

ARCH CAPITAL GROUP LTD  
Form 10-Q/A  
January 27, 2004

[QuickLinks](#) -- Click here to rapidly navigate through this document

---

---

**UNITED STATES  
SECURITIES AND EXCHANGE COMMISSION**

WASHINGTON, D.C. 20549

**FORM 10-Q/A**

(Mark One)

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

For the quarterly period ended September 30, 2003

Or

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

For the transition period \_\_\_\_\_ to \_\_\_\_\_  
Commission file number: 0-26456

**ARCH CAPITAL GROUP LTD.**

(Exact name of registrant as specified in its charter)

**Bermuda**

(State or other jurisdiction of  
incorporation or organization)

**Not Applicable**

(I.R.S. Employer  
Identification No.)

**Wessex House, 45 Reid Street  
Hamilton HM 12 Bermuda**

(Address of principal executive offices)

(Zip Code)

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

---

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

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

Yes  No

Indicate by check mark whether the Registrant is an accelerated filer (as defined in Rule 12b-2 of the Exchange Act).

# Edgar Filing: ARCH CAPITAL GROUP LTD - Form 10-Q/A

Yes *y* No *o*

Indicate the number of shares outstanding of each of the issuer's classes of common shares.

<u>Class</u>	<u>Outstanding at December 31, 2003</u>
Common Shares, \$0.01 par value	28,200,372

## *ARCH CAPITAL GROUP LTD.*

### *INDEX*

Page No.

*Item 2 Management's Discussion and Analysis of Financial Condition And Results of Operations*

Signatures

Index to Exhibits

Exhibit 31.1

Exhibit 31.2

Exhibit 32.1

Exhibit 32.2

1

### **EXPLANATORY NOTE**

We are filing this Amendment No. 1 ("Amendment No. 1") to our quarterly report on Form 10-Q for the quarter ended September 30, 2003, as filed with the Securities and Exchange Commission on November 12, 2003 (the "Original Form 10-Q"), to reflect certain revisions in Item 2 of Part I. This Amendment No. 1 speaks as of the date of the Original Form 10-Q, except for the certifications, which speak as of their respective dates and the filing date of this Amendment No. 1. This Amendment No. 1 does not reflect events occurring after the filing of the Original Form 10-Q, nor does it modify or update the disclosure in the Original Form 10-Q except as specifically set forth herein.

### **Item 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS**

The following discussion and analysis contains forward-looking statements which involve inherent risks and uncertainties. All statements other than statements of historical fact are forward-looking statements. These statements are based on our current assessment of risks and uncertainties. Actual results may differ materially from those expressed or implied in these statements. Important factors that could cause actual events or results to differ materially from those indicated in such statements are discussed in this report, including the section entitled "Cautionary Note Regarding Forward Looking Statements," and in our periodic reports filed with the Securities and Exchange Commission ("SEC").

#### **General**

##### *The Company*

Arch Capital Group Ltd. ("ACGL"), a Bermuda public limited liability company with over \$1.6 billion in equity capital, provides insurance and reinsurance on a worldwide basis through its wholly owned subsidiaries. While we are positioned to provide a full range of property and casualty insurance and reinsurance lines, we are focusing on writing specialty lines of insurance and reinsurance. 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 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. It is our belief that our existing Bermuda and U.S.-based underwriting

platform, our strong management team and our capital that is unencumbered by significant exposure to pre-2002 risks have enabled us to establish a strong presence in an attractive insurance and reinsurance marketplace.

### **Critical Accounting Policies, Estimates and Recent Accounting Pronouncements**

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 very limited historical information has been reported to us through September 30, 2003. 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 generally accepted accounting principles ("GAAP") to establish reserves for losses and loss adjustment expenses that arise from the business we underwrite. These reserves are balance sheet liabilities representing estimates of future amounts required to pay losses and loss adjustment expenses for insured or reinsured claims which have occurred at or before the balance sheet date.

2

---

Insurance loss reserves are inherently subject to uncertainty. The period of time from the occurrence of a loss through the settlement of the liability may extend many years into the future. During this period, additional facts and trends will become known and, as these factors become apparent, reserves will be adjusted in the period in which the new information becomes known. While reserves are established based upon available information, certain factors, such as those inherent in the political, judicial and legal systems, including judicial and litigation trends and legislation changes, could impact the ultimate liability. Changes to our prior year loss reserves can impact our current underwriting results by (1) reducing our reported results if the prior year reserves prove to be deficient or (2) improving our reported results if the prior year reserves prove to be redundant. The reserves for losses and loss adjustment expenses 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, and it is likely that the ultimate liability may exceed or be less than such estimates. We utilize actuarial models as well as available historical insurance and reinsurance industry loss ratio experience and loss development patterns to assist in the establishment of appropriate loss reserves. Even actuarially sound methods can lead to subsequent adjustments to loss reserves that are both significant and irregular due to the nature of the risks written, potentially by a material amount.

For reinsurance assumed, case reserves are based on reports received from ceding companies, supplemented by our estimates of reserves for which ceding company reports have not been received. 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 and 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. Reserves are also established to provide for 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. In accordance with industry practice, we also maintain incurred but not reported ("IBNR") reserves. Such reserves are established to provide for incurred claims which have not yet been reported to an insurer or reinsurer as well as to actuarially adjust for any projected variance in case reserving.

Even though most insurance policies 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 very significantly exceed the premiums received on the underlying policies. We attempt to limit our risk of loss through reinsurance and may also use retrocessional arrangements. The availability and cost of reinsurance and retrocessional protection is subject to market conditions, which are beyond our control.

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. Our reserving method for 2002 and 2003 was primarily 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. These ratios consider, among other things, rate increases 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 very limited historical information has been reported to us through September 30, 2003 due to our start-up nature. As actual loss information is reported to us and we develop our own loss experience, our reserving methods will also include other actuarial techniques. It is possible that claims in respect of events that have occurred could exceed our reserves and have a material adverse effect on our results of operations in a particular period or our financial condition in general.

Under GAAP, we are only permitted to establish loss and loss adjustment expense reserves for losses that have occurred on or before the financial statement date. Case reserves and IBNR reserves contemplate these obligations. No contingency reserve allowances are established 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.

#### *Premium Revenues and Related Expenses*

Insurance premiums written are generally recorded at the policy inception and are primarily earned on a pro rata basis in accordance with the terms of the policies. Premiums written include estimates in our program business which are generally reported on a lag basis. Unearned premium reserves represent the portion of such premiums written that relates to the unexpired terms of in-force insurance policies.

Reinsurance premiums written include amounts reported by the ceding companies, supplemented by our own estimates of premiums for which ceding company reports have not been received. 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 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, 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.

As actual premiums are reported by the ceding companies, management evaluates the appropriateness of the premium estimates, and any adjustment to these estimates is recorded in the period in which it becomes known. Adjustments to original premium estimates could be material and such adjustments could directly and significantly impact earnings in the period they are determined because the subject premium may be fully or substantially earned. A significant portion of amounts included as premiums receivable, which represent estimated premiums written, net of commissions, is not currently due based on the terms of the underlying contracts.

Reinsurance premiums assumed are earned generally 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 losses which occur during the term of the contract or policy, which typically extends 12 months. Accordingly, the premium is reflected as earned evenly over the term. Pro rata contracts, which are written on a risks attaching basis, cover losses which attach to the underlying insurance policies written during the terms of such pro rata contracts. Premiums earned on a risks attaching basis 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 under these contracts, are recorded based upon the projected experience under those 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 a margin. 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 and financial quota share coverages.

Certain assumed reinsurance contracts, which pursuant to Statement of Financial Accounting Standards ("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, for financial reporting

purposes, not to transfer insurance risk, are accounted for using the deposit method of accounting as prescribed in Statement of Position 98-7, "Deposit Accounting: Accounting for Insurance and Reinsurance Contracts That Do Not Transfer Insurance Risk." 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 when the estimated profit margin is implicit it is reflected as an offset to incurred losses. For those contracts that do not transfer an element of underwriting risk, the estimated profit is reflected in earnings over the estimated settlement period using the interest method and such profit is included in investment income.

Under GAAP, 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 consist principally of commissions and brokerage expenses. Other operating expenses also include expenses that vary with, and are directly related to, the acquisition of business. Acquisition expenses are reflected net of ceding commissions received from unaffiliated reinsurers. Deferred acquisition costs are carried at their estimated realizable value based on the related unearned premiums and take into account anticipated losses and loss adjustment expenses, based on historical and current experience, and anticipated investment income.

Policy-related fee income, such as billing, cancellation and reinstatement fees, is primarily recognized as earned when substantially all of the related services have been provided. Policy-related fee income will vary in the future related to such activity and is earned primarily in our non-standard automobile business.

### *Collection of Insurance-Related Balances*

We are subject to credit risk with respect to our reinsurance ceded because the ceding of risk to reinsurers or retrocessionaires does not relieve us of our liability to the clients or companies we insure or reinsure. 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 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. We provide for probable losses resulting from our inability to collect amounts due from managing general agents, brokers and other clients.

### *Valuation Allowance*

We record a valuation allowance to reduce certain of our deferred tax assets to the amount that is more likely than not to be realized. We have considered future taxable income and feasible tax planning strategies in assessing the need for a valuation allowance. In the event we determine that we would not be able to realize all or part of our deferred tax assets in the future, an adjustment to the deferred tax asset would be charged to income in the period such determination was made. In addition, if we subsequently assessed that the valuation allowance was no longer needed, a benefit would be recorded to income in the period in which such determination was made.

