

XL CAPITAL LTD  
Form 10-Q  
November 09, 2006

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**UNITED STATES  
SECURITIES AND EXCHANGE COMMISSION  
Washington, D.C. 20549**

**FORM 10-Q**

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

**For the quarterly period ended September 30, 2006**

OR

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

**For the transition period from \_\_\_\_\_ to \_\_\_\_\_**

Commission file number 1-10804

**XL CAPITAL LTD**

**(Exact name of registrant as specified in its charter)**

CAYMAN ISLANDS  
(State or other jurisdiction of  
incorporation or organization)

98-0191089  
(I.R.S. Employer  
Identification No.)

**XL House, One Bermudiana Road, Hamilton, Bermuda HM 11  
(Address of principal executive offices and zip code)**

**(441) 292-8515**

**(Registrant's telephone number, including area code)**

Indicate by check mark whether the registrant: (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes x No o

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

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act). Yes o No x

As of October 30, 2006, there were 180,573,133 outstanding Class A Ordinary Shares, \$0.01 par value per share, of the registrant.



**XL CAPITAL LTD**

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## PART I FINANCIAL INFORMATION

## ITEM 1. FINANCIAL STATEMENTS

**XL CAPITAL LTD**  
**CONSOLIDATED BALANCE SHEETS**  
(U.S. dollars in thousands, except share amounts)

	(Unaudited) September 30, 2006	December 31, 2005
<b>ASSETS</b>		
Investments:		
Fixed maturities at fair value (amortized cost: 2006, \$34,564,249; 2005, \$31,984,076)	\$ 34,765,259	\$ 32,309,565
Equity securities, at fair value (cost: 2006, \$694,175; 2005, \$696,858)	847,308	868,801
Short-term investments, at fair value (amortized cost: 2006, \$3,105,784; 2005, \$2,552,589)	3,099,684	2,546,073
	<hr/>	<hr/>
Total investments available for sale	38,712,251	35,724,439
Investments in affiliates	2,112,353	2,046,721
Other investments	500,155	399,417
	<hr/>	<hr/>
Total investments	41,324,759	38,170,577
Cash and cash equivalents	2,128,221	3,693,475
Accrued investment income	432,176	391,660
Deferred acquisition costs	940,881	866,200
Prepaid reinsurance premiums	1,357,649	1,067,556
Premiums receivable	4,082,824	3,799,041
Reinsurance balances receivable	1,237,011	1,043,013
Unpaid losses and loss expenses recoverable	5,532,054	6,441,522
Goodwill and other intangible assets	1,817,229	1,814,544
Deferred tax asset, net	296,985	318,399
Other assets	630,210	848,914
	<hr/>	<hr/>
Total assets	\$ 59,779,999	\$ 58,454,901
	<hr/>	<hr/>
<b>LIABILITIES AND SHAREHOLDERS EQUITY</b>		
Liabilities:		
Unpaid losses and loss expenses	\$ 23,292,278	\$ 23,767,672
Deposit liabilities	8,103,553	8,240,987
Future policy benefit reserves	6,075,259	5,606,461
Unearned premiums	6,088,306	5,388,996
Notes payable and debt	3,368,132	3,412,698
Reinsurance balances payable	1,272,934	1,414,752
Net payable for investments purchased	246,593	639,034
Other liabilities	1,259,642	1,414,496
	<hr/>	<hr/>
Total liabilities	\$ 49,706,697	\$ 49,885,096
	<hr/>	<hr/>

See accompanying Notes to Unaudited Consolidated Financial Statements

**XL CAPITAL LTD**  
**CONSOLIDATED BALANCE SHEETS**  
(U.S. dollars in thousands, except share amounts)

	<u>(Unaudited)</u> <u>September 30,</u> <u>2006</u>	<u>December 31,</u> <u>2005</u>
<b>Commitments and Contingencies</b>		
Minority interest in equity of consolidated subsidiaries	\$ 549,327	\$ 50,518
<b>Shareholders' Equity:</b>		
Series A preference ordinary shares, 9,200,000 authorized, par value \$0.01 Issued and outstanding: 2006 and 2005, 9,200,000	\$ 92	\$ 92
Series B preference ordinary shares, 11,500,000 authorized, par value \$0.01 Issued and outstanding: 2006 and 2005, 11,500,000	115	115
Series C preference ordinary shares, 20,000,000 authorized, par value \$0.01 Issued and outstanding 2006 and 2005, nil		
Class A ordinary shares, 999,990,000 authorized, par value \$0.01 Issued and outstanding: 2006, 180,508,133; 2005, 179,528,593	1,805	1,795
Additional paid in capital	6,411,090	6,377,375
Accumulated other comprehensive (loss) income	240,556	268,243
Retained earnings	2,870,317	1,824,191
<b>Total shareholders' equity</b>	<b>\$ 9,523,975</b>	<b>\$ 8,471,811</b>
<b>Total liabilities and shareholders' equity</b>	<b>\$ 59,779,999</b>	<b>\$ 58,454,901</b>

