

XL CAPITAL LTD
Form 10-Q
November 09, 2007

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

FORM 10-Q

**S QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF
THE SECURITIES EXCHANGE ACT OF 1934
For the quarterly period ended September 30, 2007**
OR
**£ TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF
THE SECURITIES EXCHANGE ACT OF 1934
For the transition period from _ to _**
Commission file number 1-10804

XL CAPITAL LTD
(Exact name of registrant as specified in its charter)

CAYMAN ISLANDS 98-0191089
(State or other jurisdiction of (I.R.S. Employer
incorporation or organization) 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 S No £

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 S Accelerated filer £ Non-accelerated filer £

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

As of November 6, 2007, there were 178,353,270 outstanding Class A Ordinary Shares, \$0.01 par value per share, of the registrant.

XL CAPITAL LTD

INDEX TO FORM 10-Q

	Page No
<u>PART I FINANCIAL INFORMATION</u>	
Item 1. <u>Financial Statements:</u>	
<u>Consolidated Balance Sheets as at September 30, 2007 (Unaudited) and December 31, 2006</u>	3
<u>Consolidated Statements of Income for the Three Months Ended September 30, 2007 and 2006 (Unaudited) and the Nine Months Ended September 30, 2007 and 2006 (Unaudited)</u>	5
<u>Consolidated Statements of Comprehensive Income for the Three Months Ended September 30, 2007 and 2006 (Unaudited) and the Nine Months Ended September 30, 2007 and 2006 (Unaudited)</u>	6
<u>Consolidated Statements of Shareholders' Equity for the Nine Months Ended September 30, 2007 and 2006 (Unaudited)</u>	7
<u>Consolidated Statements of Cash Flows for the Nine Months Ended September 30, 2007 and 2006 (Unaudited)</u>	8
<u>Notes to Unaudited Consolidated Financial Statements</u>	9
Item 2. <u>Management's Discussion and Analysis of Financial Condition and Results of Operations</u>	27
Item 3. <u>Quantitative and Qualitative Disclosures About Market Risk</u>	64
Item 4. <u>Controls and Procedures</u>	69
<u>PART II OTHER INFORMATION</u>	
Item 1. <u>Legal Proceedings</u>	70
Item 1A. <u>Risk Factors</u>	73
Item 2. <u>Unregistered Sales of Equity Securities and Use of Proceeds</u>	73
Item 6. <u>Exhibits</u>	73
<u>Signatures</u>	74

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, 2007	December 31, 2006
ASSETS		
Investments:		
Fixed maturities at fair value (amortized cost: 2007, \$36,527,309; 2006, \$35,979,759)	\$ 35,791,400	\$ 36,121,358
Equity securities, at fair value (cost: 2007, \$635,756; 2006, \$705,517)	847,084	891,138
Short-term investments, at fair value (amortized cost: 2007, \$2,011,378; 2006, \$2,340,304)	2,000,151	2,338,487
Total investments available for sale	38,638,635	39,350,983
Investments in affiliates	3,429,614	2,308,781
Other investments (amortized cost: 2007, \$604,892; 2006, \$417,762)	682,289	476,889
Total investments	42,750,538	42,136,653
Cash and cash equivalents	3,185,239	2,223,748
Accrued investment income	482,875	432,618
Deferred acquisition costs	861,999	870,237
Prepaid reinsurance premiums	1,244,512	1,178,516
Premiums receivable	3,896,225	3,591,238
Reinsurance balances receivable	846,703	1,106,651
Unpaid losses and loss expenses recoverable	4,840,071	5,027,772
Goodwill and other intangible assets	1,806,636	1,818,096
Deferred tax asset, net	336,528	346,122
Other assets	636,988	577,219
Total assets	\$ 60,888,314	\$ 59,308,870
 LIABILITIES AND SHAREHOLDERS EQUITY		
Liabilities:		
Unpaid losses and loss expenses	\$ 23,014,994	\$ 22,895,021
Deposit liabilities	8,682,988	7,857,827
Future policy benefit reserves	6,870,922	6,476,057

Edgar Filing: XL CAPITAL LTD - Form 10-Q

Unearned premiums	5,371,645	5,652,897
Notes payable and debt	2,866,399	3,368,376
Reinsurance balances payable	912,042	902,841
Net payable for investments purchased	362,809	104,739
Other liabilities	1,372,239	1,357,825
Total liabilities	\$ 49,454,038	\$ 48,615,583