---

### *Investments*

We currently classify all of our publicly traded fixed maturity investments, short-term investments and equity securities as "available for sale" and, accordingly, they are carried at estimated fair value. The fair value of publicly traded fixed maturity securities and publicly traded equity securities is estimated using quoted market prices or dealer quotes. 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 investment managers. Investments included in our private portfolio include securities issued by privately held companies. Our investments in privately held equity securities, other than those carried under the equity method of accounting, 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. We apply Accounting Principles Board ("APB") Opinion No. 18, "The Equity Method of Accounting for Investments in Common Stock," for privately held equity investments accounted for under the equity method, and we record our percentage share of the investee company's net income or loss.

In accordance with SFAS No. 115, "Accounting for Certain Investments in Debt and Equity Securities," we periodically review our investments to determine whether a decline in fair value below the amortized cost basis is other than temporary. If such decline in fair value is

## Edgar Filing: ARCH CAPITAL GROUP LTD - Form 10-Q/A

judged to be other than temporary, we would write down the investment to fair value as a new cost basis and the amount of the write-down would be charged to income as a realized loss. The new cost basis would not be changed for subsequent recoveries in fair value.

### *Stock Issued to Employees*

We have adopted the provisions of APB Opinion No. 25, "Accounting for Stock Issued to Employees," and related interpretations in accounting for employee stock options because the alternative fair value accounting provided for under SFAS No. 123, "Accounting for Stock-Based Compensation," requires the use of option valuation models that we believe were not developed for use in valuing employee stock options. Accordingly, under APB No. 25, compensation expense for stock option grants is recognized only to the extent that the fair value of the underlying stock exceeds the exercise price of the option at the measurement date.

For restricted shares granted, we record deferred compensation equal to the market value of the shares at the measurement date, which is amortized and primarily charged to income as non-cash compensation over the vesting period. These restricted shares are recorded as outstanding upon issuance (regardless of any vesting period). See " Results of Operations Non-Cash Compensation."

### *Recent Accounting Pronouncements*

See note 3, "Accounting Pronouncements," of the notes accompanying our consolidated financial statements.

### **Results of Operations Three Months ended September 30, 2003 and 2002**

The following table sets forth net income and earnings per share data:

	Three Months Ended September 30,	
	2003	2002
(in thousands, except share data)		
	(Unaudited)	
Net income (loss)	\$ 82,587	\$ (7,721)
Diluted net income (loss) per share	\$ 1.22	\$ (0.36)
Diluted average shares outstanding	67,774,722	21,497,224

6

Net income increased to \$82.6 million for the 2003 third quarter, compared to a loss of \$7.7 million for the 2002 third quarter. The increase in net income was primarily due to a significant increase in the underwriting results of both our reinsurance and insurance operations, as discussed in " Segment Information" below. In addition, net income increased due to growth in our investment results. Basic earnings per share data does not include the significant number of preference shares outstanding in 2003 and 2002. As a result of the net loss for the three months ended September 30, 2002, diluted net loss per share and diluted average shares outstanding for the 2002 third quarter do not include the impact of 39,304,796 shares of dilutive securities, since the inclusion of such securities would be anti-dilutive. Since we reported net income for the nine months ended September 30, 2002, the computation of diluted shares outstanding includes dilutive securities for such year-to-date period.

### *Segment Information*

We classify our businesses into two underwriting segments reinsurance and insurance and a corporate and other segment (non-underwriting). SFAS No. 131, "Disclosures About Segments of an Enterprise and Related Information," requires certain disclosures about operating segments in a manner that is consistent with how management evaluates the performance of the segment. For a description of our underwriting segments, refer to note 4, "Segment Information," of the notes accompanying our consolidated financial statements. Segment performance is evaluated primarily based on underwriting income or loss.

#### *Reinsurance Segment*

## Edgar Filing: ARCH CAPITAL GROUP LTD - Form 10-Q/A

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

(in thousands)	Three Months Ended September 30,	
	2003	2002
	(Unaudited)	
Gross premiums written	\$ 411,443	\$ 215,326
Net premiums written	397,418	204,530
Net premiums earned	\$ 348,883	\$ 143,497
Other underwriting-related fee income	1,369	
Losses and loss adjustment expenses	(223,419)	(90,216)
Acquisition expenses, net	(79,011)	(36,212)
Other operating expenses	(8,862)	(4,108)
	\$ 38,960	\$ 12,961
<b>Underwriting Ratios</b>		
Loss ratio	64.0%	62.9%
Acquisition expense ratio	22.6%	25.2%
Other operating expense ratio	2.5%	2.9%
	89.1%	91.0%

*Underwriting Income.* The reinsurance segment's underwriting income increased to \$39.0 million for the 2003 third quarter, compared to \$13.0 million for the 2002 third quarter. The combined ratio for the reinsurance segment was 89.1% for the 2003 third quarter, compared to 91.0% for the 2002 third quarter. The components of the reinsurance segment's underwriting income are discussed below.

*Premiums Written.* Gross premiums written for our reinsurance segment increased to \$411.4 million for the 2003 third quarter, compared to \$215.3 million for the 2002 third quarter. We are currently retaining

7

substantially all of our reinsurance premiums written. We do, however, participate in "common account" retrocessional arrangements for certain treaties. Such arrangements reduce the effect of individual or aggregate losses to all companies participating on such treaties, including the reinsurer, such as us, and the ceding company. We will continue to evaluate our retrocessional requirements.

Net premiums written for our reinsurance segment increased to \$397.4 million for the 2003 third quarter, compared to \$204.5 million for the 2002 third quarter. Over half of the increase in net premiums written was attributable to casualty business. During the 2003 third quarter, the reinsurance segment significantly increased its quota share participation in an account included in its other specialty line of business retroactive to January 1, 2003. As a result, net premiums written in the 2003 third quarter included approximately \$20.0 million relating to the increased participation in such contract covering the first six months of 2003.

For the 2003 third quarter, 81.7% of net premiums written were generated from pro rata contracts and 18.3% were derived from excess of loss treaties. For the 2002 third quarter, 64.2% of net premiums written were generated from pro rata contracts and 35.8% were derived from excess of loss treaties. Pro rata contracts are typically written at a lower loss ratio and higher expense ratio than excess of loss business.

Set forth below is summary information regarding our reinsurance segment's net premiums written by major line of business:

	Three Months Ended September 30,	
	2003	2002

Edgar Filing: ARCH CAPITAL GROUP LTD - Form 10-Q/A

		Three Months Ended September 30,			
		2003		2002	
		Amount	% of Total	Amount	% of Total
(in thousands)		(Unaudited)			
<b>Major line of business:</b>					
<b>Net premiums written</b>					
Casualty	\$	174,945	44.0%	\$ 76,896	37.6%
Other specialty		107,638	27.1%	38,341	18.7%
Property excluding property catastrophe		76,996	19.4%	42,193	20.6%
Property catastrophe		21,872	5.5%	23,105	11.3%
Marine and aviation		14,548	3.7%	9,724	4.8%
Casualty clash		1,650	0.4%	3,661	1.8%
Non-traditional		(231)	(0.1)%	10,610	5.2%
<b>Total</b>	<b>\$</b>	<b>397,418</b>	<b>100.0%</b>	<b>\$ 204,530</b>	<b>100.0%</b>

For information regarding net premiums written produced by geographic location, refer to note 4, "Segment Information," of the notes accompanying our consolidated financial statements.

*Net Premiums Earned.* Net premiums earned for our reinsurance segment increased to \$348.9 million for the 2003 third quarter, compared to \$143.5 million for the 2002 third quarter. Over 47% of the increase in net premiums earned was attributable to casualty business. Net premiums earned reflects period to period changes in net premiums written, including the mix and type of business. For the 2003 third quarter, 73.6% of net premiums earned were generated from pro rata contracts, while 26.4% of net premiums earned were generated from excess of loss treaties. For the 2002 third quarter, 46.5% of net premiums earned were generated from pro rata contracts, while 53.5% of net premiums earned were generated from excess of loss treaties.

8

Set forth below is summary information regarding our reinsurance segment's net premiums earned by major line of business:

		Three Months Ended September 30,			
		2003		2002	
		Amount	% of Total	Amount	% of Total
(in thousands)		(Unaudited)			
<b>Major line of business:</b>					
<b>Net premiums earned</b>					
Casualty	\$	123,840	35.5%	\$ 26,203	18.2%
Other specialty		83,984	24.1%	35,796	24.9%
Property excluding property catastrophe		81,645	23.4%	24,121	16.8%
Property catastrophe		24,408	7.0%	24,341	17.0%
Marine and aviation		18,333	5.2%	8,718	6.1%
Non-traditional		14,010	4.0%	20,305	14.2%



Edgar Filing: ARCH CAPITAL GROUP LTD - Form 10-Q/A

	Three Months Ended September 30,			
Casualty clash	2,663	0.8%	4,013	2.8%
Total	\$ 348,883	100.0%	\$ 143,497	100.0%

*Other Underwriting-Related Fee Income.* Certain assumed reinsurance contracts are deemed, for financial reporting purposes, not to transfer insurance risk, and are accounted for using the deposit method of accounting. For those contracts that contain an element of underwriting risk, the estimated profit margin is deferred and amortized over the contract period. When the estimated profit margin is explicit, the margin is reflected as fee income. We recorded \$1.4 million of fee income on such contracts for the 2003 third quarter.

