ARCH CAPITAL GROUP LTD.
Form 10-Q
May 12, 2014
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UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549

FORM 10-Q

(Mark One)

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

For the period ended March 31, 2014

Or

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

Commission file number: 001-26456

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.)

Waterloo House, Ground Floor
100 Pitts Bay Road
Pembroke HM 08, Bermuda
(Address of principal executive offices)

(441) 278-9250
(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 has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes x No o

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, or a smaller reporting company. See the definitions of "large accelerated filer," "accelerated filer" and "smaller reporting company" in Rule 12b-2 of the Exchange Act.

Large accelerated filer x
Accelerated filer o

Non-accelerated filer o
Smaller reporting company o

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

The number of the registrant's common shares (par value, $0.0033 per share) outstanding as of May 1, 2014 was 134,099,536.

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Report of Independent Registered Public Accounting Firm

To the Board of Directors and Shareholders of
Arch Capital Group Ltd.:

We have reviewed the accompanying condensed consolidated balance sheet of Arch Capital Group Ltd. and its subsidiaries (the "Company") as of March 31, 2014, and the related condensed consolidated statements of income for the three-month periods ended March 31, 2014 and March 31, 2013, and the condensed consolidated statements of comprehensive income, changes in shareholders' equity and cash flows for the three-month periods ended March 31, 2014 and March 31, 2013. These interim financial statements are the responsibility of the Company's management.

We conducted our review in accordance with the standards of the Public Company Accounting Oversight Board (United States). A review of interim financial information consists principally of applying analytical procedures and making inquiries of persons responsible for financial and accounting matters. It is substantially less in scope than an audit conducted in accordance with the standards of the Public Company Accounting Oversight Board (United States), the objective of which is the expression of an opinion regarding the financial statements taken as a whole. Accordingly, we do not express such an opinion.

Based on our review, we are not aware of any material modifications that should be made to the accompanying condensed consolidated interim financial statements for them to be in conformity with accounting principles generally accepted in the United States of America.

We previously audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the consolidated balance sheet as of December 31, 2013, and the related consolidated statements of income, comprehensive income, changes in shareholders' equity, and cash flows for the year then ended (not presented herein), and in our report dated March 3, 2014, we expressed an unqualified opinion on those consolidated financial statements. In our opinion, the information set forth in the accompanying consolidated balance sheet information as of December 31, 2013, is fairly stated in all material respects in relation to the consolidated balance sheet from which it has been derived.

/s/ PricewaterhouseCoopers LLP

New York, NY
May 12, 2014

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ARCH CAPITAL GROUP LTD. AND SUBSIDIARIES
CONSOLIDATED BALANCE SHEETS
(U.S. dollars in thousands, except share data)

	(Unaudited) March 31, 2014	December 31, 2013
Assets		
Investments:		
Fixed maturities available for sale, at fair value (amortized cost: $9,722,364 and $9,564,634)	$9,775,730	$9,571,776
Short-term investments available for sale, at fair value (amortized cost: $1,485,378 and $1,477,584)	1,484,280	1,478,367
Investment of funds received under securities lending, at fair value (amortized cost: $93,274 and $97,943)	96,264	100,584
Equity securities available for sale, at fair value (cost: $475,868 and $433,275)	548,168	496,824
Other investments available for sale, at fair value (cost: $417,762 and $488,687)	426,917	498,310
Investments accounted for using the fair value option	1,256,650	1,221,534
Investments accounted for using the equity method	255,488	244,339
Total investments	13,843,497	13,611,734
Cash	1,569,605	434,057
Accrued investment income	59,701	66,848
Investment in joint venture (cost: $100,000)	102,803	104,856
Fixed maturities and short-term investments pledged under securities lending, at fair value	100,590	105,081
Premiums receivable	1,008,375	753,924
Reinsurance recoverable on unpaid and paid losses and loss adjustment expenses	1,790,025	1,804,330
Contractholder receivables	1,118,991	1,064,246
Prepaid reinsurance premiums	349,077	328,343
Deferred acquisition costs, net	384,294	342,314
Receivable for securities sold	426,431	50,555
Goodwill and intangible assets	120,875	27,319
Other assets	926,094	872,487
Total assets	$21,800,358	$19,566,094
Liabilities		
Reserve for losses and loss adjustment expenses	$8,938,958	$8,824,696
Unearned premiums	2,148,475	1,896,365
Reinsurance balances payable	201,794	196,167
Contractholder payables	1,118,991	1,064,246
Deposit accounting liabilities	409,080	421,297
Senior notes	800,000	800,000
Revolving credit agreement borrowings	100,000	100,000
Securities lending payable	103,330	107,999
Payable for securities purchased	499,473	51,318
Other liabilities	575,394	456,510
Total liabilities	14,895,495	13,918,598
Commitments and Contingencies		
Redeemable noncontrolling interests (1)	219,234	—

Shareholders’ Equity		
Non-cumulative preferred shares	325,000	325,000
Common shares ($0.0033 par, shares issued: 170,006,958 and 169,560,591)	567	565
Additional paid-in capital	320,503	299,517
Retained earnings	6,219,170	6,042,154
Accumulated other comprehensive income, net of deferred income tax	123,719	74,964
Common shares held in treasury, at cost (shares: 35,922,820 and 35,885,707)	(1,096,826)	(1,094,704)
Total shareholders' equity available to Arch	5,892,133	5,647,496
Non-redeemable noncontrolling interests (1)	793,496	—
Total shareholders’ equity	6,685,629	5,647,496
Total liabilities, noncontrolling interests and shareholders’ equity	$21,800,358	$19,566,094

(1) See Note 4.

See Notes to Consolidated Financial Statements

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ARCH CAPITAL GROUP LTD. AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF INCOME
(U.S. dollars in thousands, except share data)

	(Unaudited) Three Months Ended March 31,	
	2014	2013
Revenues		
Net premiums written	$1,064,990	$952,776
Change in unearned premiums	(205,210)	(200,006)
Net premiums earned	859,780	752,770
Net investment income	66,994	65,672
Net realized gains	19,697	58,340
Other-than-temporary impairment losses	(2,971)	(2,248)
Less investment impairments recognized in other comprehensive income, before taxes	—	2
Net impairment losses recognized in earnings	(2,971)	(2,246)
Other underwriting income	1,582	538
Equity in net income of investment funds accounted for using the equity method	3,253	13,823
Other income (loss)	(2,104)	1,244
Total revenues	946,231	890,141
Expenses		
Losses and loss adjustment expenses	436,240	399,403
Acquisition expenses	160,342	127,592
Other operating expenses	145,799	120,183
Interest expense	14,404	5,898
Net foreign exchange losses (gains)	6,563	(24,264)
Total expenses	763,348	628,812
Income before income taxes	182,883	261,329
Income tax expense	3,738	4,853
Net income	$179,145	$256,476
Net (income) loss attributable to noncontrolling interests (1)	3,355	—
Net income available to Arch	182,500	256,476
Preferred dividends	5,484	5,484
Net income available to common shareholders	$177,016	$250,992
Net income per common share		
Basic	$1.34	$1.92
Diluted	$1.30	$1.85
Weighted average common shares and common share equivalents outstanding		
Basic	131,857,910	130,907,902
Diluted	136,562,717	135,409,288

(1) See Note 4.