See accompanying Notes to Unaudited Consolidated Financial Statements

**XL CAPITAL LTD**  
**CONSOLIDATED STATEMENTS OF INCOME**  
(U.S. dollars in thousands, except per share amounts)

	(Unaudited) Three Months Ended September 30,		(Unaudited) Nine Months Ended September 30,	
	2006	2005	2006	2005
<b>Revenues:</b>				
Net premiums earned	\$ 1,855,064	\$ 1,800,054	\$ 5,658,203	\$ 7,412,257
Net investment income	518,281	366,692	1,455,645	1,042,298
Net realized (losses) gains on investments	(52,656)	53,223	(53,495)	203,949
Net realized and unrealized gains on derivative instruments	611	17,982	78,700	15,219
Net income from investment affiliates	39,370	56,735	174,612	116,473
Fee income and other	3,494	1,621	23,086	15,733
<b>Total revenues</b>	<b>\$ 2,364,164</b>	<b>\$ 2,296,307</b>	<b>\$ 7,336,751</b>	<b>\$ 8,805,929</b>
<b>Expenses:</b>				
Net losses and loss expenses incurred	\$ 1,040,167	\$ 2,590,969	\$ 3,256,852	\$ 4,995,737
Claims and policy benefits	156,028	142,957	531,361	2,289,248
Acquisition costs	260,877	296,018	823,476	901,400
Operating expenses	276,425	262,315	817,450	758,421
Exchange losses	21,943	5,159	75,385	5,388
Interest expense	150,388	89,748	412,889	275,800
Amortization of intangible assets	420	2,668	1,935	8,504
<b>Total expenses</b>	<b>\$ 1,906,248</b>	<b>\$ 3,389,834</b>	<b>\$ 5,919,348</b>	<b>\$ 9,234,498</b>
Income (loss) before minority interest, income tax charge (benefit) and equity in net (income) of insurance and financial affiliates	\$ 457,916	\$ (1,093,527)	\$ 1,417,403	\$ (428,569)
Minority interest in net income of subsidiary	8,355	2,411	10,613	6,765
Income tax charge (benefit)	43,655	(47,338)	176,728	47,312
Net (income) from operating affiliates	(19,964)	(9,479)	(51,560)	(42,525)
<b>Net income (loss)</b>	<b>425,870</b>	<b>(1,039,121)</b>	<b>1,281,622</b>	<b>(440,121)</b>
Preference share dividends	10,081	10,080	30,241	30,240
<b>Net income (loss) available to ordinary shareholders</b>	<b>\$ 415,789</b>	<b>\$ (1,049,201)</b>	<b>\$ 1,251,381</b>	<b>\$ (470,361)</b>
Weighted average ordinary shares and ordinary share equivalents outstanding basic	178,818	139,266	178,662	138,823
Weighted average ordinary shares and ordinary share equivalents outstanding diluted	179,439	139,266	179,298	138,823
Earnings (loss) per ordinary share and ordinary share equivalent basic	\$ 2.33	\$ (7.53)	\$ 7.00	\$ (3.39)
Earnings (loss) per ordinary share and ordinary share equivalent diluted	\$ 2.32	\$ (7.53)	\$ 6.98	\$ (3.39)

See accompanying Notes to Unaudited Consolidated Financial Statements



**XL CAPITAL LTD**  
**CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME**  
(U.S. dollars in thousands)

	(Unaudited) Three Months Ended September 30,		(Unaudited) Nine Months Ended September 30,	
	2006	2005	2006	2005
Net income (loss)	\$ 425,870	\$ (1,039,121)	\$ 1,281,622	\$ (440,121)
Change in net unrealized appreciation (depreciation) of investments, net of tax	641,548	(271,073)	(114,937)	(226,970)
Amortization of derivative loss on cash flow hedge	159	159	471	471
Foreign currency translation adjustments, net	(2,172)	36,528	94,826	115,850
Net unrealized (loss) gain on future policy benefit reserves	(1,685)	3,458	(14,595)	9,049
Minority interest share in change in accumulated other comprehensive loss in SCA	(7,676)		(7,676)	
Realization of loss on sale of SCA	14,224		14,224	
Comprehensive income (loss)	<u>\$ 1,070,268</u>	<u>\$ (1,270,049)</u>	<u>\$ 1,253,935</u>	<u>\$ (541,721)</u>

See accompanying Notes to Unaudited Consolidated Financial Statements



**XL CAPITAL LTD**  
**CONSOLIDATED STATEMENTS OF SHAREHOLDERS EQUITY**  
(U.S. dollars in thousands)

	(Unaudited) Nine Months Ended September 30,	
	2006	2005
<b>Series A and B Preference Ordinary Shares:</b>		
Balance beginning of year	\$ 207	\$ 207
Issue of shares		
Balance end of period	\$ 207	\$ 207
<b>Class A Ordinary Shares:</b>		
Balance beginning of year	\$ 1,795	\$ 1,389
Issue of shares	8	9
Exercise of stock options	3	8
Repurchase of shares	(1)	(1)
Balance end of period	\$ 1,805	\$ 1,405
<b>Additional Paid in Capital:</b>		
Balance beginning of year	\$ 6,377,375	\$ 3,880,187
Issue of shares	53,011	69,871
Repurchase of ordinary shares	(2,830)	(1,776)
Stock option expense	17,354	15,345
Exercise of stock options	13,772	33,864
Net change in deferred compensation	(6,492)	(34,397)
Net loss on sale of SCA	(30,100)	
Realization of Accumulated Other Comprehensive Loss on sale of SCA	(11,000)	
Balance end of period	\$ 6,411,090	\$ 3,963,094
<b>Accumulated Other Comprehensive Income:</b>		
Balance beginning of year	\$ 268,243	\$ 460,273
Net change in unrealized gains (losses) on investment portfolio, net of tax	(134,263)	(232,086)
Net change in unrealized gains (losses) on investment portfolio of affiliates	19,326	5,116
Amortization of derivative loss on cash flow hedge	471	471
Impact of net unrealized gain (losses) on future policy benefit reserves	(14,595)	9,049
Currency translation adjustments	94,826	115,850
Realization of loss on sale of SCA	14,224	
Minority interest share in charge in accumulated other comprehensive loss in SCA	(7,676)	
Balance end of period	\$ 240,556	\$ 358,673
<b>Retained Earnings:</b>		
Balance beginning of year	\$ 1,824,191	\$ 3,396,639
Net income (loss)	1,281,622	(440,121)
Dividends on Series A and B preference ordinary shares	(30,241)	(30,240)
Dividends on Class A ordinary shares	(202,471)	(207,344)
Repurchase of ordinary shares	(2,784)	(3,013)
Balance end of period	\$ 2,870,317	\$ 2,715,921

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**Total Shareholders Equity**