*Losses and Loss Adjustment Expenses.* Reinsurance segment losses and loss adjustment expenses incurred for the 2003 third quarter were \$223.4 million, or 64.0% of net premiums earned, compared to \$90.2 million, or 62.9%, for the 2002 third quarter. The 2003 third quarter loss ratio benefited from favorable development on losses originally recorded during 2002 of \$14.2 million, which resulted in a 4.1 point reduction in the loss ratio. Most of the reduction occurred in short-tail lines of business and resulted from a lower than expected amount of reported claims. The remainder of the difference in the loss ratio compared to the 2002 third quarter resulted from changes in the mix of business earned in the quarter. 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 the 2003 third quarter was 22.6%, compared to 25.2% for the 2002 third quarter, and the other operating expense ratio for the 2003 third quarter was 2.5%, compared to 2.9% for the 2002 third quarter. Movements in the acquisition expense ratio reflect changes in the percentage of net premiums earned from pro rata contracts along with the mix of business. While aggregate operating expenses were higher for the 2003 third quarter compared to the 2002 third quarter, the operating expense ratio decreased primarily due to the growth in net premiums earned in the 2003 period.

9

*Insurance Segment*

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

	Three Months Ended September 30,	
	2003	2002
(in thousands)	(Unaudited)	
Gross premiums written	\$ 558,863	\$ 208,425
Net premiums written	376,749	114,154
Net premiums earned	\$ 260,073	\$ 40,482
Policy-related fee income	3,583	2,570
Losses and loss adjustment expenses	(168,555)	(29,904)
Acquisition expenses, net	(36,840)	(2,815)
Other operating expenses	(33,654)	(10,903)
Underwriting income (loss)	\$ 24,607	\$ (570)
<b>Underwriting Ratios</b>		
Loss ratio	64.8%	73.9%
Acquisition expense ratio(1)	12.8%	0.6%
Other operating expense ratio	12.9%	26.9%
Combined ratio	90.5%	101.4%

Three Months Ended  
September 30,

(1)

The acquisition expense ratio is adjusted to include certain policy-related fee income.

*Underwriting Income (Loss).* The insurance segment's underwriting income was \$24.6 million for the 2003 third quarter, compared to a loss of \$570,000 for the 2002 third quarter. The combined ratio for the insurance segment was 90.5% for the 2003 third quarter, compared to 101.4% for the 2002 third quarter. The components of the insurance segment's underwriting income or loss are discussed below.

*Premiums Written.* Gross premiums written for our insurance segment increased to \$558.9 million for the 2003 third quarter, compared to \$208.4 million for the 2002 third quarter. During 2002, the insurance segment established new profit centers in various specialty lines and began writing business in these new areas of focus primarily during the last six months of the year. The insurance segment also added a number of new accounts in its program business during 2002. In addition to new business written in the 2003 third quarter, premiums written also include the renewal of certain accounts initially written in 2002. Accordingly, premiums written by the insurance segment during the 2003 third quarter were significantly higher than the comparable 2002 third quarter.

Net premiums written for our insurance segment increased to \$376.7 million for the 2003 third quarter, compared to \$114.2 million for the 2002 third quarter. Contributing to this increase was a \$93.1 million increase in program business, a \$46.5 million increase in casualty business and a \$42.3 million increase in construction and surety business. The insurance segment also significantly reduced the percentage of business ceded to unaffiliated reinsurers in its program business during 2002 contributing to the growth in net premiums written.

10

Set forth below is summary information regarding the insurance segment's net premiums written by major line of business:

	Three Months Ended September 30,			
	2003		2002	
	Amount	% of Total	Amount	% of Total
(in thousands)	(Unaudited)			
<b>Major line of business:</b>				
<b>Net premiums written</b>				
Programs	\$ 116,172	30.8%	\$ 23,106	20.2%
Casualty	68,788	18.3%	22,263	19.5%
Construction and surety	53,374	14.2%	11,055	9.7%
Property	42,770	11.3%	18,553	16.3%
Executive assurance	34,817	9.2%	15,388	13.5%
Professional liability	28,850	7.7%	5,492	4.8%
Healthcare	9,855	2.6%	3,453	3.0%
Other	22,123	5.9%	14,844	13.0%
Total	\$ 376,749	100.0%	\$ 114,154	100.0%

For information regarding net premiums written produced by geographic location, refer to note 4, "Segment Information," of the notes accompanying our consolidated financial statements.

## Edgar Filing: ARCH CAPITAL GROUP LTD - Form 10-Q/A

*Net Premiums Earned.* Net premiums earned for our insurance segment increased to \$260.1 million for the 2003 third quarter, compared to \$40.5 million for the 2002 third quarter. Contributing to this increase was a \$73.1 million increase in program business, a \$41.3 million increase in casualty business and a \$24.4 million increase in construction and surety business.

Set forth below is summary information regarding the insurance segment's net premiums earned by major line of business:

(in thousands)	Three Months Ended September 30,			
	2003		2002	
	Amount	% of Total	Amount	% of Total
	(Unaudited)			
<b>Major line of business:</b>				
<b>Net premiums earned</b>				
Programs	\$ 81,712	31.4%	\$ 8,581	21.2%
Casualty	46,660	17.9%	5,379	13.3%
Property	27,730	10.7%	5,312	13.1%
Construction and surety	25,672	9.9%	1,274	3.2%
Executive assurance	24,380	9.4%	5,392	13.3%
Professional liability	21,428	8.2%	1,593	3.9%
Healthcare	10,900	4.2%	327	0.8%
Other	21,591	8.3%	12,624	31.2%
	\$ 260,073	100.0%	\$ 40,482	100.0%

11

*Policy-Related Fee Income.* Policy-related fee income for our insurance segment was \$3.6 million for the 2003 third quarter, compared to \$2.6 million for the 2002 third quarter. Such amounts were earned primarily on our non-standard automobile business.

*Losses and Loss Adjustment Expenses.* Insurance segment losses and loss adjustment expenses incurred for the 2003 third quarter were \$168.6 million, or 64.8% of net premiums earned, compared to \$29.9 million, or 73.9%, for the 2002 third quarter. The loss ratio for the 2003 third quarter reflects a significantly higher percentage of business from our specialty lines than in the 2002 third quarter, which included a higher percentage of business from our non-standard auto business. To date, in our specialty lines, we have recorded lower loss ratios than in our non-standard auto business. In addition, the 2003 third quarter loss ratio benefited from favorable development on losses originally recorded in prior years of \$188,000, which generated a 0.1 point reduction in the loss ratio. Such amount consisted of \$2.6 million of favorable development in non-standard auto and short-tail lines which was partially offset by \$2.4 million of adverse development in certain program 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 certain policy-related fee income and is influenced by, among other things, (1) the amount of ceding commissions received from unaffiliated reinsurers and (2) the amount of business written on a surplus lines (non-admitted) basis. The acquisition expense ratio was 12.8% for the 2003 third quarter (net of 1.4 points of policy-related fee income), compared to 0.6% for the 2002 third quarter (net of 6.3 points of policy-related fee income). The increase in the acquisition expense ratio resulted from the increased contribution of business from our insurance segment's new areas of focus in the 2003 period and a reduction in ceding commissions due from unaffiliated reinsurers.

The other operating expense ratio for the 2003 third quarter was 12.9%, compared to 26.9% for the 2002 third quarter. While aggregate operating expenses were higher for the 2003 third quarter compared to the 2002 third quarter in connection with the growth in gross premiums written, the operating expense ratio decreased primarily due to the growth in net premiums earned in the 2003 period.

**Net Investment Income**

Net investment income was \$20.5 million for the 2003 third quarter, compared to \$14.9 million for the 2002 third quarter. The increase in net investment income for the 2003 third quarter was due to the significant increase in our invested assets primarily resulting from cash flow from operations in 2003 and 2002, which more than offset the effect of lower yields available in the financial markets in 2003 compared to 2002. Our pre-tax and after-tax investment yields, respectively, for the 2003 third quarter were 2.8% and 2.5%, compared to 4.2% and 4.1% for the 2002 third quarter. 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.

**Net Realized Investment Gains or Losses**

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

	Three Months Ended September 30,	
	2003	2002
(in thousands)		
	(Unaudited)	
Fixed maturities	\$ 11,130	\$ (497)
Privately held securities	236	(339)
<b>Total</b>	<b>\$ 11,366</b>	<b>\$ (836)</b>

Net realized gains or losses in our fixed income portfolio during the 2003 and 2002 periods resulted from the sale of certain securities to reduce credit exposure and from sales related to rebalancing the portfolio.

**Other**

Other fee income, net of related expenses, represents revenues and expenses provided by our non-underwriting operations. Other income is generated by our investments in privately held securities. At September 30, 2003, we held five investments in privately held securities. Three of such investments are accounted for under the equity method of accounting. Under the equity method, we record a proportionate share of the investee company's net income or loss based on our ownership percentage in such investment, which amounted to \$546,000 for the 2003 third quarter, compared to \$185,000 for the 2002 third quarter. Other expenses primarily represent certain holding company costs necessary to support our growing worldwide insurance and reinsurance operations and costs associated with operating as a publicly-traded company.

**Net Foreign Exchange Gains or Losses**

Net foreign exchange gains for the 2003 third quarter of \$3,708,000 consisted of net unrealized gains of \$3,212,000 and net realized gains of \$496,000. Net foreign exchange losses for the 2002 third quarter of \$726,000 consisted of net unrealized losses of \$2,352,000 and net realized gains of \$1,626,000. Foreign exchange gains and losses vary with fluctuations in currency rates and result from the translation of foreign denominated monetary assets and liabilities. These gains and losses could add significant volatility to our net income in future periods.