See Notes to Consolidated Financial Statements

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ARCH CAPITAL GROUP LTD. AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME
(U.S. dollars in thousands)

	(Unaudited) Three Months Ended March 31,	
	2014	2013
Comprehensive Income		
Net income	$179,145	$256,476
Other comprehensive income, net of deferred income tax		
Unrealized appreciation in value of available-for-sale investments:		
Unrealized holding gains arising during period	71,353	9,471
Portion of other-than-temporary impairment losses recognized in other comprehensive income, net of deferred income tax	—	(2)
Reclassification of net realized gains, net of income taxes, included in net income	(21,249)	(38,701)
Foreign currency translation adjustments	(1,349)	(28,222)
Comprehensive income	227,900	199,022
Net (income) loss attributable to noncontrolling interests (1)	3,355	—
Other comprehensive (income) loss attributable to noncontrolling interests	—	—
Comprehensive (income) loss attributable to noncontrolling interests	3,355	—
Comprehensive income available to Arch	$231,255	$199,022

(1) See Note 4.

See Notes to Consolidated Financial Statements

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ARCH CAPITAL GROUP LTD. AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF CHANGES IN SHAREHOLDERS' EQUITY
(U.S. dollars in thousands)

	(Unaudited) Three Months Ended March 31,	
	2014	2013
Non-Cumulative Preferred Shares		
Balance at beginning and end of period	$325,000	$325,000
Common Shares		
Balance at beginning of year	565	561
Common shares issued, net	2	—
Balance at end of period	567	561
Additional Paid-in Capital		
Balance at beginning of year	299,517	227,778
Exercise of stock options	8,054	3,093
Amortization of share-based compensation	14,175	11,543
Other	(1,243)	78
Balance at end of period	320,503	242,492
Retained Earnings		
Balance at beginning of year	6,042,154	5,354,361
Net income	179,145	256,476
Net (income) loss attributable to noncontrolling interests (1)	3,355	—
Preferred share dividends	(5,484)	(5,484)
Balance at end of period	6,219,170	5,605,353
Accumulated Other Comprehensive Income		
Balance at beginning of year	74,964	287,017
Unrealized appreciation in value of available-for-sale investments, net of deferred income tax:		
Balance at beginning of year	80,692	289,956
Unrealized holding gains (losses) arising during period, net of reclassification adjustment	50,104	(29,230)
Portion of other-than-temporary impairment losses recognized in other comprehensive income, net of deferred income tax	—	(2)
Balance at end of period	130,796	260,724
Foreign currency translation adjustments:		
Balance at beginning of year	(5,728)	(2,939)
Foreign currency translation adjustments	(1,349)	(28,222)
Balance at end of period	(7,077)	(31,161)
Balance at end of period	123,719	229,563
Common Shares Held in Treasury, at Cost		
Balance at beginning of year	(1,094,704)	(1,025,839)
Shares repurchased for treasury	(2,122)	(41,600)
Balance at end of period	(1,096,826)	(1,067,439)

Total shareholders’ equity available to Arch	5,892,133	5,335,530
Noncontrolling interests (1)	793,496	—
Total shareholders’ equity	$6,685,629	$5,335,530

(1) See Note 4.

See Notes to Consolidated Financial Statements

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ARCH CAPITAL GROUP LTD. AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF CASH FLOWS
(U.S. dollars in thousands)

	(Unaudited) Three Months Ended March 31,	
	2014	2013
Operating Activities		
Net income	$179,145	$256,476
Adjustments to reconcile net income to net cash provided by operating activities:		
Net realized gains	(22,367)	(59,504)
Net impairment losses recognized in earnings	2,971	2,246
Equity in net income or loss of investment funds accounted for using the equity method and other income or loss	9,559	23,052
Share-based compensation	14,175	11,543
Changes in:		
Reserve for losses and loss adjustment expenses, net of unpaid losses and loss adjustment expenses recoverable	10,326	(22,182)
Unearned premiums, net of prepaid reinsurance premiums	205,210	200,006
Premiums receivable	(242,616)	(198,814)
Deferred acquisition costs, net	(41,988)	(45,159)
Reinsurance balances payable	5,428	17,365
Other liabilities	59,285	23,811
Other items	19,041	(3,181)
Net Cash Provided By Operating Activities	198,169	205,659
Investing Activities		
Purchases of:		
Fixed maturity investments	(7,131,071)	(3,970,320)
Equity securities	(89,227)	(63,353)
Other investments	(304,454)	(250,442)
Proceeds from the sales of:		
Fixed maturity investments	7,014,281	3,796,638
Equity securities	49,614	81,513
Other investments	331,176	280,010
Proceeds from redemptions and maturities of fixed maturity investments	168,484	181,727
Net (purchases) sales of short-term investments	156,262	(221,444)
Change in investment of securities lending collateral	4,669	(41,019)
Purchase of business, net of cash acquired (1)	(235,578)	—
Purchases of furniture, equipment and other assets	(5,382)	(3,742)
Net Cash Used For Investing Activities	(41,226)	(210,432)
Financing Activities		
Purchases of common shares under share repurchase program	—	(40,964)
Proceeds from common shares issued, net	3,021	1,280
Change in securities lending collateral	(4,669)	41,019
Third party investment in non-redeemable noncontrolling interests (2)	796,903	—
Third party investment in redeemable noncontrolling interests (2)	186,893	—
Other	1,700	1,084

Preferred dividends paid	(5,484)	(5,484)
Net Cash Provided By (Used For) Financing Activities	978,364	(3,065)
Effects of exchange rate changes on foreign currency cash	241	(6,436)
Increase (decrease) in cash	1,135,548	(14,274)
Cash beginning of year	434,057	371,041
Cash end of period	$1,569,605	$356,767

(1) See Note 2.
(2) See Note 4.

See Notes to Consolidated Financial Statements

1. General

Arch Capital Group Ltd. ("ACGL") is a Bermuda public limited liability company which provides insurance and reinsurance on a worldwide basis through its subsidiaries (together with ACGL, the "Company").

On January 30, 2014, the Company acquired CMG Mortgage Insurance Company and its affiliated mortgage insurance companies (together, "CMG Entities") and the mortgage insurance platform and related assets from PMI Mortgage Insurance Co. ("PMI") (see Note 2).

On March 20, 2014, the Company acquired approximately 11% of Watford Holdings Ltd.'s common equity and a warrant to purchase additional common equity for $100 million. Watford Holdings Ltd. is the parent of Watford Re Ltd., a newly-formed multi-line Bermuda reinsurance company (together with Watford Holdings Ltd., "Watford"). Watford is considered a variable interest entity ("VIE") and the Company concluded that it is the primary beneficiary of Watford. As such, the results of Watford are included in the Company's consolidated financial statements (see Note 4).

The interim consolidated financial statements have been prepared in conformity with accounting principles generally accepted in the United States of America ("GAAP") and include the accounts of the Company and Watford. All significant intercompany transactions and balances have been eliminated in consolidation. 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 from those estimates and assumptions. In the opinion of management, the accompanying unaudited interim consolidated financial statements reflect all adjustments (consisting of normally recurring accruals) necessary for a fair statement of results on an interim basis. The results of any interim period are not necessarily indicative of the results for a full year or any future periods.

Certain information and footnote disclosures normally included in financial statements prepared in accordance with GAAP have been condensed or omitted; however, management believes that the disclosures are adequate to make the information presented not misleading. This report should be read in conjunction with the Company's Annual Report on Form 10-K for the year ended December 31, 2013 ("2013 Form 10-K"), including the Company's audited consolidated financial statements and related notes.

The Company has reclassified the presentation of certain prior year information to conform to the current presentation. Such reclassifications had no effect on the Company's net income, comprehensive income, shareholders' equity or cash flows. Tabular amounts are in U.S. Dollars in thousands, except share amounts, unless otherwise noted.