\$ 9,523,975

\$ 7,039,300

See accompanying Notes to Unaudited Consolidated Financial Statements

**XL CAPITAL LTD**  
**CONSOLIDATED STATEMENTS OF CASH FLOWS**  
(U.S. dollars in thousands)

	(Unaudited) Nine Months Ended September 30,	
	2006	2005 (restated)*
<b>Cash flows provided by operating activities:</b>		
Net income (loss)	\$ 1,281,622	\$ (440,121)
Adjustments to reconcile net income to net cash provided by (used in) operating activities:		
Net realized losses (gains) on investments	53,495	(203,949)
Net realized and unrealized (gains) losses on derivative instruments	(78,700)	(15,219)
Amortization of (discounts) premiums on fixed maturities	(18,359)	38,914
Equity in net income from investment, insurance and financial affiliates	(226,172)	(158,998)
Amortization of deferred compensation	45,923	27,993
Accretion of convertible debt	725	731
Accretion of deposit liabilities	261,494	151,953
Unpaid losses and loss expenses	(851,837)	3,456,112
Future policy benefit reserves	22,666	1,776,599
Unearned premiums	608,718	794,826
Premiums receivable	(194,175)	(340,953)
Unpaid losses and loss expenses recoverable	1,015,037	(846,198)
Prepaid reinsurance premiums	(278,054)	(147,951)
Reinsurance balances receivable	(179,951)	(14,139)
Deferred acquisition costs	(57,465)	(98,978)
Reinsurance balances payable	(142,448)	(16,960)
Deferred tax asset	34,191	15,795
Other assets	303,907	(76,069)
Other	(88,482)	48,676
Total adjustments	\$ 230,513	\$ 4,392,185
Net cash provided by operating activities	\$ 1,512,135	\$ 3,952,064
<b>Cash flows used in investing activities:</b>		
Proceeds from sale of fixed maturities and short-term investments	\$ 16,618,562	\$ 16,455,068
Proceeds from redemption of fixed maturities and short-term investments	897,854	812,582
Proceeds from sale of equity securities	1,048,623	950,790
Purchases of fixed maturities and short-term investments	(20,207,649)	(22,853,444)
Purchases of equity securities	(971,591)	(777,904)
Net acquisitions less dispositions of affiliates	177,695	13,954
Acquisition of subsidiaries, net of cash acquired	(12,600)	
Net proceeds on sale of shares of SCA	104,650	
Other investments	(96,396)	44,880
Other assets	4,087	
Net cash used in investing activities	\$ (2,436,765)	\$ (5,354,074)
<b>Cash flows provided by financing activities:</b>		
Proceeds from exercise of stock options and issuance of common shares	13,293	40,297
Repurchase of shares	(5,616)	(4,790)
Dividends paid	(232,711)	(237,584)
Proceeds from notes payable and issuance of equity units		
Repayment of loans	(45,291)	
Deposit liabilities	(398,553)	1,563,157

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Net cash flow on securities lending	(335,661)	(70,773)
Proceeds from issuance of shares of SCA	342,227	
	<u>          </u>	<u>          </u>
Net cash (used in) provided by financing activities	\$ (662,312)	\$ 1,290,307
Effects of exchange rate changes on foreign currency cash	21,688	(35,434)
	<u>          </u>	<u>          </u>
(Decrease) increase in cash and cash equivalents	(1,565,254)	(147,137)
<b>Cash and cash equivalents beginning of period</b>	<b>3,693,475</b>	<b>2,203,726</b>
	<u>          </u>	<u>          </u>
<b>Cash and cash equivalents end of period</b>	<b>\$ 2,128,221</b>	<b>\$ 2,056,589</b>
	<u>          </u>	<u>          </u>

\* See Note 1

See accompanying Notes to Unaudited Consolidated Financial Statements

**XL CAPITAL LTD**  
**NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS**

**1. Basis of Preparation and Consolidation**

These unaudited consolidated financial statements include the accounts of the Company and all of its subsidiaries and have been prepared in accordance with accounting principles generally accepted in the United States of America. ( GAAP ) for interim financial information and with the instructions to Form 10-Q and Article 10 of Regulation S-X. Accordingly, they do not include all of the information and footnotes required by GAAP for complete financial statements. In the opinion of management, these unaudited financial statements reflect all adjustments (consisting of normal recurring accruals) considered necessary for a fair presentation of financial position and results of operations as at the end of and for the periods presented. The results of operations for any interim period are not necessarily indicative of the results for a full year. All significant inter-company accounts and transactions have been eliminated. The preparation of financial statements in conformity with GAAP requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ materially from these estimates.

To facilitate period-to-period comparisons, certain reclassifications have been made to prior period consolidated financial statement amounts to conform to current period presentation. There was no effect on net income from this change in presentation.

Unless the context otherwise indicates, references herein to the Company include XL Capital Ltd and its consolidated subsidiaries.

**Statement of Cash Flows**

The Statement of Consolidated Cash Flows for the nine-month period ended September 30, 2005 has been restated. On November 5, 2006, management of the Company determined that the Company had incorrectly included the impact of foreign exchange rate changes on Cash flows provided by operating activities, Cash flows used in investing activities, Cash flows provided by financing activities, and Effects of exchange rate changes on foreign currency cash in the Company's Consolidated Statements of Cash Flows and, therefore, a restatement would be required to eliminate the impact of those rate changes on balances held in certain foreign currency denominated subsidiaries.

