, 2005 incorporated herein by reference.

**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 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 three months ended March 31, 2006, ceded premiums written represented approximately 25.2% of gross premiums written, compared to 21.8%, 18.8% and 15.1%, respectively, for the years ended December 31, 2005, 2004 and 2003.

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 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 March 31, 2006, approximately 94.0% of our reinsurance recoverables on paid and unpaid losses of \$1.51 billion (not including prepaid reinsurance premiums) were due from carriers which had an A.M. Best Company rating of "A-" or better. No reinsurance recoverables from any one carrier exceeded 5.6% of our total shareholders' equity at March 31, 2006. 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. See "Our reliance on brokers subjects us to their credit risk." See also "Management's Discussion and Analysis of Financial Condition and Results of Operations - General Overview" contained in our Annual Report on Form 10-K for the year ended December 31, 2005 incorporated herein by reference and contained in our Quarterly Report on Form 10-Q for the quarter ended March 31, 2006 incorporated herein by reference and "Our Company - Regulation U.S. Insurance Regulation - General" contained in our Annual Report on Form 10-K for the year ended December 31, 2005 incorporated herein by reference.

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.

In addition, we engage in intercompany reinsurance arrangements between our U.S. operations and our Bermuda reinsurance operations. Some U.S. insurance companies have been lobbying Congress to pass legislation intended to eliminate certain perceived tax advantages of U.S. insurance companies with Bermuda affiliates, which result principally from reinsurance arrangements between or among U.S. insurance companies and their Bermuda affiliates.

**Risks Relating to Our Company**

**Our success will depend on our ability to establish and maintain 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.**

Financial strength and claims paying ratings from third party internationally recognized statistical rating organizations or agencies are instrumental in establishing the competitive positions of companies in our industry. Periodically, rating agencies evaluate us to confirm that we continue to meet their criteria for the ratings assigned to us by them. 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 and have a material adverse impact on our financial condition and results of operations.

**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 March 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 March 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 43.7% 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 31.0% and 12.7% of our outstanding voting shares, respectively, as of March 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 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 eleven 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.

**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 2005, approximately 19.2% and 13.3% 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, 2005. 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 incept, 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 (80.9% as of March 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 2005, 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 March 31, 2006, mortgage-backed securities (excluding commercial mortgage backed securities) constituted approximately 5.6% of our cash and invested assets. As with other fixed income investments, the fair market 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" in our Annual Report on Form 10-K for the year ended December 31, 2005 and in our Quarterly Report on Form 10-Q for the quarter ended March 31, 2006, each incorporated herein by reference.

**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. 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.

**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;

S-18

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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, which we call the 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. 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 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. 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, 2005 and 2004, ACGL received dividends of \$22.0 million and \$11.0 million, respectively, 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. In addition, Arch Re Bermuda is prohibited from declaring or paying in any financial year dividends of more than 25% of its total statutory capital and surplus (as shown on its previous financial year's statutory balance sheet) unless it files, at least seven days before payment of such dividends, with the Bermuda Monetary Authority an affidavit stating that it will continue to meet the required margins. In addition, Arch Re Bermuda is prohibited, without prior approval of the Bermuda Monetary Authority, from reducing by 15% or more its total statutory capital, as set out in its previous year's statutory financial statements. At December 31, 2005, as determined under Bermuda law, Arch Re Bermuda had statutory capital of \$1.66 billion and statutory capital and surplus of \$2.19 billion. Such amounts include interests in U.S. insurance and reinsurance subsidiaries. Accordingly, Arch Re Bermuda can pay approximately \$249 million in dividends or distributions to ACGL during 2006 without prior approval under Bermuda law, as discussed above. Our U.S. insurance and reinsurance subsidiaries can pay \$80.3 million in dividends or distributions to Arch-U.S., our U.S. holding company, which is owned by Arch Re Bermuda, during 2006 without prior regulatory approval. Such dividends or distributions may be subject to applicable withholding or other taxes. Arch-Europe can pay approximately £3.8 million, or \$6.5 million, in dividends to ACGL during 2006 without prior notice and approval by the FSA.

In addition, the ability of our insurance and reinsurance subsidiaries to pay dividends 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 gains, recorded in the statement of income, for the year ended December 31, 2005 were \$22.2 million, compared to net foreign exchange losses for the year ended December 31, 2004 of \$17.4 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