2. Business Acquired

On January 30, 2014, the Company's U.S.-based subsidiaries completed the acquisition of the CMG Entities through a stock purchase agreement ("SPA") from its previous owners, PMI, which has been in rehabilitation under the receivership of the Arizona Department of Insurance since 2011, and CMFG Life Insurance Company ("CUNA Mutual"). In addition, the Company entered into a distribution agreement with CUNA Mutual and a reinsurance agreement with an affiliate of CUNA Mutual. CMG Mortgage Insurance Company has been renamed "Arch Mortgage Insurance Company" ("Arch MI U.S."). As part of the transaction, Arch MI U.S. obtained approval as an eligible mortgage insurer from Fannie Mae and Freddie Mac (each a government sponsored enterprise or "GSE"), subject to maintaining certain ongoing requirements.

In addition, through an asset purchase agreement ("APA") with PMI, the Company acquired the mortgage insurance operating platform of PMI, 100% of the capital stock of PMI Mortgage Assurance Co., a mortgage insurance company licensed in all 50 states (renamed Arch Mortgage Guaranty Company), and entered into a quota share reinsurance agreement pursuant to which Arch Reinsurance Ltd. agreed to provide 100% quota share indemnity reinsurance to PMI for all certificates of insurance that were issued by PMI between and including January 1, 2009 and December 31, 2011 that were not in default as of an agreed upon effective date. Other than this quota share, no PMI legacy exposures were assumed in the transaction. As part of the transaction, the Company entered into a services agreement with PMI to provide certain necessary operational services to administer the run-off of PMI's legacy business at the direction of PMI. Arch MI U.S. also entered into a quota share reinsurance agreement whereby it will cede 20% of all new primary flow mortgage insurance business post-closing (both credit union and non-credit union business) on the first $25 billion in original loan amounts to PMI, on a funds-withheld basis.

The completion of the SPA and APA transactions enabled the Company to enter the U.S. mortgage insurance marketplace and serve all lenders nationwide. The arrangements with CUNA Mutual also provided a seamless transition and enabled the Company to provide uninterrupted access and services to the credit union marketplace.

At closing, the Company paid aggregate consideration of $160.6 million (80% of the actual closing date book value of the CMG Entities) under the SPA and $84.6 million under the APA. Additionally, the SPA contains provisions for additional contingent consideration payments, subject to an overall maximum payment of 150% of closing book value of the pre-closing portfolio of the CMG Entities as re-calculated over an earn-out period and payable at the third, fifth and sixth anniversaries after closing (subject to a one time extension period of one to three years at the sellers' discretion). The maximum amount of contingent consideration payments is $136.3 million. To the extent that the adjusted book value of the CMG Entities drops below the cumulative amount paid by the Company, no additional payments would be due. To determine the fair value of the contingent consideration liability, the Company estimated future payments using a weighted average cost of capital approach at a rate of return of 15% which reflects the industry-weighted average rate of return on debt and equity as required by market participants. The fair value of the contingent consideration liability was $41.8 million at closing. The contingent consideration liability, which is included in 'other liabilities' in the consolidated balance sheets, is remeasured at fair value at each balance sheet date ($43.2 million at March 31, 2014) until the contingency is resolved with changes in fair value recognized in 'net realized gains (losses).'

The following table summarizes the fair value of net assets acquired and allocation of purchase price:

	Total	Useful Life
Purchase price		
Cash paid	$245,157	
Contingent consideration liability	41,762	
Total purchase price (a)	$286,919	
Assets acquired		
Cash	$9,579	
Investments, at fair value	312,093	
Intangible asset -- acquired insurance contracts	46,473	5 years
Intangible asset -- operating platform	29,900	5 years
Intangible asset -- favorable lease contract	1,056	5 years
Intangible asset -- insurance licenses	16,858	Indefinite
Other assets acquired	21,691	
Total assets acquired	437,650	
Liabilities acquired		
Reserves for losses and loss adjustment expenses	$121,572	
Unearned premiums	26,261	
Intangible liability -- unfavorable service contract	9,533	9 years
Other liabilities acquired	7,217	
Total liabilities acquired	164,583	
Net assets acquired (b)	$273,067	
Goodwill (a)-(b)	$13,852	

The Company recognized goodwill of $13.9 million that is primarily attributed to PMI's assembled workforce, access to the mortgage insurance market through an existing operating platform, and additional synergies to be realized in the future. Under U.S. tax principles, which differentiate between taxable and non-taxable business combinations, the

Company estimates that $48.0 million of goodwill is expected to be deductible for tax purposes.

The Company includes the operations of Arch MI U.S. in its mortgage segment (see Note 6).

3. Significant Accounting Policies

As discussed in Note 2, the Company completed its acquisition of the CMG Entities on January 30, 2014. As such, the Company has added relevant sections pertaining to mortgage insurance to its significant accounting policies as described in Note 2, "Significant Accounting Policies," of its audited consolidated financial statements and related notes of the 2013 Form 10-K.

(b) Premium Revenues and Related Expenses

Insurance. Insurance premiums written are generally recorded at the policy inception and are primarily earned on a pro rata basis over the terms of the policies for all products, usually 12 months. Premiums written include estimates in the Company’s programs, specialty lines, lenders products business and for participation in involuntary pools. Such premium estimates are derived from multiple sources which include the historical experience of the underlying business, similar business and available industry information. Unearned premium reserves represent the portion of premiums written that relates to the unexpired terms of in-force insurance policies.

Reinsurance. Reinsurance premiums written include amounts reported by brokers and ceding companies, supplemented by the Company’s own estimates of premiums where reports have not been received. The determination of premium estimates requires a review of the Company’s experience with the ceding companies, familiarity with each market, the timing of the reported information, an analysis and understanding of the characteristics of each line of business, and management’s judgment of the impact of various factors, including premium or loss trends, on the volume of business written and ceded to the Company. On an ongoing basis, the Company’s underwriters review the amounts reported by these third parties for reasonableness based on their experience and knowledge of the subject class of business, taking into account the Company’s historical experience with the brokers or ceding companies. In addition, reinsurance contracts under which the Company assumes business generally contain specific provisions which allow the Company to perform audits of the ceding company to ensure compliance with the terms and conditions of the contract, including accurate and timely reporting of information. Based on a review of all available information, management establishes premium estimates where reports have not been received. Premium estimates are updated when new information is received and differences between such estimates and actual amounts are recorded in the period in which estimates are changed or the actual amounts are determined.

Reinsurance premiums written are recorded based on the type of contracts the Company writes. Premiums on the Company’s excess of loss and pro rata reinsurance contracts are estimated when the business is underwritten. For excess of loss contracts, premiums are recorded as written based on the terms of the contract. Estimates of premiums written under pro rata contracts are recorded in the period in which the underlying risks are expected to incept and are based on information provided by the brokers and the ceding companies. For multi-year reinsurance treaties which are payable in annual installments, generally, only the initial annual installment is included as premiums written at policy inception due to the ability of the reinsured to commute or cancel coverage during the term of the policy. The remaining annual installments are included as premiums written at each successive anniversary date within the multi-year term.

Reinstatement premiums for the Company’s insurance and reinsurance operations are recognized at the time a loss event occurs, where coverage limits for the remaining life of the contract are reinstated under pre-defined contract terms. Reinstatement premiums, if obligatory, are fully earned when recognized. The accrual of reinstatement premiums is based on an estimate of losses and loss adjustment expenses, which reflects management’s judgment. Premium estimates are reviewed by management at least quarterly. Such review includes a comparison of actual reported premiums to expected ultimate premiums along with a review of the aging and collection of premium estimates. Based on management’s review, the appropriateness of the premium estimates is evaluated, and any adjustment to these estimates is recorded in the period in which it becomes known. Adjustments to premium estimates could be material and such adjustments could directly and significantly impact earnings favorably or unfavorably in the period they are determined because the estimated premium may be fully or substantially earned. A significant portion of amounts included as premiums receivable, which represent estimated premiums written, net of commissions, are not currently due based on the terms of the underlying contracts.