The following Condensed Statement of Consolidated Cash Flows for the nine months ended September 30, 2005 sets forth the effects of this restatement:

	<b>Nine Months Ended September 30, 2005</b>		
	<b>As Previously Reported</b>	<b>Adjustments</b>	<b>As Restated</b>
Net cash provided by operating activities	\$ 3,182,762	\$ 769,302	\$ 3,952,064
Net cash used in investing activities	(4,601,015)	(753,059)	(5,354,074)
Net cash provided by financing activities	1,273,146	17,161	1,290,307
Effects of exchange rate changes on foreign currency cash	(2,030)	(33,404)	(35,434)
Net change in cash and cash equivalents	\$ (147,137)	\$	\$ (147,137)
Cash and cash equivalents at the beginning of year	2,203,726		2,203,726
Cash and cash equivalents at the end of year	\$ 2,056,589	\$	\$ 2,056,589

XL CAPITAL LTD  
NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS (continued)

**2. Significant Accounting Policies**

(a) Stock-Based compensation

Effective January 1, 2003, the Company adopted the fair value recognition provisions of Statement of Financial Accounting Standards ( FAS ) No. 123, *Accounting for Stock-Based Compensation* ( FAS 123 ), as amended by FAS No. 148, *Accounting for Stock-Based Compensation Transition and Disclosure* ( FAS 148 ), under the prospective method for options granted subsequent to January 1, 2003. Prior to 2003, the Company accounted for options under the disclosure-only provisions of FAS 123 and no stock-based employee compensation cost was included in net income as all options granted had an exercise price equal to the market value of the Company's ordinary shares on the date of the grant. At September 30, 2006, the Company had several stock based Performance Incentive Programs, which are described more fully in Note 19 to the consolidated financial statements filed on Form 10-K/A for the year ended December 31, 2005. Stock-based compensation issued under these plans generally have a life of not longer than ten years and vest as set forth at the time of grant. Options currently vest annually over three or four years from the date of grant. The Company recognizes compensation costs for stock options and restricted stock on a straight-line basis over the requisite service period for each award.

In 2004, the FASB issued SFAS No.123 (revised 2004) ( FAS 123(r) ), *Share-Based Payment*, which is a revision of SFAS 123. SFAS 123(r) superseded FAS 123 and APB 25, and amended SFAS 95, *Statement of Cash Flows*. Generally, the approach to accounting for share-based payments in FAS 123(r) is similar to the approach described in FAS 123, which the Company adopted on a prospective basis in 2003. However, FAS 123(r) requires all share-based payments to employees, including grants of employee stock options (for all grant years), to be recognized in the financial statements over the vesting period based on their grant date fair values.

The Company adopted FAS 123(r) effective January 1, 2006 using the modified-prospective method to account for share-based payments made to employees. The modified-prospective method is similar to the modified-prospective method described in SFAS 148. Under this method, compensation cost is recognized beginning with the effective date (a) based on the requirements of FAS 123(r) for all share-based payments granted after the effective date and (b) based on the requirements of FAS 123(r) for all awards granted to employees prior to the effective date of FAS 123(r) that remain unvested on the effective date.

Effective August 4, 2006, the Board of Directors of Security Capital Assurance Ltd ( SCA ) a consolidated subsidiary of the Company as discussed in Note 4, adopted the 2006 Long-Term Incentive and Share Award Plan, which is referred to as the SCA Plan . The SCA Plan provides for the grant to eligible employees, consultants and directors of stock options, share appreciation rights ( SARs ), restricted shares, restricted share units, performance shares, performance units, dividend equivalents, and other share-based awards ( Awards ). An aggregate of 3,848,182 common shares has been reserved for issuance under the SCA Plan, subject to anti-dilution adjustments in the event of certain changes in our capital structure. Shares issued pursuant to the SCA Plan will be either authorized but unissued shares or treasury shares.

The SCA Plan will be administered by SCA's Compensation Committee or such other Board committee (or the entire Board) as may be designated by SCA's Board, which is referred to as the Committee. The Committee will determine which eligible employees, consultants and directors receive Awards, the types of Awards to be received and the terms and conditions thereof. However, the exercise price of options and SARs will not be less than the fair market value of the shares on the date of grant, and the term will not be longer than ten years from the date of grant. In the event of a change in control (as defined in the SCA Plan), all awards granted under the SCA Plan then outstanding but not then exercisable (or subject to restrictions) shall become immediately exercisable, all restrictions shall lapse, and any performance criteria shall be deemed satisfied, unless otherwise provided in the applicable Award agreement.

The fair value of each option grant is estimated on the date of grant using the Black-Scholes option pricing model with the following weighted average assumptions:

**XL CAPITAL LTD**  
**NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS (continued)**

**2. Significant Accounting Policies (continued)**

	XL Capital Ltd (Unaudited)		SCA (Unaudited)
	Three and Nine Months Ended September 30, 2006	Three and Nine Months Ended September 30, 2005	Three and Nine Months Ended September 30, 2006
Dividend yield	2.1%	2.6%	0.0%
Risk free interest rate	4.7%	4.0%	5.0%
Expected volatility	25.0%	25.0%	25.0%
Expected lives	5.5 years	5.5 years	4.4 years

The risk free interest rate is based on U.S. Treasury rates. The expected lives are estimated using the historical exercise behavior of grant recipients. The expected volatility is determined based upon a combination of the historical volatility of the Company's stock and the implied volatility derived from publicly traded options.

In the first nine months of 2006 and 2005, the Company granted 187,800 and 1,877,500 options, respectively, to purchase its ordinary shares to directors and employees related to incentive compensation plans, with a weighted average grant-date fair value of \$17.34 and \$17.04, respectively. During the three-month periods ended September 30, 2006 and 2005, the Company recognized \$4.8 million and \$4.9 million, respectively, of compensation expense, net of tax, related to its stock option plans. During the nine-month periods ended September 30, 2006 and 2005, the Company recognized \$15.0 million and \$13.3 million, respectively, of compensation expense, net of tax, related to its stock option plan. Total intrinsic value of stock options exercised during the nine-month periods ended September 30, 2006 and 2005 was \$4.1 million and \$16.2 million, respectively.

The following is a summary of stock options as of September 30, 2006, and related activity for the nine months ended September 30, 2006 for the Company:

	Number of Shares	Weighted Average Exercise Price	Weighted Average Remaining Contractual Term	Aggregate Intrinsic Value (000s)
Outstanding beginning of period	12,745,290	\$ 75.35	6.0 years	
Granted	187,800	67.18		
Exercised	(266,789)	50.68		
Cancelled	(641,420)	79.36		
Outstanding end of period	12,024,881	\$ 75.56	5.2 years	\$ 32,437
Options exercisable	9,569,846	\$ 75.60	4.5 years	\$ 32,298
Options available for grant*	13,058,111			

\* Available for grant includes shares that may be granted as either stock options or restricted stock.