See accompanying Notes to Unaudited Consolidated Financial Statements

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

	(Unaudited) September 30, 2007	December 31, 2006
Commitments and Contingencies		
Minority interest in equity of consolidated subsidiaries	\$ 2,485	\$ 562,121
Shareholders' Equity:		
Series A preference ordinary shares, 23,000,000 authorized, par value \$0.01. Issued and outstanding: 2007, nil; 2006, 9,200,000	\$	\$ 92
Series B preference ordinary shares, 27,000,000 authorized, par value \$0.01. Issued and outstanding: 2007 and 2006, 11,500,000	115	115
Series E preference ordinary shares, 1,000,000 authorized, par value \$0.01. Issued and outstanding: 2007, 1,000,000; 2006, nil	10	
Class A ordinary shares, 999,990,000 authorized, par value \$0.01. Issued and outstanding: 2007, 179,697,903; 2006, 180,983,611	1,797	1,810
Additional paid in capital	7,678,436	6,451,569
Accumulated other comprehensive (loss) income	(172,589)	411,405
Retained earnings	3,924,022	3,266,175
Total shareholders' equity	\$ 11,431,791	\$ 10,131,166
Total liabilities and shareholders' equity	\$ 60,888,314	\$ 59,308,870

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,	
	2007	2006	2007	2006
Revenues:				
Net premiums earned	\$ 1,730,582	\$ 1,855,064	\$ 5,451,931	\$ 5,658,203
Net investment income	567,987	518,281	1,688,294	1,455,645
Net realized (losses) on investments	(160,208)	(52,656)	(132,620)	(53,495)
Net realized and unrealized (losses) gains on derivative instruments	(58,162)	611	(41,233)	78,700
Net income from investment affiliates	69,435	39,370	255,414	174,612
Fee income and other	3,653	3,494	11,639	23,086
 Total revenues	 \$ 2,153,287	 \$ 2,364,164	 \$ 7,233,425	 \$ 7,336,751
Expenses:				
Net losses and loss expenses incurred	\$ 920,564	\$ 1,025,740	\$ 2,857,299	\$ 3,229,249
Claims and policy benefits	195,440	170,455	662,883	558,964
Acquisition costs	253,077	260,877	811,049	823,476
Operating expenses	270,540	276,425	857,595	817,450
Exchange (gains) losses	(26,204)	21,943	19,965	75,385
Interest expense	151,018	150,388	458,504	412,889
Amortization of intangible assets	420	420	1,260	1,935
 Total expenses	 \$ 1,764,855	 \$ 1,906,248	 \$ 5,668,555	 \$ 5,919,348
 Income before minority interest, income tax and net income from operating affiliates	 \$ 388,432	 \$ 457,916	 \$ 1,564,870	 \$ 1,417,403
Minority interest in net income of subsidiary		8,355	23,994	10,613
Income tax	58,715	43,655	192,758	176,728

Edgar Filing: XL CAPITAL LTD - Form 10-Q

Net income from operating affiliates	41,919	19,964	140,640	51,560
Net income	371,636	425,870	1,488,758	1,281,622
Preference share dividends	(43,661)	(10,081)	(66,530)	(30,241)
Net income available to ordinary shareholders	\$ 327,975	\$ 415,789	\$ 1,422,228	\$ 1,251,381
Weighted average ordinary shares and ordinary share equivalents outstanding basic	178,788	178,818	178,886	178,662
Weighted average ordinary shares and ordinary share equivalents outstanding diluted	179,781	179,439	180,340	179,298
Earnings per ordinary share and ordinary share equivalent basic	\$ 1.83	\$ 2.33	\$ 7.95	\$ 7.00
Earnings per ordinary share and ordinary share equivalent diluted	\$ 1.82	\$ 2.32	\$ 7.89	\$ 6.98