Reinsurance premiums written, irrespective of the class of business, are generally earned on a pro rata basis over the terms of the underlying policies or reinsurance contracts. Contracts and policies written on a “losses occurring” basis cover claims that may occur during the term of the contract or policy, which is typically 12 months. Accordingly, the premium is earned evenly over the term. Contracts which are written on a “risks attaching” basis cover claims which attach to the underlying insurance policies written during the terms of such contracts. Premiums earned on such contracts usually extend beyond the original term of the reinsurance contract, typically resulting in recognition of premiums earned over a 24-month period. Certain of the Company’s reinsurance contracts include provisions that adjust premiums or acquisition expenses based upon the experience under the contracts. Premiums written and earned, as well as related acquisition expenses, are recorded based upon the projected experience under such contracts.

The Company also writes certain reinsurance business that is intended to provide insurers with risk management solutions that complement traditional reinsurance. Under these contracts, the Company assumes a measured amount of insurance risk in

exchange for an anticipated margin, which is typically lower than on traditional reinsurance contracts. The terms and conditions of these contracts may include additional or return premiums based on loss experience, loss corridors, sublimits and caps. Examples of such business include aggregate stop-loss coverages, financial quota share coverages and multi- year retrospectively rated excess of loss coverages. If these contracts are deemed to transfer risk, they are accounted for as reinsurance.

Mortgage. Mortgage guaranty insurance policies are contracts that are generally non-cancelable by the insurer, are renewable at a fixed price, and provide for payment of premiums on a monthly, annual or single basis. Upon renewal, the Company is not able to re-underwrite or re-price its policies. Consistent with industry accounting practices, premiums written on a monthly basis are earned as coverage is provided. Premiums written on an annual basis are amortized on a monthly pro rata basis over the year of coverage. Primary mortgage insurance premiums written on policies covering more than one year are referred to as single premiums. A portion of the revenue from single premiums is recognized in premiums earned in the current period, and the remaining portion is deferred as unearned premiums and earned over the expected life of the policy. If single premium policies related to insured loans are canceled due to repayment by the borrower, and the premium is non-refundable, the remaining unearned premium related to each canceled policy is recognized as earned premium upon notification of the cancellation.

Unearned premiums represent the portion of premiums written that is applicable to the estimated unexpired risk of insured loans. A portion of premium payments may be refundable if the insured cancels coverage, which generally occurs when the loan is repaid, the loan amortizes to a sufficiently low amount to trigger a lender permitted or legally required cancellation, or the value of the property has increased sufficiently in accordance with the terms of the contract. Premium refunds reduce premiums earned in the consolidated statements of operations.

Acquisition Costs. Acquisition expenses and other expenses related to the Company’s underwriting operations that vary with, and are directly related to, the successful acquisition or renewal of business are deferred and amortized based on the type of contract. For property and casualty insurance and reinsurance contracts, deferred acquisition costs are amortized over the period in which the related premiums are earned. Consistent with mortgage insurance industry accounting practice, amortization of acquisition costs related to the mortgage insurance contracts for each underwriting year’s book of business is charged against revenue in proportion to estimated gross profits. Estimated gross profits are comprised of earned premiums, interest income, losses and loss adjustment expenses. For each underwriting year, the Company estimates the rate of amortization to reflect actual experience and any changes to persistency or loss development.

Acquisition expenses, net of ceding commissions received from reinsurers, consist principally of commissions and premium taxes paid to obtain the Company’s business. Other operating expenses also include expenses that vary with, and are directly related to, the acquisition of business. Deferred acquisition costs are carried at their estimated realizable value and take into account anticipated losses and loss adjustment expenses, based on historical and current experience, and anticipated investment income. A premium deficiency occurs if the sum of anticipated losses and loss adjustment expenses, unamortized acquisition costs and maintenance costs exceed unearned premiums and anticipated investment income. A premium deficiency is recorded by charging any unamortized acquisition costs to expense to the extent required in order to eliminate the deficiency. If the premium deficiency exceeds unamortized acquisition costs then a liability is accrued for the excess deficiency.

(i) Reserves for Losses and Loss Adjustment Expenses

Insurance and Reinsurance. The reserve for losses and loss adjustment expenses consists of estimates of unpaid reported losses and loss adjustment expenses and estimates for losses incurred but not reported. The reserve for unpaid reported losses and loss adjustment expenses, established by management based on reports from ceding companies and claims from insureds, excludes estimates of amounts due from insureds related to losses under high deductible policies, and represents the estimated ultimate cost of events or conditions that have been reported to or specifically identified by the Company. Such reserves are supplemented by management’s estimates of reserves for losses incurred for which reports or claims have not been received. The Company’s reserves are based on a combination of reserving methods, incorporating both Company and industry loss development patterns. The Company selects the initial expected loss and loss adjustment expense ratios based on information derived by its underwriters and actuaries during the initial pricing of the business, supplemented by industry data where appropriate. Such ratios consider, among other things, rate changes and changes in terms and conditions that have been observed in the market. These estimates are reviewed regularly and, as experience develops and new information becomes known, the reserves are adjusted as necessary. Such adjustments, if any, are reflected in income in the period in which they are determined. As actual loss information has been reported, the Company has developed its own loss experience and its reserving methods include other actuarial techniques. Over time, such techniques have been given further weight in its reserving process based on the continuing maturation of the Company’s reserves. Inherent in the estimates of ultimate losses and loss adjustment expenses are expected trends in claims severity and frequency and other factors which may vary significantly as claims are settled. Accordingly, ultimate losses and loss adjustment expenses may differ materially from the amounts recorded in the accompanying consolidated financial statements. Losses and loss adjustment expenses are recorded on an undiscounted basis, except for excess workers’ compensation and employers’ liability business written by the Company’s insurance operations.

Mortgage. The reserves for mortgage guaranty insurance losses and loss adjustment expenses are the estimated claim settlement costs on notices of default that have been received by the Company, as well as loan defaults that have been incurred but have not been reported by the lenders. Consistent with industry accounting practice, the Company does not establish loss reserves for future claims on insured loans that are not currently in default (defined as two consecutive missed payments). The Company establishes loss reserves on a case-by-case basis when insured loans are identified as currently in default using estimated claim rates and average claim sizes for each report year, net of any salvage recoverable. The Company also reserves for defaults that have occurred but have not yet been reported to the Company prior to the close of an accounting period. To determine this reserve, the Company estimates the number of defaults not yet reported using historical information regarding late reported delinquencies and applies estimated claim rates and claim sizes for the estimated defaults not yet reported.

The establishment of reserves across the Company’s segments is an inherently uncertain process, are necessarily based on estimates, and the ultimate net cost may vary from such estimates. The methods for making such estimates and for establishing the resulting liability are reviewed and updated using the most current information available. Any resulting adjustments, which may be material, are reflected in current operations

(q) Goodwill and Intangible Assets

Goodwill represents the excess of the purchase price of an acquisition over the fair value of the net assets acquired and is assigned to the applicable reporting unit at acquisition. Goodwill is not amortized and is evaluated for impairment on an annual basis. Impairment tests may be performed more frequently if the facts and circumstances indicate a possible impairment. In performing impairment tests, the Company may first assess qualitative factors to determine whether it is more likely than not (that is, more than a 50% probability) that the fair value of a reporting unit exceeds its carrying amount as a basis for determining whether it is necessary to perform the two-step goodwill impairment test described in the accounting guidance.