The aggregate intrinsic value in the table above represents the total pre-tax intrinsic value (the difference between the Company's closing stock price on the last trading day of the third quarter of fiscal 2006 and the exercise price, multiplied by the number of in-the-money-options) that would have been received by the option holders had all option holders exercised their options on September 30, 2006. Total unrecognized stock based compensation expense related to non-vested stock options was approximately \$33.3 million as of September 30, 2006, related to

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approximately 12.0 million options, that is expected to be recognized over a weighted-average period of 1.5 years.

In the first nine months of 2006, the Company incurred no additional stock based compensation due to the adoption of FAS 123(r) related to the vesting in 2006 of options granted prior to January 1, 2003, as all options granted prior to that date had been fully vested by September 30, 2006.

At the effective date of the initial public offering ( IPO ) of SCA, SCA awarded 647,963 stock options (the IPO Awards ) to directors and employees at an exercise price of \$20.50. Of the total stock options awarded, 200,000 were granted to directors, of which 50,000 relate to directors, who as officers of the Company, pledged such options to the Company. There were no other stock option awards made through September 30, 2006. The Awards vest as set forth in the applicable Award agreements and the requisite service period is equivalent to the vesting period. The IPO Awards contain certain restrictions, prior to vesting, relating to, among other things, forfeiture in the event of termination of employment and transferability. The IPO Awards awarded had a weighted average grant-date fair value of \$6.06, a weighted average remaining contractual term of 7.65 years, and an aggregate intrinsic value of \$2.2 million. None of these options were exercisable at September 30, 2006. During the three and nine months ended September 30, 2006, SCA recognized approximately \$0.2 million of compensation expense, net of tax, related to its stock option awards. There were no stock options exercised or cancelled dur-



**XL CAPITAL LTD**  
**NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS (continued)**

**2. Significant Accounting Policies (continued)**

ing the nine months ended September 30, 2006. Total unrecognized stock based compensation expense related to non-vested stock options was approximately \$3.6 million as of the end of September 30, 2006, related to 647,963 options, which is expected to be recognized over a weighted-average period of 2.4 years.

For all periods presented prior to 2006, and for all options granted prior to January 1, 2003, the Company accounted for stock option grants under the recognition and measurement principles of APB 25 and related interpretations and accordingly, recognized no compensation expense for these stock options granted to employees. The following table illustrates the effect on earnings per share for the three-month and nine-month periods ended September 30, 2005, if the Company had applied the fair value recognition to all of its stock-based employee compensation:

	<b>(Unaudited) Three Months Ended September 30, 2005</b>	<b>(Unaudited) Nine Months Ended September 30, 2005</b>
<b>(U.S. dollars in thousands, except per share amounts)</b>		
Net income (loss) available to ordinary shareholders as reported	\$ (1,049,201)	\$ (470,361)
Add: Stock based employee compensation expense included in reported net income, net of related tax	5,659	15,390
Deduct: Total stock based employee compensation expense determined under fair value based method for all awards, net of related tax effects	(5,689)	(20,007)
Pro forma net income (loss) available to ordinary shareholders	<u>\$ (1,049,231)</u>	<u>\$ (474,978)</u>
<b>Earnings (loss) per ordinary share:</b>		
Basic as reported	\$ (7.53)	\$ (3.39)
Basic pro forma	\$ (7.53)	\$ (3.39)
Diluted as reported	\$ (7.53)	\$ (3.39)
Diluted pro forma	\$ (7.53)	\$ (3.39)

Restricted stock awards issued under the 1991 Performance Incentive Program and under the SCA Plan vest as set forth in the applicable award agreements. These shares contained certain restrictions prior to vesting, relating to, among other things, forfeiture in the event of termination of employment and transferability.

In first nine months of 2006 and 2005, the Company granted 786,862 and 901,050 shares, respectively, of its restricted common shares to its directors and employees related to incentive compensation plans, with a weighted average grant date fair value per share of \$66.48 and \$75.38, respectively. During the three-month periods ended September 30, 2006 and 2005, \$15.4 million and \$7.5 million, respectively, was charged to compensation expense related to restricted stock awards. During the nine-month periods ended September 30, 2006 and 2005, \$45.9 million and \$28.0 million, respectively, was charged to compensation expense related to restricted stock awards. Total unrecognized stock based compensation expense related to non-vested restricted stock awards was approximately \$102.9 million as of the end of September 30, 2006, related to approximately 1.9 million restricted stock awards, which is expected to be recognized over 2.6 years. Non-vested restricted stock awards as of September 30, 2006 and for the nine months then ended for the Company were as follows:

	<b>Number of shares (thousands)</b>	<b>Weighted- Average Grant Date Fair Value</b>
Unvested at December 31, 2005	1,529	\$ 62.43
Granted	787	\$ 66.48
Vested	(405)	\$ 74.97
Forfeited	(11)	\$ 72.49
Unvested at September 30, 2006	<u>1,900</u>	<u>\$ 71.89</u>



**XL CAPITAL LTD**  
**NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS (continued)**

At the effective date of the SCA IPO, SCA awarded 500,428 shares of restricted stock with a weighted average grant date fair value of \$20.50. All awards were made to directors and employees. There were no other restricted stock awards made through September 30, 2006. The awards vest as set forth in the applicable award agreements. During the three and nine months ended September 30, 2006, SCA recognized approximately \$0.5 million of compensation expense related to its restricted stock awards. There were no restricted stock vested or forfeited during the nine months ended September 30, 2006. Total unrecognized stock based compensation expense related to non-vested restricted stock was approximately \$9.8 million as of September 30, 2006, related to 500,428 options, which is expected to be recognized over a weighted-average period of 4.3 years.