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,	
	2007	2006	2007	2006
Net income	\$ 371,636	\$ 425,870	\$ 1,488,758	\$ 1,281,622
Change in net unrealized (depreciation) appreciation of investments, net of tax	(142,221)	641,548	(867,605)	(114,937)
Change in value on cash flow hedge	110	159	4,227	471
Foreign currency translation adjustments, net	177,691	(2,172)	272,975	94,826
Net unrealized gain (loss) on future policy benefit reserves	2,092	(1,685)	1,819	(14,595)
Minority interest share in change in accumulated other comprehensive loss in SCA		(7,676)		(7,676)
Realization of accumulated other comprehensive loss on sale of SCA		14,224	4,953	14,224
Additional pension liability	(175)		(363)	
Comprehensive income	\$ 409,133	\$ 1,070,268	\$ 904,764	\$ 1,253,935

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,	
	2007	2006
Series A, B and E Preference Ordinary Shares:		
Balance beginning of year	\$ 207	\$ 207
Issuance of Series E preference ordinary shares	10	
Redemption of Series A preference ordinary shares	(92)	
Balance end of period	\$ 125	\$ 207
Class A Ordinary Shares:		
Balance beginning of year	\$ 1,810	\$ 1,795
Issue of shares	112	8
Exercise of stock options	8	3
Repurchase of shares	(133)	(1)
Balance end of period	\$ 1,797	\$ 1,805
Additional Paid in Capital:		
Balance beginning of year	\$ 6,451,569	\$ 6,377,375
Issuance of Class A ordinary shares	869,102	53,011
Issuance of Series E preference ordinary shares	983,786	
Repurchase of Class A ordinary shares	(451,312)	(2,830)
Redemption of Series A preference ordinary shares	(229,908)	
Stock option expense	11,084	17,354
Exercise of stock options	50,325	13,772
Net change in deferred compensation	(6,210)	(6,492)
Net loss on sale of SCA		(30,100)
Realization of accumulated other comprehensive loss on sale of SCA		(11,000)
Balance end of period	\$ 7,678,436	\$ 6,411,090
Accumulated Other Comprehensive Income (Loss):		
Balance beginning of year	\$ 411,405	\$ 268,243
Net change in unrealized (losses) on investment portfolio, net of tax	(865,687)	(134,263)
	(1,918)	19,326

Edgar Filing: XL CAPITAL LTD - Form 10-Q

Net change in unrealized (losses) gains on affiliate and other investments, net of tax		
Change in value on cash flow hedge	4,227	471
Impact of net unrealized gain (loss) on future policy benefit reserves	1,819	(14,595)
Foreign currency translation adjustments	272,975	94,826
Realization of accumulated other comprehensive loss on sale of SCA	4,953	14,224
Minority interest share in charge in accumulated other comprehensive loss in SCA		(7,676)
Additional pension liability	(363)	
Balance end of period	\$ (172,589)	\$ 240,556
Retained Earnings:		
Balance beginning of year	\$ 3,266,175	\$ 1,824,191
Net income	1,488,758	1,281,622
Dividends on Series A, B and E preference ordinary shares	(66,530)	(30,241)
Dividends on Class A ordinary shares	(206,492)	(202,471)
Repurchase of Class A ordinary shares	(557,889)	(2,784)
Balance end of period	\$ 3,924,022	\$ 2,870,317
Total Shareholders Equity	\$ 11,431,791	\$ 9,523,975

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,	
	2007	2006
Cash flows provided by operating activities:		
Net income	\$ 1,488,758	\$ 1,281,622
Adjustments to reconcile net income to net cash provided by operating activities:		
Net realized losses on investments	132,620	53,495
Net realized and unrealized losses (gains) on derivative instruments	41,233	(78,700)
Amortization of (discounts) on fixed maturities	(63,545)	(18,359)
Net (income) from investment and operating affiliates	(396,054)	(226,172)
Amortization of deferred compensation	38,149	45,923
Accretion of convertible debt	1,013	725
Accretion of deposit liabilities	306,176	261,494
Unpaid losses and loss expenses	(22,479)	(858,959)
Future policy benefit reserves	69,921	29,788
Unearned premiums	471,198	608,718
Premiums receivable	(234,234)	(194,175)
Unpaid losses and loss expenses recoverable	231,154	1,015,037
Prepaid reinsurance premiums	(101,672)	(278,054)
Reinsurance balances receivable	274,570	(179,951)
Deferred acquisition costs	(100,247)	(57,465)
Reinsurance balances payable	(6,602)	(142,448)
Deferred tax asset	6,626	34,191
Other	(137,347)	215,425
Total adjustments	\$ 510,480	\$ 230,513
Net cash provided by operating activities	\$ 1,999,238	\$ 1,512,135
Cash flows used in investing activities:		
Proceeds from sale of fixed maturities and short-term investments	\$ 19,312,713	\$ 16,618,562
Proceeds from redemption of fixed maturities and short-term investments	1,473,034	897,854
Proceeds from sale of equity securities	655,665	1,048,623
Proceeds from sale of SCA common shares, net of cash sold upon de-consolidation	(110,843)	