Indefinite-lived intangible assets, such as insurance licenses, are not amortized and are evaluated for impairment similar to goodwill. Finite-lived intangible assets and liabilities include the value of insurance and reinsurance contracts, which are estimated based on the present value of future expected cash flows and amortized in ‘acquisition expenses’ in proportion to the estimated profits expected to be realized. Other finite-lived intangible assets or liabilities, including favorable or unfavorable contracts, are amortized in ‘other operating expenses’ over their useful lives. Finite-lived intangible assets and liabilities are periodically reviewed for indicators of impairment. An impairment is recognized when the carrying amount is not recoverable from its undiscounted cash flows and is measured as the difference between the carrying amount and fair value.

If goodwill or intangible assets are impaired, such assets are written down to their realizable values with the related expense recorded in the Company’s results of operations.

4. Variable Interest Entity and Noncontrolling Interests

Variable interest entity

A VIE refers to an entity that has characteristics such as (i) insufficient equity at risk to allow the entity to finance its activities without additional financial support or (ii) instances where the equity investors, as a group, do not have characteristics of a controlling financial interest. The primary beneficiary of a VIE is defined as the variable interest holder that is determined to have the controlling financial interest as a result of having both (i) the power to direct the activities of a VIE that most significantly impact the economic performance of the VIE and (ii) the obligation to absorb losses or right to receive benefits from the VIE that could potentially be significant to the VIE. If a company is determined to be the primary beneficiary, it is required to consolidate the VIE in its financial statements.

In March 2014, Watford raised approximately $1.1 billion of capital consisting of $907.3 million in common equity ($895.6 million net of issuance costs) and $226.6 million in preference equity ($219.2 million net of issuance costs and discount). The Company invested $100.0 million and acquired approximately 11% of Watford Holdings Ltd.'s common equity and a warrant to purchase additional common equity. Arch Underwriters Ltd. ("AUL"), a subsidiary of the Company, acts as Watford's reinsurance manager, and Highbridge Principal Strategies, LLC ("Highbridge"), a subsidiary of JPMorgan Chase & Co., manages Watford's investment assets, each under separate long term services agreements. John Rathgeber, previously Vice Chairman of Arch Worldwide Reinsurance Group, was named CEO of Watford. In addition, Marc Grandisson, Chairman and CEO of Arch Worldwide Reinsurance and Mortgage Groups, and Nicolas Papadopoulo, Chairman and CEO of Arch Reinsurance Ltd., were appointed to the board of directors of Watford.

The Company concluded that Watford is a VIE due to both the reinsurance management services agreement with AUL and the investment management agreement with Highbridge. Both of these agreements provide for services for an extended period of time with limited termination rights by Watford. In addition, these agreements allow for both AUL and Highbridge to participate in the favorable results of Watford in the form of performance fees. To determine if the Company is the primary beneficiary of Watford, the Company concluded that the most significant activity of Watford pertains to the insurance activities arising from the reinsurance management services agreement, as these activities will ultimately generate the investable assets required by Highbridge to execute the investment strategy. In addition, the Company factored into its analysis qualitative aspects of the relationship with Watford that are indicative of power to direct the insurance activities. These aspects coupled with the Company's board seats and a former executive of the Company serving as Watford's CEO resulted in the Company concluding that it is the primary beneficiary of Watford. As such, the results of Watford are included in the Company's consolidated financial statements.

The Company concluded that Watford represents a separate operating segment and provides the income statement and total investable assets, total assets and total liabilities of Watford within Note 6. Because Watford is an independent company, the assets of Watford can be used only to settle obligations of Watford and Watford is solely responsible for its own liabilities and commitments. The Company's financial exposure to Watford is limited to its investment in Watford's common shares and counterparty credit risk (mitigated by collateral) arising from the reinsurance transactions.

Non-redeemable noncontrolling interests

The Company accounts for the portion of Watford's common equity attributable to third party investors in the shareholders' equity section of its consolidated balance sheets. The noncontrolling ownership in Watford's common shares was approximately 89% at March 31, 2014. The portion of Watford's income or loss attributable to third party investors is recorded in the consolidated statements of income as 'net (income) loss attributable to noncontrolling

interests.’ The following table sets forth activity in the non-redeemable noncontrolling interests:

	Three Months Ended March 31, 2014
Balance, beginning of year	$—
Sale of shares to noncontrolling interests	796,903
Net (loss) income attributable to noncontrolling interests	(3,407)
Balance, end of period	$793,496

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Redeemable noncontrolling interests

The Company accounts for redeemable noncontrolling interests in the mezzanine section of its consolidated balance sheets in accordance with applicable accounting guidance. Such redeemable noncontrolling interests represent the 9,065,200 cumulative redeemable preference shares ("Watford Preference Shares") issued in late March 2014 with a par value of $0.01 per share and a liquidation preference of $25.00 per share. The Watford Preference Shares were issued at a discounted amount of $24.50 per share. Due to the timing of the issuance, not all amounts subscribed were collected by Watford by March 31, 2014. Holders of the Watford Preference Shares will be entitled to receive, if declared by Watford's board, quarterly cash dividends on the last day of March, June, September, and December commencing June 30, 2014. Dividends will accrue from the closing date to June 30, 2019 at a fixed rate of 8.5% per annum. From June 30, 2019 and subsequent, dividends will accrue based on a floating rate equal to the 3 month U.S. dollar LIBOR (with a 1% floor) plus a margin based on the difference between the fixed rate and the 5 year mid swap rate to the floating rate as set out on the IRSB18. The Watford Preference Shares may be redeemed by Watford on or after June 30, 2019 or at the option of the preferred shareholders at any time on or after June 30, 2034. Because the redemption features are not solely within the control of Watford, the Company accounts for the redeemable noncontrolling interests in the Watford Preference Shares in the mezzanine section of its consolidated balance sheets. Third party investors own 100% of the Watford Preference Shares at March 31, 2014. Preferred dividends, including the accretion of the discount and issuance costs, are included as 'net (income) loss attributable to noncontrolling interests' in the Company's consolidated statements of income.

5. Earnings Per Common Share

The following table sets forth the computation of basic and diluted earnings per common share:

	Three Months Ended March 31,	
	2014	2013
Numerator:		
Net income	$179,145	$256,476
Net (income) loss attributable to noncontrolling interests	3,355	—
Net income available to Arch	182,500	256,476
Preferred dividends	(5,484)	(5,484)
Net income available to Arch common shareholders	$177,016	$250,992
Denominator:		
Weighted average common shares outstanding — basic	131,857,910	130,907,902
Effect of dilutive common share equivalents:		
Nonvested restricted shares	1,346,401	1,290,161
Stock options (1)	3,358,406	3,211,225
Weighted average common shares and common share equivalents outstanding — diluted	136,562,717	135,409,288
Earnings per common share:		
Basic	$1.34	$1.92
Diluted	$1.30	$1.85

(1) Certain stock options were not included in the computation of diluted earnings per share where the exercise price of the stock options exceeded the average market price and would have been anti-dilutive or where, when applying the treasury stock method to in-the-money options, the sum of the proceeds, including unrecognized compensation,

exceeded the average market price and would have been anti-dilutive. For the 2014 first quarter and 2013 first quarter, the number of stock options excluded were 759,172 and 1,016,043, respectively.

6. Segment Information

During the 2014 first quarter, to reflect activity during the period as described below, the Company changed its segment structure and added two new segments (mortgage and 'other'). The Company now classifies its businesses into three underwriting segments — insurance, reinsurance and mortgage — and two other operating segments — 'other' and corporate (non-underwriting). The Company determined its reportable segments using the management approach described in accounting guidance regarding disclosures about segments of an enterprise and related information. The accounting policies of the segments are the same as those used for the preparation of the Company's consolidated financial statements. Intersegment business is allocated to the segment accountable for the underwriting results.