FAS 123(r) requires that compensation costs be recognized for unvested stock-based compensation awards over the period through the date that the employee is no longer required to provide future services to earn the award, rather than over the explicit service period. Accordingly, the Company has adopted this policy of recognizing compensation cost to coincide with the date that the employee is eligible to retire, rather than the actual retirement date, for all options granted. In the first nine months of 2006, the Company incurred \$8.2 million of additional stock based compensation expense due to the adoption of FAS 123(r) related to this treatment of retirement eligible employees as compared to the previous attribution methodology.

### **3. Recent Accounting Pronouncements**

In February 2006, the FASB issued FAS 155, *Accounting for Certain Hybrid Financial Instruments – an amendment of FASB Statements No. 133 and 140*. This standard permits fair value re-measurement of an entire hybrid financial instrument that contains an embedded derivative that otherwise would require bifurcation; narrows the scope exemption applicable to interest-only strips and principal-only strips from FAS 133, clarifies that only the simplest separations of interest payments and principal payments qualify as not being subject to the requirements of FAS 133; establishes a requirement to evaluate interests in securitized financial assets to identify interests that are freestanding derivatives or that are hybrid financial instruments that contain an embedded derivative requiring bifurcation; clarifies that concentrations of credit risk in the form of subordination are not embedded derivatives; and amends FAS 140 to eliminate the prohibition on a qualifying special-purpose entity from holding a derivative financial instrument that pertains to a beneficial interest other than another derivative financial instrument. This statement is intended to require more consistent accounting that eliminates exemptions and provides a means to simplify the accounting for hybrid financial instruments. This statement is effective for all financial instruments acquired or issued after January 1, 2007 and is not expected to have a material impact on the Company's financial condition or results of operations. As at September 30, 2006 the Company has not elected to apply the fair value option for any hybrid financial instruments.

In April 2006, the FASB issued FSP FIN 46(R)-6, *Determining the Variability to be Considered in Applying FIN 46(R)*, which states that the variability to be considered when applying FIN 46(R) should be based on an analysis of the design of an entity, which entails analyzing the nature of the risks in the entity, determining the purpose for which the entity was created and determining the variability the entity is designed to create and pass along to its interest holders. Typically, assets and operations of the entity create the variability (and thus are not variable interests), while liabilities and equity interests absorb that variability (and thus, are variable interests). The role of a contract or arrangement in the design of the entity, regardless of its legal form or accounting classification, shall dictate whether that interest should be treated as creating or absorbing variability for the entity. The guidance in this FSP must be applied as of July 1, 2006, and is not expected to have a material impact on the Company's financial condition or results of operations but will form an important part of the Company's evaluation of any relevant structures going forward.

In June 2006, the FASB ratified a consensus on the EITF Issue No. 06-03 (EITF 06-03) related to the classification of certain sales, value added and excise taxes within the income statement. This EITF would become effective for the Company in the first quarter of our fiscal year 2007. The Company is in the process of evaluating the impact of this EITF on disclosures relating to presentation of such taxes on the statement of operations.

**XL CAPITAL LTD**  
**NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS (continued)**

**3. Recent Accounting Pronouncements (continued)**

In July 2006, the FASB issued Interpretation No. 48, *Accounting for Uncertainty in Income Taxes* ( FIN 48 ), which clarifies the accounting for uncertainty in income taxes recognized in an enterprise's financial statements in accordance with FASB Statement No. 109, *Accounting for Income Taxes*. FIN 48 prescribes a recognition threshold and measurement attribute for the financial statement recognition and measurement of a tax position taken or expected to be taken in a tax return. FIN 48 also provides guidance on derecognition, classification, interest and penalties, accounting in interim periods, disclosure, and transition. The provisions of FIN 48 must be applied beginning January 1, 2007. The Company is currently evaluating the impact of this guidance on the Company's financial condition and results of operations.

In September 2006, the FASB issued proposed FSP FAS 123(R)-e, *Amendment of FASB Staff Position FAS 123(R)-1*, which addresses whether the modification of an instrument in connection with an equity restructuring or a business combination should be considered a modification for purposes of applying FSP FAS 123(R)-1, *Classification and Measurement of Freestanding Financial Instruments Originally Issued in Exchange for Employee Services under FASB Statement No. 123(R)*. The FASB staff has taken the position that for instruments that were originally issued as employee compensation and then exchanged or changed, where the only change is a change to the terms of an award to reflect an equity restructuring or a business combination that occurs when the holders are no longer employees, then no change in the recognition and measurement (due to a change in classification) of these instruments will result if, there is (i) no increase in value to the holders of the instrument or (ii) the exchange or change in the terms of the award is not made in contemplation of an equity restructuring or a business combination and (iii) all holders of the same class of equity instruments (for example, stock options) are treated in a similar manner. These provisions must be applied in the first reporting period beginning after the date the final FSP is posted to the FASB's website. This guidance is not expected to have a significant impact on the Company's financial condition or results of operations.

In September 2006, the FASB issued FAS No. 158, *Employers' Accounting for Defined Benefit Pension and Other Postretirement Plans, an amendment of FASB Statements No. 87, 88, 106, and 132(R)* ( SFAS 158 ). Under the new standard, companies must recognize a net liability or asset to report the funded status of their defined benefit pension and other postretirement benefit plans on their balance sheets and to recognize changes in that funded status in the year in which the changes occur through comprehensive income. The recognition and disclosure provisions of SFAS 158 will be required to be adopted as of December 31, 2006. This guidance it is not expected to have a material impact on on the Company's financial condition and results of operations.

In September 2006, the Securities and Exchange Commission (the SEC ) issued Staff Accounting Bulletin No. 108 ( SAB 108 ), *Considering the Effects of Prior Year Misstatements when Quantifying Misstatements in Current Year Financial Statements*, which provides interpretive guidance on the consideration of the effects of prior year misstatements in quantifying current year misstatements for the purpose of a materiality assessment. SAB 108 is effective for companies with fiscal years ending after November 15, 2006 and is required to be adopted by the Company in its fiscal year ending December 31, 2006. However, early application is encouraged in any report for an interim period filed after the publication of this guidance. The Company is currently assessing the impact of the adoption of SAB 108.