Edgar Filing: XL CAPITAL LTD - Form 10-Q

Net proceeds from sale of SCA common shares		104,650
Purchases of fixed maturities and short-term investments	(22,513,672)	(20,207,649)
Purchases of equity securities	(545,942)	(971,591)
Net acquisitions less dispositions of affiliates	250	177,695
Acquisition of subsidiaries, net of cash acquired		(12,600)
Other investments	(186,625)	(96,396)
Other assets		4,087
Net cash used in investing activities	\$ (1,915,420)	\$ (2,436,765)
Cash flows provided by (used in) financing activities:		
Proceeds from exercise of stock options and issuance of Class A ordinary shares	\$ 875,333	\$ 13,293
Proceeds from issuance of Series E preference ordinary shares	983,796	
Redemption of Series A preference ordinary shares	(230,000)	
Repurchase of Class A ordinary shares	(1,009,334)	(5,616)
Dividends paid	(228,902)	(232,711)
Proceeds from issuance of debt	322,836	
Repayment of debt	(825,000)	(45,291)
Deposit liabilities	517,958	(398,553)
Net cash flow on securities lending	196,736	(335,661)
Proceeds from issuance of SCA common shares		342,227
Proceeds from issuance of SCA Series A perpetual preference shares	247,248	
Dividends paid to minority shareholders of SCA	(16,130)	
Net cash provided by (used in) financing activities	\$ 834,541	\$ (662,312)
Effects of exchange rate changes on foreign currency cash	43,132	21,688
Increase (decrease) in cash and cash equivalents	961,491	(1,565,254)
Cash and cash equivalents beginning of period	2,223,748	3,693,475
Cash and cash equivalents end of period	\$ 3,185,239	\$ 2,128,221

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 addition, the year-end balance sheet data was derived from audited financial statements but does not include all disclosures required by accounting principles generally accepted in the United States of America. 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.

2. Significant Accounting Policies

(a) Uncertain Tax Provisions

The Company is not subject to any taxes in the Cayman Islands on either income or capital gains under current Cayman law. The Company has received an undertaking that the Company will be exempted from Cayman Islands income or capital gains taxes until June 2018 in the event of any such taxes being imposed. The Company's Bermuda subsidiaries are not subject to any income, withholding or capital gains taxes under current Bermuda law. In the event that there is a change such that these taxes are imposed, the Bermuda subsidiaries would be exempted from any such tax until March 2016 pursuant to the Bermuda Exempted Undertakings Tax Protection Act of 1966, and Amended Act of 1987. The Company's Indian subsidiary is not subject to certain income and capital gains taxes under current Indian law. This subsidiary is exempt from these taxes until March 31, 2009 pursuant to the Income Tax Act 1961.

The Company's U.S. subsidiaries are subject to federal, state and local corporate income taxes and other taxes applicable to U.S. corporations. The provision for federal income taxes has been determined under the principles of the consolidated tax provisions of the Internal Revenue Code and Regulations thereunder. Should the U.S. subsidiaries pay a dividend to the Company, withholding taxes will apply. The Company has operations in subsidiary and branch form in various other jurisdictions around the world, including but not limited to the U.K., Switzerland, Ireland, Germany, France, Luxembourg and various countries in Latin America that are subject to relevant taxes in those jurisdictions.

The Company adopted the provisions of FASB Interpretation No. 48 (FIN 48), Accounting for Uncertainty in Income Taxes, on January 1, 2007. The Company did not recognize any liabilities for unrecognized tax benefits as a result of the implementation of FIN 48.

With few exceptions, the Company is no longer subject to tax examinations by tax authorities in the major jurisdictions in which the Company operates for years prior to 2003 in the U.S. and 2001 in the U.K.

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

2. Significant Accounting Policies (continued)

The U.K. taxation authority, HM Revenue and Customs, has currently ongoing examinations of the Company's U.K. income tax returns for the years ended December 31, 2001 to December 31, 2004.