The Company's insurance, reinsurance and mortgage segments each have managers who are responsible for the overall profitability of their respective segments and who are directly accountable to the Company's chief operating decision makers, the Chairman, President and Chief Executive Officer of ACGL and the Chief Financial Officer of ACGL. The chief operating decision makers do not assess performance, measure return on equity or make resource allocation decisions on a line of business basis. Management measures segment performance for its three underwriting segments based on underwriting income or loss. The Company does not manage its assets by underwriting segment and, accordingly, investment income is not allocated to each underwriting segment.

The corporate (non-underwriting) segment results include net investment income, other income (loss), other expenses incurred by the Company, interest expense, net realized gains or losses, net impairment losses included in earnings, equity in net income (loss) of investment funds accounted for using the equity method, net foreign exchange gains or losses, income taxes and items related to the Company's non-cumulative preferred shares. Such amounts exclude the results of the 'other' segment.

The 'other' segment includes the results of Watford (see Note 4). Watford has its own management and board of directors that is responsible for the overall profitability of the 'other' segment. For the 'other' segment, performance is measured based on net income or loss.

The following tables summarize the Company’s underwriting income or loss by segment, together with a reconciliation of underwriting income or loss to net income available to common shareholders:

	Three Months Ended March 31, 2014					
	Insurance	Reinsurance	Mortgage	Sub-Total	Other	Total
Gross premiums written (1)	$730,646	$517,053	$47,907	$1,295,136	$32,194	$1,295,136
Premiums ceded	(185,044)	(73,127)	(4,639)	(262,340)	—	(230,146)
Net premiums written	545,602	443,926	43,268	1,032,796	32,194	1,064,990
Change in unearned premiums	(68,101)	(102,578)	(4,503)	(175,182)	(30,028)	(205,210)
Net premiums earned	477,501	341,348	38,765	857,614	2,166	859,780
Other underwriting income	500	316	766	1,582	—	1,582
Losses and loss adjustment expenses	(286,770)	(139,636)	(8,478)	(434,884)	(1,356)	(436,240)
Acquisition expenses, net	(76,932)	(73,433)	(9,154)	(159,519)	(823)	(160,342)
Other operating expenses	(81,144)	(36,195)	(13,876)	(131,215)	(1,109)	(132,324)
Underwriting income (loss)	$33,155	$92,400	$8,023	133,578	(1,122)	132,456
Net investment income				66,993	1	66,994
Net realized gains				19,697	—	19,697
Net impairment losses recognized in earnings				(2,971)	—	(2,971)
Equity in net income of investment funds accounted for using the equity method				3,253	—	3,253
Other income (loss)				(2,104)	—	(2,104)
Other expenses				(10,799)	(2,676)	(13,475)
Interest expense				(14,404)	—	(14,404)
Net foreign exchange gains (losses)				(6,656)	93	(6,563)
Income before income taxes				186,587	(3,704)	182,883
Income tax expense				(3,738)	—	(3,738)
Net income (loss)				182,849	(3,704)	179,145
Net (income) loss attributable to noncontrolling interests				—	3,355	3,355
Net income available to Arch				182,849	(349)	182,500
Preferred dividends				(5,484)	—	(5,484)
Net income available to Arch common shareholders				$177,365	$(349)	$177,016
Underwriting Ratios						
Loss ratio	60.1%	40.9%	21.9%	50.7%	62.6%	50.7%
Acquisition expense ratio (2)	16.0%	21.5%	23.6%	18.5%	38.0%	18.6%
Other operating expense ratio	17.0%	10.6%	35.8%	15.3%	51.2%	15.4%
Combined ratio	93.1%	73.0%	81.3%	84.5%	151.8%	84.7%

Total investable assets	$14,261,106	$1,083,280	$15,344,386
Total assets	20,653,897	1,146,461	21,800,358
Total liabilities	14,860,124	35,371	14,895,495

(1) Certain amounts included in the gross premiums written of each segment are related to intersegment transactions. Accordingly, the sum of gross premiums written for each segment does not agree to the total gross premiums written as shown in the table above due to the elimination of intersegment transactions in the total.

(2) The acquisition expense ratio is adjusted to include certain other underwriting income.

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	Three Months Ended March 31, 2013					
	Insurance	Reinsurance	Mortgage	Sub-Total	Other	Total
Gross premiums written (1)	$688,817	$450,447	$25,758	$1,163,699	$—	$1,163,699
Premiums ceded	(184,267)	(27,979)	—	(210,923)	—	(210,923)
Net premiums written	504,550	422,468	25,758	952,776	—	952,776
Change in unearned premiums	(59,585)	(126,315)	(14,106)	(200,006)	—	(200,006)
Net premiums earned	444,965	296,153	11,652	752,770	—	752,770
Other underwriting income	525	13	—	538	—	538
Losses and loss adjustment expenses	(283,467)	(113,857)	(2,079)	(399,403)	—	(399,403)
Acquisition expenses, net	(70,758)	(53,143)	(3,691)	(127,592)	—	(127,592)
Other operating expenses	(76,315)	(32,197)	(1,403)	(109,915)	—	(109,915)
Underwriting income	$14,950	$96,969	$4,479	116,398	—	116,398
Net investment income				65,672	—	65,672
Net realized gains				58,340	—	58,340
Net impairment losses recognized in earnings				(2,246)	—	(2,246)
Equity in net income of investment funds accounted for using the equity method				13,823	—	13,823
Other income (loss)				1,244	—	1,244
Other expenses				(10,268)	—	(10,268)
Interest expense				(5,898)	—	(5,898)
Net foreign exchange gains				24,264	—	24,264
Income before income taxes				261,329	—	261,329
Income tax expense				(4,853)	—	(4,853)
Net income				256,476	—	256,476
Net (income) loss attributable to noncontrolling interests				—	—	—
Net income available to Arch				256,476	—	256,476
Preferred dividends				(5,484)	—	(5,484)
Net income available to Arch common shareholders				$250,992	$—	$250,992
Underwriting Ratios						
Loss ratio	63.7%	38.4%	17.8%	53.1%	—%	53.1%
Acquisition expense ratio (2)	15.8%	17.9%	31.7%	16.9%	—%	16.9%
Other operating expense ratio	17.2%	10.9%	12.0%	14.6%	—%	14.6%
Combined ratio	96.7%	67.2%	61.5%	84.6%	—%	84.6%
Total investable assets				$13,132,116	$—	$13,132,116
Total assets				18,757,061	—	18,757,061
Total liabilities				13,421,531	—	13,421,531

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(1) Certain amounts included in the gross premiums written of each segment are related to intersegment transactions. Accordingly, the sum of gross premiums written for each segment does not agree to the total gross premiums written as shown in the table above due to the elimination of intersegment transactions in the total.

(2) The acquisition expense ratio is adjusted to include other underwriting income.

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7. Investment Information

At March 31, 2014, total investable assets of $15.34 billion included $14.26 billion managed by the Company and $1.08 billion attributable to Watford. Due to the timing of Watford's launch, the cash proceeds received from Watford's capital raising activities was not invested at March 31, 2014 and, as such, Watford's investable assets were included in the Company's cash balance at such date. As such, the tables in this footnote do not reflect any Watford balances except for the net investment income table. See Note 4 for further details on Watford.