In September 2006, the FASB issued FAS No. 157, *Fair Value Measurements* ( FAS 157 ) which defines fair value, establishes a framework for measuring fair value in generally accepted accounting principles, and expands disclosures about fair value measurements. FAS 157 is applicable in conjunction with other accounting pronouncements that require or permit fair value measurements, where the FASB previously concluded in those accounting pronouncements that fair value is the relevant measurement attribute. Accordingly, FAS 157 does not require any new fair value measurements. FAS No. 157 will be effective for interim and annual financial statements issued after January 1, 2008. The Company is currently evaluating the impact of FAS 157; however, it is not expected to have a material impact on on the Company's financial condition and results of operations.

**XL CAPITAL LTD**  
**NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS (continued)**

**4. Sale of Financial Guaranty Business**

On August 7, 2006, the Company completed the sale of approximately 37% of its financial guaranty reinsurance and insurance businesses (the Transferred Business) through an initial public offering (IPO) of 23.4 million common shares of SCA at \$20.50 per share. SCA was incorporated in Bermuda in March 2006 for the sole purpose of becoming the parent company for the Transferred Business.

As part of the overall structuring of the IPO, certain formation transactions occurred in order to move all units included in the IPO under SCA. Also in connection with the IPO, the Company has entered into reinsurance agreements with SCA to retain certain insurance risks along with the related liabilities. At their inception, these contracts had no effect on the Company's income. In addition, the Company has entered into arrangements to provide adverse development protection to SCA related to certain limited risks where the Company would pay up to the limits of the underlying coverages. The Company has also entered into a number of agreements with SCA that govern certain aspects of the relationship, including service agreements under which the Company will provide certain services to SCA for a limited period of time. For further details on related party transactions with SCA, see SCA's reports filed with the SEC.

In addition, the Company has committed to provide a capital contribution to SCA currently estimated to be between \$8.0 million and \$12.0 million relating to certain unvested long-term compensation previously awarded by the Company to newly transferred SCA employees under its long-term compensation plans. The ultimate amount and timing of such contribution is expected to be finalized by the managements and boards of directors of SCA and the Company by the end of the current fiscal year.

Subsequent to the completion of the IPO, the Company owns 63% of the outstanding common shares of SCA, although there are certain limitations on the Company's voting rights. These limitations were put into place in response to increased rating agency desire for greater independence of XL Capital Assurance Inc. (XLCA) and XL Financial Assurance Ltd. (XLFA), in order to address the differential between the triple-A ratings of these two companies and the remaining affiliated companies within the XL Capital Ltd group. The principal two limitations are as follows:

- i. Pursuant to SCA's bye-laws, the votes conferred by the common shares owned by the Company may not exceed, with respect to any matter presented to SCA's shareholders for their action or consideration, 47.5% of the aggregate voting power of all common shares entitled to vote on such matters, except with respect to elections of all directors (including independent directors) where the votes conferred by the common shares owned by the Company may not exceed 50.1% of the aggregate voting power of all common shares entitled to vote. In this respect, it is relevant that for all matters, the aggregate voting power of any other individual shareholder is limited to a maximum of 9.5% of the aggregate voting power of all common shares entitled to vote. It is further relevant that none of these voting restrictions shall apply to up to three non-affiliated transferees of shares from the Company.
- ii. The Company has the right to appoint 4 out of the 9 directors of SCA, and pursuant to formation agreements is required to maintain a majority of directors on the board of SCA who are independent under applicable New York Stock Exchange Rules, and are neither a director nor an officer of any member of the XL Capital Ltd group.

From an accounting perspective, these limitations did not result in a loss of control and as such, the Company continues to consolidate SCA based upon the aggregate impact of its retained controlling interest established through the Company's economic interests and voting rights as well as through its level of participation in certain committees of the SCA board of directors, including its majority representation on SCA's Finance and Risk Oversight Committee. The voting limitations noted above can be reduced or eliminated upon receipt by SCA of written confirmation from each nationally recognized rating agency, then providing a financial strength rating for SCA, that such financial strength rating is or will be determined without reference to the ratings of any member of the XL Capital Ltd group or

**XL CAPITAL LTD**  
**NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS (continued)**

**4. Sale of Financial Guaranty Business (continued)**

that the then financial strength rating issued by it will not at the time of such confirmation be adversely affected by the elimination or adjustment of such limitations. The 37% ownership interest in SCA held by the public and SCA management is recorded as a minority interest in the Company's financial statements.

Upon completion of the IPO, the Company received proceeds, net of offering costs, of approximately \$104.7 million. The transaction resulted in a pre-tax reduction of shareholders' equity of \$33.7 million, representing the difference between the carrying value of 100% of SCA immediately prior to the IPO and the sum of the proceeds and the remaining carrying value of the Company's ownership interest in SCA subsequent to the IPO; as well as, other costs and taxes incurred on the transaction. The portion of the reduction related to the primary offering of shares by SCA of \$30.1 million was recorded as a direct reduction to shareholders' equity, while the portion of the reduction related to the shares sold in the secondary offering of \$3.6 million was included in realized gains (losses) in the accompanying statement of operations. In addition, the Company incurred income tax expenses of \$6.0 million principally related to the transfer of XLCA to XL Insurance (Bermuda) Ltd, prior to the contribution of XLCA to SCA.

The Company has also realized portions of SCA's accumulated other comprehensive loss as a result of the primary and secondary offerings of \$11.0 million and \$3.2 million, respectively. These amounts have no impact on total net shareholders equity and have been recorded in a manner consistent with the losses above.

The combined impact of the sale on net income was a pre and post-tax loss of \$6.8 million and \$12.8 million, respectively.

**5. Segment Information**

Following the IPO of SCA and changes in certain executive management responsibilities in 2006, the Company changed the reporting segments under which certain business units are reported in order to reflect these changes. All periods presented reflect these changes. The Company is now organized into five operating segments: Insurance, Reinsurance, Life Operations, SCA, and Financial Lines in addition to a corporate segment that includes the general investment and financing operations of the Company.