**Non-Cash Compensation**

Non-cash compensation primarily results from restricted shares granted in connection with our 2001 underwriting initiative. Non-cash compensation expense for the 2003 third quarter was \$3.9 million, compared to \$29.5 million for the 2002 third quarter. The 2002 third quarter amount reflected the accelerated vesting of certain restricted common shares granted to the chairman of our board of directors. The accelerated recognition in the 2002 third quarter had no effect on our shareholders' equity and had the effect of reducing non-cash compensation in subsequent periods. See note 10, "Transactions with Related Parties," of the notes accompanying our consolidated financial statements. Absent significant additional restricted share grants, non-cash compensation expense is currently expected to be approximately \$3.1 million in the 2003 fourth quarter.

**Income Taxes**

## Edgar Filing: ARCH CAPITAL GROUP LTD - Form 10-Q/A

Income tax expense was \$9.9 million for the 2003 third quarter, compared to \$392,000 for the 2002 third quarter. During the 2003 third quarter, we reversed a \$773,000 valuation allowance. Our effective tax rate may fluctuate from period to period based on the relative mix of income reported by jurisdiction due primarily to the varying tax rates of each jurisdiction. Our quarterly tax provision is adjusted to reflect changes in our expected annual tax rates, if any. See note 9, "Income Taxes," of the notes accompanying our consolidated financial statements.

### *Extraordinary Gain*

We recorded an extraordinary gain of \$816,000 in the 2003 third quarter related to the acquisition of Personal Service Insurance Company ("PSIC") in the 2002 fourth quarter. The extraordinary gain represents an adjustment to the fair value of PSIC due to the recognition of deferred tax assets as a result of the acquisition.

13

### Results of Operations Nine Months ended September 30, 2003 and 2002

The following table sets forth net income and earnings per share data:

(in thousands, except share data)	Nine Months Ended September 30,	
	2003	2002
	(Unaudited)	
Net income	\$ 196,857	\$ 15,471
Diluted earnings per share	\$ 2.91	\$ 0.27
Diluted average shares outstanding	67,539,330	57,200,973

Net income increased to \$196.9 million for the nine months ended September 30, 2003, compared to \$15.5 million for the nine months ended September 30, 2002. The increase in net income was primarily due to a significant increase in the underwriting results of both our reinsurance and insurance operations, as discussed in "Segment Information" below. In addition, net income increased due to growth in our investment results. The increase in diluted average shares outstanding for the nine months ended September 30, 2003 compared to the nine months ended September 30, 2002 is primarily due to the issuance during 2002 of common shares in a stock offering and upon the exercise of warrants.

### *Segment Information*

#### *Reinsurance Segment*

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

(in thousands)	Nine Months Ended September 30,	
	2003	2002
	(Unaudited)	
Gross premiums written	\$ 1,311,142	\$ 660,526
Net premiums written	1,268,374	646,010
Net premiums earned	\$ 932,334	\$ 295,360
Other underwriting-related fee income	5,097	
Losses and loss adjustment expenses	(591,131)	(198,221)

Edgar Filing: ARCH CAPITAL GROUP LTD - Form 10-Q/A

	Nine Months Ended September 30,	
	2003	2002
Acquisition expenses, net	(217,379)	(59,699)
Other operating expenses	(22,644)	(10,241)
Underwriting income	\$ 106,277	\$ 27,199
<b>Underwriting Ratios</b>		
Loss ratio	63.4%	67.1%
Acquisition expense ratio	23.3%	20.2%
Other operating expense ratio	2.4%	3.5%
Combined ratio	89.1%	90.8%

*Underwriting Income.* The reinsurance segment's underwriting income increased to \$106.3 million for the nine months ended September 30, 2003, compared to \$27.2 million for the nine months ended September 30, 2002. The combined ratio for the reinsurance segment was 89.1% for the nine months ended September 30, 2003, compared to 90.8% for the nine months ended September 30, 2002. The components of the reinsurance segment's underwriting income are discussed below.

14

*Premiums Written.* Gross premiums written increased to \$1.31 billion for the nine months ended September 30, 2003 from \$660.5 million for the nine months ended September 30, 2002. Net premiums written for our reinsurance segment increased to \$1.27 billion for the nine months ended September 30, 2003, compared to \$646.0 million for the nine months ended September 30, 2002. Over half of the increase in net premiums written was attributable to casualty business. For the nine months ended September 30, 2003, 69.6% of net premiums written were generated from pro rata contracts and 30.4% were derived from excess of loss treaties. For the nine months ended September 30, 2002, 50.2% of net premiums written were generated from pro rata contracts and 49.8% were derived from excess of loss treaties.

Set forth below is summary information regarding the reinsurance segment's net premiums written by major line of business:

	Nine Months Ended September 30,			
	2003		2002	
	Amount	% of Total	Amount	% of Total
(in thousands)				
(Unaudited)				
<b>Major line of business:</b>				
<b>Net premiums written</b>				
Casualty	\$ 480,769	37.9%	\$ 133,764	20.7%
Other specialty	311,579	24.6%	139,790	21.6%
Property excluding property catastrophe	258,844	20.4%	126,068	19.5%
Property catastrophe	93,982	7.4%	102,135	15.8%
Marine and aviation	60,318	4.8%	38,322	5.9%
Non-traditional	51,352	4.0%	89,341	13.9%
Casualty clash	11,530	0.9%	16,590	2.6%
Total	\$ 1,268,374	100.0%	\$ 646,010	100.0%

## Edgar Filing: ARCH CAPITAL GROUP LTD - Form 10-Q/A

For information regarding net premiums written produced by geographic location, refer to note 4, "Segment Information," of the notes accompanying our consolidated financial statements.

*Net Premiums Earned.* Net premiums earned for our reinsurance segment increased to \$932.3 million for the nine months ended September 30, 2003, compared to \$295.4 million for the nine months ended September 30, 2002. The increase in net premiums earned occurred in all major lines of business. For the nine months ended September 30, 2003, 68.2% of net premiums earned were generated from pro rata contracts, while 31.8% of net premiums earned were generated from excess of loss treaties. For the nine months ended September 30, 2002, 40.9% of net premiums earned were generated from pro rata contracts, while 59.1% of net premiums earned were generated from excess of loss treaties.

15

Set forth below is summary information regarding the reinsurance segment's net premiums earned by major line of business:

(in thousands)	Nine Months Ended September 30,			
	2003		2002	
	Amount	% of Total	Amount	% of Total
	(Unaudited)			
<b>Major line of business:</b>				
<b>Net premiums earned</b>				
Casualty	\$ 314,448	33.7%	\$ 45,347	15.4%
Property excluding property catastrophe	213,396	22.9%	48,460	16.4%
Other specialty	204,572	21.9%	68,770	23.3%
Property catastrophe	81,653	8.8%	56,195	19.0%
Marine and aviation	55,604	6.0%	18,730	6.3%
Non-traditional	52,461	5.6%	47,768	16.2%
Casualty clash	10,200	1.1%	10,090	3.4%
	\$ 932,334	100.0%	\$ 295,360	100.0%
Total				

*Other Underwriting-Related Fee Income.* Certain assumed reinsurance contracts are deemed, for financial reporting purposes, not to transfer insurance risk, and are accounted for using the deposit method of accounting. For those contracts that contain an element of underwriting risk, the estimated profit margin is deferred and amortized over the contract period. When the estimated profit margin is explicit, the margin is reflected as fee income. We recorded \$5.1 million of fee income on such contracts for the nine months ended September 30, 2003.

*Losses and Loss Adjustment Expenses.* Reinsurance segment losses and loss adjustment expenses incurred for the nine months ended September 30, 2003 were \$591.1 million, or 63.4% of net premiums earned, compared to \$198.2 million, or 67.1%, for the nine months ended September 30, 2002. The loss ratio for the nine months ended September 30, 2003 benefited from favorable development on losses originally recorded during 2002 of \$43.3 million, which resulted in a 4.6 point reduction in the loss ratio. Most of the reduction occurred in short-tail lines of business and resulted from a lower than expected amount of reported claims. The remainder of the difference in the loss ratio compared to the nine months ended September 30, 2002 resulted from changes in the mix of business earned in the nine month period. 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 the nine months ended September 30, 2003 was 23.3%, compared to 20.2% for the nine months ended September 30, 2002, and the other operating expense ratio for the nine months ended September 30, 2003 was 2.4%, compared to 3.5% for the nine months ended September 30, 2002. Movements in the acquisition expense ratio reflect changes in the percentage of net premiums earned from pro rata contracts along with changes in the mix of business. While aggregate operating expenses were higher for the 2003 third quarter compared to the 2002 third quarter, the operating expense ratio decreased primarily due to the growth in net premiums earned in the 2003 period.

*Insurance Segment*

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

	Nine Months Ended September 30,	
	2003	2002
(in thousands)		
(Unaudited)		
Gross premiums written	\$ 1,283,776	\$ 358,693
Net premiums written	842,658	176,410
Net premiums earned	\$ 589,929	\$ 69,605
Policy-related fee income	10,358	6,505
Losses and loss adjustment expenses	(395,304)	(52,743)
Acquisition expenses, net	(72,244)	(4,393)
Other operating expenses	(86,145)	(22,993)
Underwriting income (loss)	\$ 46,594	\$ (4,019)
<b>Underwriting Ratios</b>		
Loss ratio	67.0%	75.8%
Acquisition expense ratio <sup>(1)</sup>	10.5%	(3.0)%
Other operating expense ratio	14.6%	33.0%
Combined ratio	92.1%	105.8%

(1)

The acquisition expense ratio is adjusted to include certain policy-related fee income.

*Underwriting Income (Loss).* The insurance segment's underwriting income was \$46.6 million for the nine months ended September 30, 2003, compared to a loss of \$4.0 million for the nine months ended September 30, 2002. The combined ratio for the insurance segment was 92.1% for the nine months ended September 30, 2003, compared to 105.8% for the nine months ended September 30, 2002. The components of the insurance segment's underwriting income or loss are discussed below.