Available For Sale Investments

The following table summarizes the fair value and cost or amortized cost of the Company's investments classified as available for sale:

	Fair Value	Gross Unrealized Gains	Gross Unrealized Losses	Cost or Amortized Cost	OTTI Unrealized Losses (2)
March 31, 2014					
Fixed maturities and fixed maturities pledged under securities lending agreements (1):					
Corporate bonds	$2,514,129	$39,704	$(20,047)	$2,494,472	$(16)
Mortgage backed securities	1,087,840	21,700	(14,253)	1,080,393	(8,217)
Municipal bonds	1,410,043	28,494	(3,742)	1,385,291	(17)
Commercial mortgage backed securities	1,023,055	11,769	(9,031)	1,020,317	—
U.S. government and government agencies	1,153,120	4,048	(5,932)	1,155,004	(19)
Non-U.S. government securities	1,114,382	14,538	(12,978)	1,112,822	—
Asset backed securities	1,573,751	11,143	(12,385)	1,574,993	(2,902)
Total	9,876,320	131,396	(78,368)	9,823,292	(11,171)
Equity securities	548,168	78,896	(6,596)	475,868	—
Other investments	426,917	24,398	(15,243)	417,762	—
Short-term investments	1,484,280	955	(2,053)	1,485,378	—
Total	$12,335,685	$235,645	$(102,260)	$12,202,300	$(11,171)
December 31, 2013					
Fixed maturities and fixed maturities pledged under securities lending agreements (1):					
Corporate bonds	$2,267,263	$35,289	$(35,537)	$2,267,511	$(16)
Mortgage backed securities	1,133,095	16,270	(22,209)	1,139,034	(9,269)
Municipal bonds	1,481,738	29,378	(9,730)	1,462,090	(17)
Commercial mortgage backed securities	1,074,497	13,972	(15,224)	1,075,749	(199)
U.S. government and government agencies	1,301,809	3,779	(11,242)	1,309,272	(19)
Non-U.S. government securities	1,085,861	14,729	(19,363)	1,090,495	—

Asset backed securities	1,332,594	20,033	(13,795)	1,326,356	(3,422)
Total	9,676,857	133,450	(127,100)	9,670,507	(12,942)
Equity securities	496,824	69,487	(5,938)	433,275	—
Other investments	498,310	28,082	(18,459)	488,687	—
Short-term investments	1,478,367	1,654	(871)	1,477,584	—
Total	$12,150,358	$232,673	$(152,368)	$12,070,053	$(12,942)

(1) In securities lending transactions, the Company receives collateral in excess of the fair value of the fixed maturities and short-term investments pledged. For purposes of this table, the Company has excluded the collateral received and reinvested and included the fixed maturities and short-term investments pledged. See "—Securities Lending Agreements."

(2) Represents the total other-than-temporary impairments ("OTTI") recognized in accumulated other comprehensive income ("AOCI"). It does not include the change in fair value subsequent to the impairment measurement date. At March 31, 2014, the net unrealized gain related to securities for which a non-credit OTTI was recognized in AOCI was $4.8 million, compared to a net unrealized gain of $6.0 million at December 31, 2013.

The following table summarizes, for all available for sale securities in an unrealized loss position, the fair value and gross unrealized loss by length of time the security has been in a continual unrealized loss position:

	Less than 12 Months		12 Months or More		Total	
	Fair Value	Gross Unrealized Losses	Fair Value	Gross Unrealized Losses	Fair Value	Gross Unrealized Losses
March 31, 2014						
Fixed maturities and fixed maturities pledged under securities lending agreements (1):						
Corporate bonds	$1,012,076	$(17,780)	$40,352	$(2,267)	$1,052,428	$(20,047)
Mortgage backed securities	434,286	(11,841)	23,033	(2,412)	457,319	(14,253)
Municipal bonds	340,349	(3,484)	3,741	(258)	344,090	(3,742)
Commercial mortgage backed securities	398,428	(8,977)	581	(54)	399,009	(9,031)
U.S. government and government agencies	764,802	(5,932)	—	—	764,802	(5,932)
Non-U.S. government securities	541,534	(10,940)	36,298	(2,038)	577,832	(12,978)
Asset backed securities	904,539	(8,424)	99,179	(3,961)	1,003,718	(12,385)
Total	4,396,014	(67,378)	203,184	(10,990)	4,599,198	(78,368)
Equity securities	102,589	(6,596)	—	—	102,589	(6,596)
Other investments	156,468	(15,243)	—	—	156,468	(15,243)
Short-term investments	180,233	(2,053)	—	—	180,233	(2,053)
Total	$4,835,304	$(91,270)	$203,184	$(10,990)	$5,038,488	$(102,260)
December 31, 2013						
Fixed maturities and fixed maturities pledged under securities lending agreements (1):						
Corporate bonds	$1,183,625	$(32,837)	$46,673	$(2,700)	$1,230,298	$(35,537)
Mortgage backed securities	778,693	(20,253)	43,634	(1,956)	822,327	(22,209)
Municipal bonds	589,009	(9,422)	6,092	(308)	595,101	(9,730)
Commercial mortgage backed securities	677,617	(15,110)	1,612	(114)	679,229	(15,224)
U.S. government and government agencies	1,144,809	(11,242)	—	—	1,144,809	(11,242)
Non-U.S. government securities	821,506	(15,776)	24,334	(3,587)	845,840	(19,363)
Asset backed securities	692,362	(10,431)	88,629	(3,364)	780,991	(13,795)
Total	5,887,621	(115,071)	210,974	(12,029)	6,098,595	(127,100)
Equity securities	76,563	(5,938)	—	—	76,563	(5,938)
Other investments	165,891	(15,775)	47,316	(2,684)	213,207	(18,459)

Short-term investments	28,170	(871)	—	—	28,170	(871)
Total	$6,158,245	$(137,655)	$258,290	$(14,713)	$6,416,535	$(152,368)

(1) In securities lending transactions, the Company receives collateral in excess of the fair value of the fixed maturities and short-term investments pledged. For purposes of this table, the Company has excluded the collateral received and reinvested and included the fixed maturities and short-term investments pledged. See "—Securities Lending Agreements."

At March 31, 2014, on a lot level basis, approximately 1,580 security lots out of a total of approximately 4,310 security lots were in an unrealized loss position and the largest single unrealized loss from a single lot in the Company's fixed maturity portfolio was $3.6 million. At December 31, 2013, on a lot level basis, approximately 2,080 security lots out of a total of approximately 4,400 security lots were in an unrealized loss position and the largest single unrealized loss from a single lot in the Company's fixed maturity portfolio was $3.5 million.

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The contractual maturities of the Company's fixed maturities and fixed maturities pledged under securities lending agreements are shown in the following table. Expected maturities, which are management's best estimates, will differ from contractual maturities because borrowers may have the right to call or prepay obligations with or without call or prepayment penalties.

	March 31, 2014		December 31, 2013	
Maturity	Fair Value	Amortized Cost	Fair Value	Amortized Cost
Due in one year or less	$286,950	$282,281	$235,330	$232,652
Due after one year through five years	3,757,966	3,731,777	3,738,500	3,718,920
Due after five years through 10 years	1,883,374	1,872,047	1,966,536	1,979,510
Due after 10 years	263,384	261,484	196,305	198,286
	6,191,674	6,147,589	6,136,671	6,129,368
Mortgage backed securities	1,087,840	1,080,393	1,133,095	1,139,034
Commercial mortgage backed securities	1,023,055	1,020,317	1,074,497	1,075,749
Asset backed securities	1,573,751	1,574,993	1,332,594	1,326,356
Total	$9,876,320	$9,823,292	$9,676,857	$9,670,507

Securities Lending Agreements

The Company operates a securities lending program under which certain of its fixed income portfolio securities are loaned to third parties, primarily major brokerage firms, for short periods of time through a lending agent. The fair value and amortized cost of fixed maturities and short-term investments pledged under securities lending agreements were $100.6 million and $100.9 million, respectively, at March 31, 2014, compared to $105.1 million and $105.9 million, respectively, at December 31, 2013. The fair value of the portfolio of collateral backing the Company's securities lending program was $96.3 million at March 31, 2014, compared to $100.6 million at December 31, 2013. Such amounts included approximately $6.3 million of sub-prime securities at March 31, 2014, compared to $6.3 million at December 31, 2013. The Company maintains legal control over the securities it lends, retains the earnings and cash flows associated with the loaned securities and receives a fee from the borrower for the temporary use of the securities. An indemnification agreement with the lending agent protects the Company in the event a borrower becomes insolvent or fails to return any of the securities on loan to the Company.