The Company's policy is to recognize any interest accrued related to unrecognized tax benefits as a component of interest expense and penalties in operating expenses. The Company did not have any accrued liabilities relating to interest and penalties as at September 30, 2007 or December 31, 2006, respectively.

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 was effective for all financial instruments acquired or issued after January 1, 2007. The Company has applied the fair value option to its investments in interest-only strips from the effective date of this standard. The fair value of interest only strips was \$13.1 million and \$17.3 million at September 30, 2007 and December 31, 2006, respectively. The application of the fair value option did not have a material impact on the Company's financial condition and results of operations.

In September 2006, the FASB issued FAS 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 the Company's financial condition and results of operations.

In October 2006, the FASB issued proposed FASB Staff Position EITF 03-6-a, Determining Whether Instruments Granted in Share-Based Payment Transactions Are Participating Securities. This FASB Staff Position (FSP) addresses whether instruments granted in share-based payment transactions may be participating securities prior to vesting and, therefore, need to be included in the earnings allocation in computing basic earnings per share (EPS) pursuant to the two-class method described in paragraphs 60 and 61 of FASB Statement No. 128, Earnings per Share. A share-based payment award that contains a non-forfeitable right to receive cash when dividends are paid to common shareholders irrespective of whether that award ultimately vests or remains unvested shall be considered a participating security as these rights to dividends provide a non-contingent transfer of value to the holder of the share-based payment award. Accordingly, these awards should be included in the computation of basic EPS pursuant to the two-class method.

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

3. Recent Accounting Pronouncements (continued)

The guidance in this proposed FSP would be effective in the first reporting period beginning after the FASB posts the final FSP to its website. All prior period EPS data will have to be adjusted retrospectively to reflect the provisions of the FSP. Under the terms of the Company's restricted stock awards, grantees are entitled to the right to receive dividends on the unvested portions of their awards. There is no requirement to return these dividends in the event the unvested awards are forfeited in the future. Accordingly, this FSP will have an impact on the Company's EPS calculations should the FASB issue the proposed guidance as final during 2007. The Company will continue to evaluate the potential impact of this guidance.

In December 2006, the FASB issued implementation guidance, FAS 133 Implementation Issue B40 Embedded Derivatives: Application of Paragraph 13(b) to Securitized Interests in Prepayable Financial Assets (DIG B40), which limits the circumstances in which prepayment risk within a securitized interest would be considered an embedded derivative. To facilitate transition, securitized interests issued before June 30, 2007, containing insignificant embedded derivatives are not subject to paragraph 13(b). The provisions of DIG B40 which became effective as of July 1, 2007 were adopted by the Company; however, the adoption of this provision did not have a material impact on the Company's financial condition or results of operations.

During February 2007, the FASB issued FAS 159, The Fair Value Option for Financial Assets and Financial Liabilities (FAS 159), which permits entities to choose to measure many financial instruments and certain other items at fair value. A company must report unrealized gains and losses on items for which the fair value option has been elected in earnings at each subsequent reporting date. The fair value option may be applied on an instrument by instrument basis, with a few exceptions. The fair value option is irrevocable (unless a new election date occurs) and the fair value option may be applied only to entire instruments and not to portions of instruments. FAS 159 will be effective for interim and annual financial statements issued after January 1, 2008. The Company is currently evaluating the potential impact of this guidance.

The Company is aware of the SEC's review of the loss reserving practices of the financial guaranty industry. The Company recognizes that there is diversity in practice among financial guaranty insurers and reinsurers with respect to their accounting policies. Current accounting literature, specifically FASB Statement of Financial Accounting Standards No. 60 Accounting and Reporting by Insurance Enterprises (FAS 60) does not specifically address the unique characteristics of financial guaranty insurance contracts. Consequently, the accounting principles applied by the industry have evolved over time and incorporate the concepts of both short-duration and long-duration contracts accounting under the provisions of FAS 60 and other accounting literature such as FAS 5 and EITF 85-20. On April 18, 2007, the FASB issued its anticipated exposure draft, Accounting for Financial Guarantee Insurance Contracts, an interpretation of FAS 60, which provides guidance for the accounting for financial guaranty insurance contracts under which it considers claims liability recognition, premium recognition, and the related amortization of deferred policy acquisition costs. This exposure draft was issued with a comment deadline of June 18, 2007. The Company has reviewed the exposure draft and will continue its loss reserving methodology as noted in Note 2 (k) of the Company's Form 10-K for the year ended December 31, 2006, until further guidance is finalized by the SEC or FASB. The Company had reserves for financial guaranty insurance contracts of \$160.1 million and \$262.7 million at September 30, 2007 and December 31, 2006, respectively.