*Premiums Written.* Gross premiums written for our insurance segment increased to \$1.28 billion for the nine months ended September 30, 2003 from \$358.7 million for the nine months ended September 30, 2002. Net premiums written for our insurance segment increased to \$842.7 million for the nine months ended September 30, 2003, compared to \$176.4 million for the nine months ended September 30, 2002. Contributing to this increase was a \$231.9 million increase in program business and a \$138.9 million increase in casualty business.

Set forth below is summary information regarding the insurance segment's net premiums written by major line of business:

Nine Months Ended  
September 30,



Edgar Filing: ARCH CAPITAL GROUP LTD - Form 10-Q/A

Nine Months Ended  
September 30,

(in thousands)

	2003		2002	
	Amount	% of Total	Amount	% of Total
(Unaudited)				
<b>Major line of business:</b>				
<b>Net premiums written</b>				
Programs	\$ 263,748	31.3%	\$ 31,802	18.0%
Casualty	169,115	20.1%	30,199	17.1%
Construction and surety	95,588	11.3%	13,698	7.8%
Executive assurance	80,583	9.6%	28,171	16.0%
Professional liability	77,538	9.2%	7,630	4.3%
Property	77,511	9.2%	23,683	13.4%
Healthcare	24,656	2.9%	3,453	2.0%
Other	53,919	6.4%	37,774	21.4%
<b>Total</b>	<b>\$ 842,658</b>	<b>100.0%</b>	<b>\$ 176,410</b>	<b>100.0%</b>

For information regarding net premiums written produced by geographic location, refer to note 4, "Segment Information," of the notes accompanying our consolidated financial statements.

*Net Premiums Earned.* Net premiums earned for our insurance segment increased to \$589.9 million for the nine months ended September 30, 2003, compared to \$69.6 million for the nine months ended September 30, 2002. Contributing to this increase was a \$169.3 million increase in program business and a \$103.0 million increase in casualty business.

Set forth below is summary information regarding the insurance segment's net premiums earned by major line of business:

(in thousands)

	2003		2002	
	Amount	% of Total	Amount	% of Total
(Unaudited)				
<b>Major line of business:</b>				
<b>Net premiums earned</b>				
Programs	\$ 182,872	31.0%	\$ 13,564	19.5%
Casualty	108,671	18.4%	5,697	8.2%
Executive assurance	59,509	10.1%	7,159	10.3%
Property	57,349	9.7%	5,699	8.2%
Construction and surety	51,402	8.7%	1,593	2.3%
Professional liability	44,555	7.6%	1,910	2.7%
Healthcare	26,797	4.5%	327	0.5%
Other	58,774	10.0%	33,656	48.3%
<b>Total</b>	<b>\$ 589,929</b>	<b>100.0%</b>	<b>\$ 69,605</b>	<b>100.0%</b>

Nine Months Ended  
September 30,

---



---

18

---

*Policy-Related Fee Income.* Policy-related fee income for our insurance segment was \$10.4 million for the nine months ended September 30, 2003, compared to \$6.5 million for the nine months ended September 30, 2002. Such amounts were earned primarily in our non-standard automobile business.

*Losses and Loss Adjustment Expenses.* Insurance segment losses and loss adjustment expenses incurred for the nine months ended September 30, 2003 were \$395.3 million, or 67.0% of net premiums earned, compared to \$52.7 million, or 75.8%, for the nine months ended September 30, 2002. The loss ratio for the nine months ended September 30, 2003 reflects a significantly higher percentage of business from our specialty insurance operations than in the nine months ended September 30, 2002, which included a higher percentage of business from our non-standard auto business. To date, in our specialty lines, we have recorded lower loss ratios than in our non-standard auto business. In addition, the loss ratio for the nine months ended September 30, 2003 was impacted by adverse development in prior years of \$2.0 million, which generated a 0.3 point increase in the loss ratio. Such amount consisted of \$4.4 million of adverse development in certain program business which was partially offset by \$2.4 million of favorable development in non-standard auto and short-tail lines. 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 was 10.5% for the nine months ended September 30, 2003 (net of 1.8 points of policy-related fee income), compared to (3.0%) for the nine months ended September 30, 2002 (net of 9.3 points of policy-related fee income). The increase in the acquisition expense ratio resulted from the increased contribution of business from our insurance segment's new areas of focus in the 2003 period and a reduction in ceding commissions due from unaffiliated reinsurers.

The other operating expense ratio for the nine months ended September 30, 2003 was 14.6%, compared to 33.0% for the nine months ended September 30, 2002. While aggregate operating expenses were higher for the nine months ended September 30, 2003 compared to the nine months ended September 30, 2002 in connection with the growth in gross premiums written, the operating expense ratio decreased primarily due to the growth in net premiums earned in the 2003 period.

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

Net investment income was \$58.8 million for the nine months ended September 30, 2003, compared to \$35.6 million for the nine months ended September 30, 2002. The increase in net investment income for the nine months ended September 30, 2003 was due to the significant increase in our invested assets primarily resulting from cash flow from operations in 2003 and 2002, which more than offset the effect of lower yields available in the financial markets in 2003 compared to 2002. Our pre-tax and after-tax investment yields, respectively, for the nine months ended September 30, 2003 were 3.0% and 2.7%, compared to 4.2% and 3.7% for the nine months ended September 30, 2002. These yields were calculated based on the amortized cost of the portfolio.

#### ***Net Realized Gains or Losses on Investments***

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

(in thousands)	Nine Months Ended September 30,	
	2003	2002
	(Unaudited)	
Fixed maturities	\$ 18,863	(\$ 4,974)
Privately held securities	693	5,877
Publicly traded equity securities		(728)
Other	1,898	
	\$ 21,454	\$ 175
<b>Total</b>	<b>\$ 21,454</b>	<b>\$ 175</b>

Nine Months Ended  
September 30,

---

---

Net realized gains in our fixed income portfolio during the nine months ended September 30, 2003 and 2002 resulted from the sale of certain securities to reduce credit exposure, and from sales related to rebalancing the portfolio. In addition, we recorded a realized gain, shown as "Other" in the table above, on proceeds received from a class action lawsuit related to a publicly traded equity security which we previously owned and for which we had recorded a significant realized loss in a prior year.

19

---

### *Other*

Other income, generated by our investments in privately held securities accounted for under the equity method of accounting, amounted to \$2.3 million for the nine months ended September 30, 2003, compared to \$1.8 million for the nine months ended September 30, 2002.

### *Net Foreign Exchange Gains or Losses*

Net foreign exchange gains for the nine months ended September 30, 2003 of \$6,519,000 consisted of net unrealized gains of \$4,859,000 and net realized gains of \$1,660,000. Net foreign exchange gains for the nine months ended September 30, 2002 of \$2,518,000 consisted of net unrealized gains of \$911,000 and net realized gains of \$1,607,000.

### *Non-Cash Compensation*

Non-cash compensation expense for the nine months ended September 30, 2003 was \$11.7 million, compared to \$42.3 million for the nine months ended September 30, 2002. The 2002 amount reflected the accelerated vesting of certain restricted common shares granted to the chairman of our board of directors. See note 10, "Transactions with Related Parties," of the notes accompanying our consolidated financial statements.

### *Income Taxes*

Our effective tax rate may fluctuate from period to period based on the relative mix of income reported by jurisdiction primarily due to the varying tax rates in each jurisdiction. Our tax provision for the nine months ended September 30, 2003 is based upon the expected annual effective tax rate of 11.4% on income before extraordinary items, excluding the reversal of a \$773,000 valuation allowance, compared to 27.6% for the nine months ended September 30, 2002, excluding the reversal of a \$7.4 million valuation allowance. The effective tax rate on income before extraordinary items, excluding the effect of net realized investment gains or losses, net foreign exchange gains or losses, other income, the reversal of deferred tax asset valuation allowances and non-cash compensation, was approximately 11.5% for the nine months ended September 30, 2003, compared to 5.4% for the nine months ended September 30, 2002. See note 9, "Income Taxes," of the notes accompanying our consolidated financial statements.

### **Liquidity and Capital Resources**

ACGL is a holding company whose assets primarily consist of the shares in its subsidiaries. Generally, we depend on our available cash resources, liquid investments and dividends or other distributions from our subsidiaries to make payments, including the payment of operating expenses we may incur and for any dividends our board of directors may determine. ACGL does not currently intend to declare any dividends.

Pursuant to a shareholders agreement that we entered into in connection with the November 2001 capital infusion, we have agreed 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 funds affiliated with Warburg Pincus LLC ("Warburg Pincus Funds"), funds affiliated with Hellman & Friedman LLC ("Hellman & Friedman Funds") and the other holders of our preference shares, pro rata, on the basis of the amount of each of these shareholders' investment in us at the time of such repurchase, preference shares having an aggregate value of \$250.0 million, at a per share price acceptable to these shareholders. See "Book Value Per Share" for details on a post-closing purchase price adjustment to be calculated as soon as practicable following November 2003.

On a consolidated basis, our aggregate invested assets, including cash and short-term investments, totaled \$3.37 billion at September 30, 2003. As of such date, ACGL's readily available cash, short-term investments and marketable securities, excluding amounts held by our regulated insurance and reinsurance subsidiaries, totaled \$16.1 million.

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 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) \$100,000,000, (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 financial statements. At December 31, 2002, Arch Re Bermuda had statutory capital and surplus as determined under Bermuda law of \$1.2 billion (including ownership interests in its subsidiaries). Accordingly, 15% of Arch Re Bermuda's capital, or approximately \$179 million, is available for dividends during 2003 without prior approval under Bermuda law, as discussed above. Our U.S. insurance and reinsurance subsidiaries, on a consolidated basis, may not pay any significant dividends or distributions during 2003 without prior regulatory approval. 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.