The Financial Lines segment was formed following the IPO of SCA. Following the IPO, the Financial Products and Services segment has been divided into Financial Lines and SCA. The Financial Lines segment includes (i) structured indemnity and structured credit products managed through the Company's financial solutions operations ( XLFS ), as well as, (ii) guaranteed investment contracts and funding agreements, (iii) political risk insurance, (iv) weather and energy management products, (v) the earnings on the Company's investment in Primus Guaranty Ltd. ( Primus ) and (vi) legacy financial guaranty business and other transactions not transferred to SCA. The SCA segment includes the triple-A rated financial guaranty insurance and reinsurance business.

The Company evaluates the performance of each segment based on underwriting results for general operations, and contribution from both life and financial operations. Other items of revenue and expenditure of the Company are not evaluated at the segment level for reporting purposes. In addition, the Company does not allocate assets by segment for its general operations. Investment assets related to the Company's life and financial operations are held in separately identified portfolios. Net investment income from these assets is included in net income from life operations and contribution from financial operations, respectively.

**XL CAPITAL LTD**  
**NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS (continued)**

**5. Segment Information (continued)****Three months ended September 30, 2006:**

(U.S. dollars in thousands)

(Unaudited)

	<u>Insurance</u>	<u>Reinsurance</u>	<u>Life Operations</u>	<u>Financial Lines</u>	<u>SCA</u>	<u>Total</u>
<b>General Operations:</b>						
Gross premium written	\$ 1,290,796	\$ 758,060				\$ 2,048,856
Net premium written	787,921	492,689				1,280,610
Net premium earned	1,015,048	684,149				1,699,197
Fee income and other	2,799	(199)				2,600
Net losses and loss expenses	639,160	387,885				1,027,045
Acquisition costs	116,152	130,428				246,580
Operating expenses (1)	153,282	48,380				201,662
Exchange losses (gains)	23,666	(2,382)				21,284
	<u>          </u>	<u>          </u>				<u>          </u>
Underwriting profit	\$ 85,587	\$ 119,639				\$ 205,226
<b>Life Operations:</b>						
Gross premium written			\$ 107,413			\$ 107,413
Net premium written			97,604			97,604
Net premium earned			97,818			97,818
Fee income and other			66			66
Claims and policy benefits			156,028			156,028
Acquisition costs			6,066			6,066
Operating expenses (1)			7,945			7,945
Exchange losses			595			595
Net investment income			87,993			87,993
			<u>          </u>			<u>          </u>
Contribution from life operations			\$ 15,243			\$ 15,243
<b>Financial Operations:</b>						
Gross premium written				\$ 5,944	\$ 85,570	\$ 91,514
Net premium written				(3,176)	100,478	97,302
Net premium earned				12,594	45,455	58,049
Fee income and other				769	59	828
Net losses and loss expenses				8,128	4,994	13,122
Acquisition costs				2,407	5,824	8,231
Operating expenses (1)				1,101	20,780	21,881
Exchange (gains) losses				(17)	81	64
				<u>          </u>	<u>          </u>	<u>          </u>
Underwriting profit				\$ 1,744	\$ 13,835	\$ 15,579
Net investment income financial guaranty				2,264	21,835	24,099
Net investment income structured products				123,332		123,332
Interest expense structured products				99,934		99,934
Operating expenses structured products (1)				9,734		9,734
Net income from financial and investment affiliates				3,900		3,900
Minority interest					1,139	1,139
Net realized and unrealized gains (losses) from derivatives				6,215	(3,216)	2,999
				<u>          </u>	<u>          </u>	<u>          </u>
Contribution from financial operations				\$ 27,787	\$ 31,315	\$ 59,102

See footnotes on following page.





**XL CAPITAL LTD**  
**NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS (continued)**

**5. Segment Information (continued)****Three months ended September 30, 2006:**

(U.S. dollars in thousands)

(Unaudited)

	<u>Insurance</u>	<u>Reinsurance</u>	<u>Life Operations</u>	<u>Financial Lines</u>	<u>SCA</u>	<u>Total</u>
<b>Corporate and other:</b>						
Net investment income – general operations						\$ 282,857
Net realized and unrealized (losses) on investments and derivative instruments (2)					\$ (156)	(55,044)
Net income from investment and other operating affiliates						55,434
Amortization of intangible benefits						420
Corporate operating expenses						35,203
Interest expense (3)						50,454
Minority interest					7,830	7,216
Income tax charge					2,747	43,655
<b>Net income</b>					<u>\$ 20,582</u>	<u>\$ 425,870</u>
<b>General Operations:</b>						
Loss and Loss expense Ratio (4)	63.0%	56.7%				60.4%
Underwriting Expense Ratio (4)	26.5%	26.2%				26.4%
Combined Ratio <sup>(4)</sup>	<u>89.5%</u>	<u>82.9%</u>				<u>86.8%</u>

(1) Operating expenses exclude corporate operating expenses, shown separately;

(2) This includes net realized losses on investments of \$52.7 million, net realized and unrealized losses on investment derivatives of \$2.4 million, but does not include unrealized appreciation or depreciation on investments, which are included in accumulated other comprehensive income (loss);

(3) Interest expense excludes interest expense related to life operations, shown separately;

(4) Ratios are based on net premiums earned from general operations. The underwriting expense ratio excludes exchange gains and losses.

**XL CAPITAL LTD**  
**NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS (continued)**

**5. Segment Information (continued)**

**Three months ended September 30, 2005:**  
**(U.S. dollars in thousands)**  
**(Unaudited)**

	<u>Insurance</u>	<u>Reinsurance</u>	<u>Life Operations</u>	<u>Financial Lines</u>	<u>SCA</u>	<u>Total</u>
<b>General Operations:</b>						
Gross premium written	\$ 1,329,271	\$ 855,300				