In June 2007, the Accounting Standards Executive Committee of the AICPA issued Statement of Position 07-1, *Clarification of the Scope of the Audit and Accounting Guide Investment Companies and Accounting by Parent Companies and Equity Method Investors for Investments in Investment Companies* (SOP 07-1). SOP 07-1 provides guidance for determining whether an entity

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

3. Recent Accounting Pronouncements (continued)

meets the definition of an investment company for financial reporting purposes and therefore should apply investment company accounting. In addition, the standard provides guidance to determine whether the specialized industry accounting principles for investment companies should be retained in the consolidated financial statements of a non-investment parent company or of an investor who has the ability to exercise significant influence over the investment company and accounts for its investment under the equity method. In addition, SOP 07-1 includes certain disclosure requirements for parent companies and equity method investors in investment companies that retain investment company accounting in the parent company's consolidated financial statements or the financial statements of an equity method investor. SOP 07-1 was expected to be effective for fiscal years beginning on or after December 15, 2007, with earlier application encouraged, however, during its October meeting the FASB agreed to issue an exposure draft that would indefinitely defer the effective date of SOP 07-1 until the FASB can reassess SOP 07-1's provisions. SOP 07-1 is not expected to have a material impact on the Company's financial condition and results of operations.

4. Segment Information

To better align the Company's operating and reporting structure with its current strategy, the Company revised its segment structure during the second quarter of 2007. Depending on the nature of the business written, the following product lines or transactions previously managed by and reported as part of the Financial Lines segment are now managed as part of the Insurance and Reinsurance segments and reported therewith: (i) structured indemnity products managed through the Company's financial solutions operations (XLFS), as well as, (ii) political risk products, (iii) weather and energy management products, and (iv) legacy financial guaranty business and other transactions not transferred to Security Capital Assurance (SCA). The earnings on the Company's investment in Primus Guaranty Ltd. (Primus) and other financial operating affiliates as well as the results of certain structured finance products are reported as a part of the Corporate segment that includes the general investment and financing operations of the Company. In addition, the guaranteed investment contract and funding agreement businesses are now reported separately within the Other Financial Lines segment.

On June 6, 2007, the Company completed the sale of a portion of SCA's common shares owned by the Company through a secondary offering and thereby reduced its ownership of SCA's outstanding common shares from approximately 63% to approximately 46%. Subsequent to this date, SCA is no longer a consolidated subsidiary or a separate operating segment of the Company and its remaining investment in SCA is now accounted for using the equity method of accounting. However, historical consolidated results of the Company will continue to include the separately reported net income of SCA through to June 6, 2007.

Given the changes in the Company's operating and reporting structure as described above, the Company is now organized into four operating segments: Insurance, Reinsurance, Life Operations, and Other Financial Lines in addition to a Corporate segment that includes the general investment and financing operations of the Company.

The Company evaluates the performance for both the Insurance and Reinsurance segments based on underwriting profit and contribution from both the Life Operations and Other Financial Lines segments. 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 investment assets by segment for its property and casualty operations. Investment assets related to (i) the Company's Life Operations and Other Financial Lines segments and (ii) certain structured products included in the Insurance and Reinsurance segments, are held in separately identified portfolios. As such, net investment income from these assets is included in the contribution from each of these segments.

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

4. Segment Information (continued)**Three months ended September 30, 2007:**

(U.S. dollars in thousands)

(Unaudited)

	Insurance	Reinsurance	Total P&C	Life Operations	Other Financial Lines (6)	Total
Gross premiums written	\$ 1,169,435	\$ 624,303	\$ 1,793,738	\$ 140,694	\$	\$ 1,934,432
Net premiums written	818,185	437,933	1,256,118	129,353		1,385,471
Net premiums earned	1,012,145	571,198	1,583,343	147,239		1,730,582
Fee income and other	3,195	380	3,575	78		3,653
Net losses and loss expenses	634,872	285,692	920,564	195,440		