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.

Cash flow from operating activities on a consolidated basis are provided by premiums collected, fee income, investment income and collected reinsurance recoverables, offset by losses and loss adjustment expense payments, reinsurance premiums payable and operating costs. Consolidated cash provided by operating activities was \$478.2 million for the 2003 third quarter, compared to \$228.5 million for the 2002 third quarter. Operating cash flow for the nine months ended September 30, 2003 was \$1.15 billion, compared to \$342.2 million for the nine months ended September 30, 2002. The increase in cash flow in the 2003 periods compared to the 2002 periods was primarily due to the growth in premium volume and a relatively low level of claim payments due, in part, to the start-up nature of our insurance and reinsurance operations.

Our expanded underwriting activities will initially be supported by our capital, and we expect that our other operational needs for the foreseeable future will be met by our balance of cash and short-term investments, as well as by funds generated from underwriting activities and investment income and proceeds on the sale or maturity of our investments. In furtherance of our business strategy, we may seek to secure external financing from time to time and may also access the public capital markets.

In September 2003, we entered into an unsecured credit facility with a syndicate of banks which provides for the borrowing of up to \$300.0 million. The credit facility is in the form of a 364-day revolving credit agreement that may be converted by us into a two-year term loan at expiration. On September 29, 2003, we borrowed \$200.0 million under the credit facility at a fixed interest rate of approximately 2.44% through March 2004. The proceeds from such borrowings were contributed to our subsidiaries to support their underwriting

activities. In addition, we paid \$1.3 million in fees in connection with the credit facility during the 2003 third quarter. Such fees were deferred and will be amortized over the loan period. The facility will be available to provide capital in support of our growing insurance and reinsurance businesses, as well as other general corporate purposes. We are required to comply with certain covenants under the credit facility agreement. 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 \$1.0 billion plus 40% of future aggregate net income (not including any future net losses) and 40% of future aggregate capital raising proceeds, and that our principal insurance and reinsurance subsidiaries maintain at least a "B++" rating from A.M. Best. See "Contractual Obligations and Commercial Commitments Credit Line" for a description of the credit facility.

On November 3, 2003, the Company filed a universal shelf registration statement with the Securities and Exchange Commission. This registration statement, which replaces the Company's previous shelf registration statement with an unused portion of approximately \$309 million, will allow for the possible future offer and sale by the Company of up to \$500 million 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, once declared effective, will enable the Company to cost effectively and efficiently access public debt and/or equity capital markets in order to meet the Company's future capital needs. Any additional issuance of common shares by us could have the effect of diluting our earnings per share and our book value per share. In addition, the registration statement will allow selling shareholders to resell up to an aggregate of 9,892,594 common shares that they own (or may acquire upon the conversion of outstanding preference shares or warrants) in one or more offerings from time to time. The shareholders are registering their shares pursuant to registration rights previously granted in connection with the 2001 capital infusion. The Company will not receive any proceeds from the shares offered by the selling shareholders.

The registration statement on Form S-3 relating to these securities has been filed with the Securities and Exchange Commission but is not yet effective. Securities described in the registration statement may not be sold nor may offers to buy be accepted prior to the time the registration statement becomes effective. This release 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.

At September 30, 2003, our total capital of \$1.84 billion consisted of revolving credit facility borrowings of \$200.0 million, representing 10.9% of the total, and shareholders' equity of \$1.64 billion, representing 89.1% of the total. At December 31, 2002, our total capital of \$1.41 billion consisted of shareholders' equity with no borrowings outstanding. The increase in our total capital during 2003 was primarily attributable to the effects of net income for the nine months ended September 30, 2003 and the borrowings under our credit facility in September 2003.

### **Certain Matters Which May Materially Affect Our Results of Operations and/or Financial Condition**

#### ***Reserves for Losses and Loss Adjustment Expenses***

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. Estimating loss reserves is inherently difficult, which is exacerbated by the fact that we are a new company with relatively limited historical experience upon which to base such estimates. We utilize actuarial models as well as available historical insurance industry loss ratio experience and loss development patterns to assist in the establishment of appropriate loss reserves. Actual losses and loss adjustment expenses paid will deviate, perhaps substantially, from the reserve estimates reflected in our financial statements. See the section above entitled " Critical Accounting Policies, Estimates and Recent Accounting Pronouncements Reserves for Losses and Loss Adjustment Expenses."

22

---

#### ***Reinsurance Protection and Recoverables***

For purposes of limiting our risk of loss, 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. For the nine months ended September 30, 2003, ceded premiums written represented approximately 14% of gross premiums written, compared to 15% for the year ended December 31, 2002. The decrease is primarily due to an increased retention of our insurance segment premiums written during 2003.

The availability and cost of reinsurance and retrocessional protection is subject to market conditions, which are beyond our control. Currently, the market for these arrangements is experiencing high demand for various products and 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. 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 September 30, 2003, approximately 81% of our reinsurance recoverables on paid and unpaid losses of \$376.0 million (not including prepaid reinsurance premiums) were due from carriers which had an A.M. Best rating of "A-" or better. Our recoverable on paid and unpaid losses from Sentry Insurance a Mutual Company represented 5.0% of our total shareholders' equity at September 30, 2003, as described below. No other reinsurance recoverables exceeded 5% of our total shareholders' equity.

The following table details our reinsurance recoverables at September 30, 2003:

Edgar Filing: ARCH CAPITAL GROUP LTD - Form 10-Q/A

	<b>% of Total</b>	<b>A.M. Best Rating(1)</b>
Sentry Insurance a Mutual Company(2)	21.8%	A+
Alternative market recoverables(3)	10.5%	NR
Lloyd's of London syndicates(4)	9.0%	A-
Swiss Reinsurance America Corporation	5.7%	A+
Employers Reinsurance Corporation	5.6%	A
Everest Reinsurance Corporation	5.4%	A+
Hartford Fire Insurance Company	4.6%	A+
Folksamerica Reinsurance Company	3.2%	A
Odyssey Reinsurance Corporation	2.8%	A
Allied World Assurance Company Ltd.	2.2%	A+
Lyndon Property Insurance Company(5)	2.1%	A-
Gerling Global Reinsurance Corporation of America	2.0%	NR
Lumbermens Mutual Casualty Company	1.2%	D
AXA Corporate Solutions Reinsurance Company	1.0%	B+
PMA Capital Insurance Company	0.9%	B++
Trenwick America Reinsurance Corporation	0.2%	NR
SCOR Reinsurance Company	0.2%	B++
All other(6)	21.6%	
<b>Total</b>	<b>100.0%</b>	

- (1) The financial strength ratings are as of November 6, 2003 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 rating of "A+" is designated "Superior"; the "A" and "A-" ratings are designated

23

"Excellent"; ratings of "B++" and "B+" are designated "Very Good"; and the "D" rating is designated "Poor." 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) In connection with our acquisition of Arch Specialty Insurance Company ("Arch Specialty") in February 2002, the seller, Sentry Insurance a Mutual Company ("Sentry"), agreed to reinsure or otherwise assume all liabilities arising out of Arch Specialty's business prior to the closing of the acquisition. The balance due from Sentry includes all such amounts.
- (3) Includes amounts recoverable from separate cell accounts in our alternative markets unit.
- (4) The A.M. Best group rating of "A-" (Excellent) has been applied to all Lloyd's of London syndicates.
- (5) In connection with our acquisition of Western Diversified Casualty Insurance Company ("Western Diversified") in June 2003, the seller, Western Diversified Services, Inc., a subsidiary of Protective Life Corporation, and certain of its affiliates (including Lyndon Property Insurance Company) agreed to reinsure or otherwise assume all liabilities arising out of Western Diversified's business prior to the closing of the acquisition. The balance due from Lyndon Property Insurance Company includes all such amounts.
- (6) The following table provides a breakdown of the "All other" category by A.M. Best rating:

	<b>% of Total</b>
Companies rated "A-" or better	18.8%
Companies not rated	2.8%
<b>Total</b>	<b>21.6%</b>

*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 lines of 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.

For our 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, wind and specific terrorism exposures, 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 percentage of our total shareholders' equity 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. 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 in the data provided by clients and brokers, the modeling techniques and the application of such techniques. In addition, depending on business opportunities and the mix of business that may comprise our insurance and reinsurance portfolio, we may seek to limit the probable maximum pre-tax loss to a higher percentage of our total shareholders' equity for our catastrophe exposed business.

For property catastrophe-related exposures from January 1, 2003 through September 30, 2003, our insurance operations entered into a reinsurance treaty which provides coverage for catastrophe-related losses equal to 95% of the first \$70 million in excess of a \$50 million retention of such losses. On October 1, 2003, our insurance operations increased their coverage for property catastrophe-related losses to 95% of the first \$95 million in excess of a \$50 million retention of such losses. In addition, our reinsurance operations have purchased reinsurance which primarily provides coverage for certain catastrophe-related losses in California and Florida. Recoveries under such reinsurance treaties are calculated based upon the size of insured industry losses. In the future, we may seek to purchase additional catastrophe or other reinsurance protection. The availability and cost of such reinsurance protection is subject to market conditions, which are beyond our control. As a result of market conditions and other factors, we may not be successful in obtaining such protection. See " Reinsurance Protection and Recoverables" above.

***Foreign Currency Exchange Rate Fluctuation***

We write business on a worldwide basis, and our net income may be affected by fluctuations in the value of currencies other than the U.S. dollar. Changes in foreign currency exchange rates can reduce our revenues and increase our liabilities and costs, as measured in the U.S. dollar as our functional currency. We have not attempted to reduce our exposure to these exchange rate risks by using hedging transactions or by investing in securities denominated in local (foreign) currencies. We may therefore suffer losses solely as a result of exchange rate fluctuations.

***Management and Operations***

As a relatively new insurance and reinsurance company, our success will depend on our ability to integrate new management and operating personnel and to establish and maintain operating procedures and internal controls (including the timely and successful implementation of our information technology initiatives) to effectively support our business and our regulatory and reporting requirements, and no assurances can be given as to the success of these endeavors. Accordingly, we have been, and are continuing to, enhance our procedures and controls, including our control over financial reporting.

***Shareholders Agreement***

The Warburg Pincus funds and the Hellman & Friedman funds together control a majority of our voting power on a fully-diluted basis and have the right to nominate a majority of directors to our board under the shareholders agreement entered into in connection with the November 2001 capital infusion. The shareholders agreement also provides that we cannot engage in certain transactions, including mergers and acquisitions and transactions in excess of certain amounts, without the consent of a designee of the Warburg Pincus funds and a designee of the Hellman & Friedman funds. These provisions could have an effect on the operation of our business and, to the extent these provisions discourage takeover attempts, they could deprive our shareholders of opportunities to realize takeover premiums for their shares or could depress the market price of our common shares. By reason of their ownership and the shareholders agreement, the Warburg Pincus funds and the

Hellman & Friedman funds are able to strongly influence or effectively control actions to be taken by us. The interests of these shareholders may differ materially from the interests of the holders of our common shares, and these shareholders could take actions that are not in the interests of the holders of our common shares.

***Contingencies Relating to the Sale of Prior Reinsurance Operations***

See note 11, "Contingencies Relating to the Sale of Prior Reinsurance Operations," of the notes accompanying our consolidated financial statements.

**Industry and Ratings**

We operate in a highly competitive environment, and since the September 11, 2001 events, new capital has entered the market. These factors may mitigate the benefits that the financial markets may perceive for the property and casualty insurance industry, and we cannot offer any assurances that we will be able to compete successfully in our industry or that the intensity of competition in our industry will not erode profitability for insurance and reinsurance companies generally, including us. In addition, we can offer no assurances that we will participate at all or to the same extent as more established or other companies in any price increases or increased profitability in our industry. If we do not share in such price increases or increased profitability, our financial condition and results of operations could be materially adversely affected.

Financial strength and claims paying ratings from third party rating 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. Our reinsurance subsidiaries, Arch Reinsurance Company and Arch Re Bermuda, and our principal insurance subsidiaries, Arch Insurance Company, Arch Specialty and Arch Excess & Surplus Insurance Company, each currently have financial strength ratings of "A-" (Excellent) from A.M. Best. With respect to our non-standard automobile insurers, American Independent Insurance Company has a financial strength rating of "B+" (Very Good) from A.M. Best, and PSIC has a financial strength rating of "A-" (Excellent) from A.M. Best.

Rating agencies have been coming under increasing pressure as a result of high-profile corporate bankruptcies and may, as a result, increase their scrutiny of rated companies, revise their rating policies or take other action. 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, 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.



**Contractual Obligations and Commercial Commitments**

*Letter of Credit Facility*

On August 12, 2003, we renewed our letter of credit facility ("LOC Facility") for up to \$250 million. The principal purpose of the LOC Facility 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. 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.

26

---

When issued under the LOC Facility, such letters of credit are secured by a portion of our investment portfolio. In addition, the LOC Facility also requires the maintenance of certain financial covenants, with which we were in compliance at September 30, 2003. At such date, we had approximately \$153.7 million in outstanding letters of credit under the LOC Facility which were secured by investments totaling \$176.8 million. In addition to letters of credit, we have and may establish insurance trust accounts in the U.S. and Canada to secure our reinsurance amounts payable as required. At September 30, 2003, CAD \$16.1 million had been set aside in Canadian trust accounts.

The LOC Facility expires on August 11, 2004. It is anticipated that the LOC Facility 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 the event such support is insufficient, we could be required to provide alternative security to cedents. This could take the form of additional insurance trusts supported by our investment portfolio or funds withheld using our cash resources. If we are unable to post security in the form of letters of credit or trust funds when required under such regulations, our operations could be significantly and negatively affected.

*Credit Line*

On September 12, 2003, we entered into an unsecured credit facility with a syndicate of banks led by JPMorgan Chase Bank and Banc of America (the "Credit Facility"). The Credit Facility is in the form of a 364-day revolving credit agreement that may be converted by us into a two-year term loan at expiration. The Credit Facility provides for the borrowing of up to \$300.0 million with interest at a rate selected by us equal to either (i) an adjusted London InterBank Offered Rate ("LIBOR") plus a margin or (ii) an alternate base rate ("Base Rate"). The Base Rate is the higher of the rate of interest established by JPMorgan Chase Bank as its prime rate or the Federal Funds rate plus 0.5% per annum. The payment terms for amounts converted into a term loan at expiration are as follows: 16.66% due 12 months following expiration, 16.67% due 18 months following expiration and 66.67% due 24 months following expiration. The facility will be available to provide capital in support of our growing insurance and reinsurance businesses, as well as other general corporate purposes.

We are required to comply with certain covenants under the Credit Facility agreement. 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 \$1.0 billion plus 40% of future aggregate net income (not including any future net losses) and 40% of future aggregate capital raising proceeds, and that our principal insurance and reinsurance subsidiaries maintain at least a "B++" rating from A.M. Best. We were in compliance with all covenants contained in the Credit Facility agreement at September 30, 2003.

On September 29, 2003, we borrowed \$200.0 million at a fixed interest rate of approximately 2.44% through March 2004. The proceeds of such borrowings were contributed to our subsidiaries to support their underwriting activities. In addition, we paid \$1.3 million in fees in connection with the Credit Facility during the 2003 third quarter. Such fees were deferred and will be amortized over the loan period.

**Investments**

At September 30, 2003, consolidated cash and invested assets totaled \$3.37 billion, consisting of \$453.5 million of cash and short-term investments, \$2.88 billion of publicly traded fixed maturity securities and \$30.5 million of privately held securities. At September 30, 2003, our fixed income portfolio, which includes fixed maturity securities and short-term investments, had an average Standard & Poor's quality rating of "AA" and an average duration of 2.0 years. Our fixed income investment portfolio is currently managed by external investment advisors under our direction in accordance with investment guidelines provided by us. Our current guidelines stress preservation of capital, market liquidity and diversification of risk.

27

---

## Edgar Filing: ARCH CAPITAL GROUP LTD - Form 10-Q/A

The following table summarizes the estimated fair value and carrying value and amortized cost of our fixed maturity securities and equity securities at September 30, 2003:

September 30, 2003				
(in thousands)	Estimated Fair Value and Carrying Value	Gross Unrealized Gains	Gross Unrealized (Losses)	Amortized Cost
(Unaudited)				
<b>Fixed maturities:</b>				
U.S. government and government agencies	\$ 1,048,870	\$ 10,364	\$ (6)	\$ 1,038,512
Corporate bonds	1,092,475	35,205	(1,108)	1,058,378
Mortgage backed securities	115,992	3,591		112,401
Asset backed securities	577,023	5,745	(734)	572,012
Municipal bonds	49,671	864		48,807
	2,884,031	55,769	(1,848)	2,830,110
<b>Equity securities:</b>				
Privately held	30,486	3,499		26,987
	Total	\$ 59,268	\$ (1,848)	\$ 2,857,097

The following table presents the Standard & Poor's credit quality distribution of our fixed maturity securities at September 30, 2003:

(in thousands)	Estimated Fair Value and Carrying Value	% of Total
<b>Fixed Maturities:</b>		
AAA	\$ 1,825,674	63.3%
AA	151,480	5.2%
A	686,157	23.8%
BBB	220,720	7.7%
	Total	100.0%

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. We currently do not utilize derivative financial instruments such as futures, forward contracts, swaps or options or other financial instruments with similar characteristics such as interest rate caps or floors and fixed-rate loan commitments. Our portfolio includes investments, such as mortgage-backed securities, which are subject to prepayment risk. Our investments in mortgage-backed securities, which amounted to approximately \$116.0 million at September 30, 2003, or 3.4% of cash and invested assets, are classified as available for sale and are not held for trading purposes.

Our privately held equity securities consist of securities issued by privately held companies that are generally restricted as to resale or are otherwise illiquid and do not have readily ascertainable market values. The risk of investing in such securities is generally greater than the risk of investing in securities of widely held, publicly traded companies. At September 30, 2003, our private equity portfolio consisted of five investments totaling \$30.5 million in fair value, with additional investment portfolio commitments in an aggregate amount of approximately \$0.4 million. We do not currently intend to make any significant investments in privately held securities over and above our current commitments. See note 7, "Investment Information," of the notes accompanying our consolidated financial statements.

## Edgar Filing: ARCH CAPITAL GROUP LTD - Form 10-Q/A

The following book value per share calculations are based on shareholders' equity of \$1.64 billion and \$1.41 billion at September 30, 2003 and December 31, 2002, respectively. Book value per share excludes the effects of stock options and Class B warrants. Diluted per share book value at September 30, 2003 increased to \$24.43 from \$21.20 at December 31, 2002. The increase in diluted per share book value was primarily attributable to our net income for the nine months ended September 30, 2003.

	September 30, 2003		December 31, 2002	
	Common Shares and Potential Common Shares	Cumulative Book Value Per Share	Common Shares and Potential Common Shares	Cumulative Book Value Per Share
	(Unaudited)			
Common shares(1)	28,137,786	\$ 29.16	27,725,334	\$ 21.48
Series A convertible preference shares	38,844,665	\$ 24.43	38,844,665	\$ 21.20
	66,982,451		66,569,999	

(1) Book value per common share at September 30, 2003 and December 31, 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 \$815.7 million, by (ii) the number of common shares outstanding. Restricted common shares are included in the number of common shares outstanding as if such shares were issued on the date of grant.

Pursuant to the subscription agreement entered in connection with the November 2001 capital infusion (the "Subscription Agreement"), a post-closing purchase price adjustment will be calculated as soon as practicable following November 2003 based on an adjustment basket. The adjustment basket will be equal to (1) the difference between value realized upon sale and the GAAP book value at the closing of the capital infusion (November 2001) (as adjusted based on a pre-determined growth rate) of agreed upon non-core assets; plus (2) the difference between GAAP net book value of our insurance balances attributable to our core insurance operations with respect to any policy or contract written or having a specified effective date at the time of the final adjustment and those balances at the closing; minus (3) reductions in book value arising from costs and expenses relating to the transaction provided under the Subscription Agreement, actual losses arising out of breach of representations under the Subscription Agreement and certain other costs and expenses. If the adjustment basket is less than zero, we will issue additional preference shares to the investors based on the decrease in value of the components of the adjustment basket. If the adjustment basket is greater than zero, we are allowed to use cash in an amount based on the increase in value of the components of the adjustment basket to repurchase common shares (other than any common shares issued upon conversion of the preference shares or exercise of the Class A warrants). In addition, on the fourth anniversary of the closing, there will be a calculation of a further adjustment basket based on (1) liabilities owed to Folksamerica (if any) under the Asset Purchase Agreement, dated as of January 10, 2000, between us and Folksamerica, and (2) specified tax and ERISA matters under the Subscription Agreement.

### Market Sensitive Instruments and Risk Management

In accordance with the SEC's Financial Reporting Release No. 48, we performed a sensitivity analysis to determine the effects that market risk exposures could have on the future earnings, fair values or cash flows of our financial instruments as of December 31, 2002. (See section captioned "Management's Discussion and Analysis of Financial Condition and Results of Operations Market Sensitive Instruments and Risk Management" included in our 2002 Annual Report on Form 10-K.) Market risk represents the risk of changes in the fair value of a financial instrument and is comprised of several components, including liquidity, basis and

price risks. At September 30, 2003, material changes in market risk exposures that affect the quantitative and qualitative disclosures presented as of December 31, 2002 are as follows:

#### *Interest Rate Risk*

## Edgar Filing: ARCH CAPITAL GROUP LTD - Form 10-Q/A

The aggregate hypothetical loss generated from an immediate parallel, adverse shift in the treasury yield curve of 100 basis points would have resulted in a decrease in market value of approximately \$57.7 million on our fixed income portfolio as of September 30, 2003. Such amount would have, on a pre-tax basis, decreased diluted book value per share by approximately \$0.86 as of September 30, 2003.

### *Foreign Currency Exchange Risk*

Foreign currency rate risk is the potential change in value, income, and cash flow arising from adverse changes in foreign currency exchange rates. A 10% depreciation of the U.S. dollar against other currencies under our outstanding contracts at September 30, 2003 would have resulted in unrealized losses of approximately \$16.7 million and would have decreased diluted earnings per share by approximately \$0.25 for the nine months ended September 30, 2003. For further discussion on foreign exchange activity, please refer to " Results of Operations Net Foreign Exchange Gains or Losses."

### **Cautionary Note Regarding Forward-Looking Statements**

The Private Securities Litigation Reform Act of 1995 provides a "safe harbor" for forward-looking statements. This report or any other written or oral statements made by or on behalf of us may include forward-looking statements, which reflect our current views with respect to future events and financial performance. All statements other than statements of historical fact included in or incorporated by reference in this report are forward-looking statements. Forward-looking statements can generally be identified by the use of forward-looking terminology such as "may," "will," "expect," "intend," "estimate," "anticipate," "believe" or "continue" or their negative or variations or similar terminology.

Forward-looking statements involve our current assessment of risks and uncertainties. Actual events and results may differ materially from those expressed or implied in these statements. Important factors that could cause actual events or results to differ materially from those indicated in such statements are discussed below, elsewhere in this report and in our periodic reports filed with the SEC, and include:

our ability to successfully implement our business strategy, as described herein;

acceptance of our products and services and security by brokers and our insureds and reinsureds;

acceptance of our business strategy, security and financial condition by rating agencies and regulators;

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;

current environment with respect to pricing and policy terms;

competition, including increased competition, on the basis of pricing, capacity, coverage terms or other factors;

our ability to successfully integrate new management and operating personnel and to establish and maintain operating procedures to effectively support our underwriting initiatives and to develop accurate actuarial data and develop and implement actuarial models and procedures;

the loss of key personnel;

the integration of businesses we have acquired or may acquire into our existing operations;

estimates and judgments, including those related to revenue recognition, insurance and other reserves, reinsurance recoverables, investment valuations, intangible assets, bad debts, income taxes, contingencies

## Edgar Filing: ARCH CAPITAL GROUP LTD - Form 10-Q/A

and litigation, 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 very limited historical information has been reported to us through September 30, 2003;

greater than expected loss ratios on business written by us and adverse development on reserves for losses and loss adjustment expenses 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;

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 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;

changes in accounting principles or the application of such principles by accounting firms or regulators;

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

rating agency policies and practices.

In addition, other general factors could affect our results, including: (a) developments in the world's financial and capital markets and our access to such markets; (b) changes in regulation or tax laws applicable to us, our subsidiaries, brokers or customers; and (c) the effects of business disruption or economic contraction due to terrorism or other hostilities.

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.

### **QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK**

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

### **CONTROLS AND PROCEDURES**

## Edgar Filing: ARCH CAPITAL GROUP LTD - Form 10-Q/A

In connection with the filing of this Form 10-Q, our management, including the Chief Executive Officer and Chief Financial Officer, conducted an evaluation of the effectiveness of disclosure controls and procedures pursuant to Exchange Act Rule 13a-14. Based on that evaluation, the Chief Executive Officer and Chief Financial Officer concluded that the disclosure controls and procedures are effective to provide reasonable assurance that all material information required to be filed in this quarterly report has been made known to them in a timely fashion. There have been no changes in internal control over financial reporting that occurred during the most recent fiscal quarter that have materially affected, or are reasonably likely to materially affect, internal

31

---

control over financial reporting, other than as described under "Management's Discussion and Analysis of Financial Condition and Results of Operations Certain Matters Which May Materially Affect Our Results of Operations and/or Financial Condition Management and Operations."

Our management, including the Chief Executive Officer and Chief Financial Officer, 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, and, as set forth above, the Chief Executive Officer and Chief Financial Officer have concluded, based on their evaluation as of September 30, 2003, that our disclosure controls and procedures were effective to provide reasonable assurance that the objectives of our disclosure control system were met.

32

---

### SIGNATURES

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

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

Date: January 27, 2004

/s/ CONSTANTINE IORDANOU

---

Constantine Iordanou  
*President and Chief Executive Officer  
(Principal Executive Officer) and Director*

Date: January 27, 2004

/s/ JOHN D. VOLLARO

---

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

33

---

### EXHIBIT INDEX

## Edgar Filing: ARCH CAPITAL GROUP LTD - Form 10-Q/A

Exhibit No.	Description
10.1*	First Lease Modification Agreement, dated as of May 7, 2003, to the Lease Agreement, dated as of September 26, 2002 ("Lease"), between Arch Insurance Company ("Arch Insurance") and BFP One Liberty Plaza Co. LLC
10.2*	Second Lease Modification Agreement, dated as of July 31, 2003, to the Lease
10.3*	Sublease Surrender Agreement, dated as of July 31, 2003, between Arch Insurance and Folksamerica Reinsurance Company
10.4*	First Amendment to the Arch Capital Group Ltd. ("ACGL") 2002 Long Term Incentive and Share Award Plan
10.5*	Amended and Restated Letter of Credit and Reimbursement Agreement, dated as of August 12, 2003 ("Amended and Restated Letter of Credit"), by and among Arch Reinsurance Ltd., Arch Reinsurance Company, Alternative Re Limited, Arch Insurance, the lenders from time to time party thereto and Fleet National Bank
10.6*	Amendment to Amended and Restated Letter of Credit, dated as of August 20, 2003
10.7*	Credit Agreement, dated as of September 12, 2003, by and among ACGL, JP Morgan Chase Bank, as Administrative Agent, Bank of America, N.A., as Syndication Agent and Commerzbank AG, New York Branch, Credit Suisse First Boston, acting through its Cayman Islands Branch, and Wachovia Bank, National Association, as Documentation Agents
15*	Accountants' Awareness Letter (regarding unaudited interim financial information)
31.1	Certification of Chief Executive Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002
31.2	Certification of Chief Financial Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002
32.1	Certification of Chief Executive Officer pursuant to Section 906 of the Sarbanes-Oxley Act of 2002
32.2	Certification of Chief Financial Officer pursuant to Section 906 of the Sarbanes-Oxley Act of 2002

\*

Previously filed with and incorporated by reference to the Registrant's original Quarterly Report on Form 10-Q for the quarterly period ended September 30, 2003, as filed with the Securities and Exchange Commission on November 12, 2003.

### QuickLinks

[ARCH CAPITAL GROUP LTD. INDEX](#)

[EXPLANATORY NOTE](#)

[QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK](#)

[CONTROLS AND PROCEDURES](#)

[SIGNATURES](#)

[EXHIBIT INDEX](#)