Other Investments

The following table summarizes the Company's other investments, including available for sale and fair value option components:

	March 31, 2014	December 31, 2013
Available for sale:		
Asian and emerging markets	$266,023	$ 331,984
Investment grade fixed income	160,894	159,115
Other	—	7,211
Total available for sale	426,917	498,310
Fair value option:		
Term loan investments (par value: $403,383 and $494,502)	410,430	512,076
Asian and emerging markets	14,817	14,054
Investment grade fixed income	91,907	75,062
Other (1)	282,670	172,088

Total fair value option	799,824	773,280
Total	$ 1,226,741	$ 1,271,590

(1) Includes fund investments with strategies in mortgage servicing rights, transportation and infrastructure assets and other.

Certain of the Company’s other investments are in investment funds for which the Company has the option to redeem at agreed upon values as described in each investment fund’s subscription agreement. Depending on the terms of the various subscription agreements, investments in investment funds may be redeemed daily, monthly, quarterly or on other terms. Two common redemption restrictions which may impact the Company’s ability to redeem these investment funds are gates and lockups. A gate is a suspension of redemptions which may be implemented by the general partner or investment manager of

the fund in order to defer, in whole or in part, the redemption request in the event the aggregate amount of redemption requests exceeds a predetermined percentage of the investment fund's net assets which may otherwise hinder the general partner or investment manager's ability to liquidate holdings in an orderly fashion in order to generate the cash necessary to fund extraordinarily large redemption payouts. A lockup period is the initial amount of time an investor is contractually required to hold the security before having the ability to redeem. If the investment funds are eligible to be redeemed, the time to redeem such fund can take weeks or months following the notification.

Fair Value Option

The following table summarizes the Company's assets and liabilities which are accounted for using the fair value option:

	March 31, 2014	December 31, 2013
Fixed maturities	$456,826	$ 448,254
Other investments	799,824	773,280
Investments accounted for using the fair value option	$1,256,650	$ 1,221,534

Net Investment Income

The components of net investment income were derived from the following sources:

	Three Months Ended March 31,	
	2014	2013
Fixed maturities	$62,449	$62,006
Term loan investments	5,669	4,217
Equity securities (dividends)	2,921	1,423
Short-term investments	406	392
Other (1)	4,718	6,299
Gross investment income	76,163	74,337
Investment expenses	(9,169)	(8,665)
Net investment income	$66,994	$65,672

(1) Includes dividends on investment funds and other items.

Net Realized Gains (Losses)

Net realized gains (losses) were as follows, excluding other-than-temporary impairment provisions:

	Three Months Ended March 31,	
	2014	2013
Available for sale securities:		
Gross gains on investment sales	$66,051	$67,020
Gross losses on investment sales	(40,013)	(25,056)
Change in fair value of assets and liabilities accounted for using the fair value option:		
Fixed maturities	(1,643)	5,058
Other investments	10,776	9,951
Equity securities	—	699

Derivative instruments (1)	(12,768)	(378)
Other (2)	(2,706)	1,046
Net realized gains (losses)	$19,697	$58,340

(1) See Note 9 for information on the Company's derivative instruments.

(2) Includes accretion of contingent liability amounts related to the acquisition of the CMG Entities (see Note 2 for further details).

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Other-Than-Temporary Impairments

The Company performs quarterly reviews of its available for sale investments in order to determine whether declines in fair value below the amortized cost basis were considered other-than-temporary in accordance with applicable guidance. The following table details the net impairment losses recognized in earnings by asset class:

	Three Months Ended March 31,	
	2014	2013
Fixed maturities:		
Mortgage backed securities	$—	$(15)
Asset backed securities	(6)	(20)
Total	(6)	(35)
Equity securities	—	(2,211)
Other investments	(2,965)	—
Net impairment losses recognized in earnings	$(2,971)	$(2,246)

The Company's net impairment losses recognized in earnings in the 2014 first quarter primarily related to one investment fund. The Company analyzed available positive and negative evidence on the fund, including the business prospects, recent events, industry and market data and other factors. Following such review, the Company determined that it did not have the intent or ability to hold such securities for a reasonable period of time by which the fair value of the securities would increase and the Company would recover its cost and, as such, the cost basis of such securities was adjusted down accordingly.

The Company believes that the $11.2 million of OTTI included in accumulated other comprehensive income at March 31, 2014 on the securities which were considered by the Company to be impaired was due to market and sector-related factors (i.e., not credit losses). At March 31, 2014, the Company did not intend to sell these securities, or any other securities which were in an unrealized loss position, and determined that it is more likely than not that the Company will not be required to sell such securities before recovery of their cost basis.

The following table provides a roll forward of the amount related to credit losses recognized in earnings for which a portion of an OTTI was recognized in accumulated other comprehensive income:

	Three Months Ended March 31,	
	2014	2013
Balance at start of period	$60,062	$62,001
Credit loss impairments recognized on securities not previously impaired	—	33
Credit loss impairments recognized on securities previously impaired	6	2
Reductions for increases in cash flows expected to be collected that are recognized over the remaining life of the security	—	—
Reductions for securities sold during the period	(12,812)	(80)
Balance at end of period	$47,256	$61,956

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Restricted Assets

The Company is required to maintain assets on deposit, which primarily consist of fixed maturities, with various regulatory authorities to support its insurance and reinsurance operations. The Company's insurance and reinsurance subsidiaries maintain assets in trust accounts as collateral for insurance and reinsurance transactions with affiliated companies and also have investments in segregated portfolios primarily to provide collateral or guarantees for letters of credit to third parties. See Note 10 for further details. The following table details the value of the Company's restricted assets:

	March 31, 2014	December 31, 2013
Assets used for collateral or guarantees:		
Affiliated transactions	$4,346,385	$ 4,060,533
Third party agreements	951,609	856,890
Deposits with U.S. regulatory authorities	350,284	302,809
Deposits with non-U.S. regulatory authorities	2	6,546
Trust funds	92,108	75,264
Total restricted assets	$5,740,388	$ 5,302,042

8. Fair Value

Accounting guidance regarding fair value measurements addresses how companies should measure fair value when they are required to use a fair value measure for recognition or disclosure purposes under GAAP and provides a common definition of fair value to be used throughout GAAP. It defines fair value as the price that would be received to sell an asset or paid to transfer a liability in an orderly fashion between market participants at the measurement date. In addition, it establishes a three-level valuation hierarchy for the disclosure of fair value measurements. The valuation hierarchy is based upon the transparency of inputs to the valuation of an asset or liability as of the measurement date. The level in the hierarchy within which a given fair value measurement falls is determined based on the lowest level input that is significant to the measurement (Level 1 being the highest priority and Level 3 being the lowest priority).

The levels in the hierarchy are defined as follows:

Level 1: Inputs to the valuation methodology are observable inputs that reflect quoted prices (unadjusted) for identical assets or liabilities in active markets

Level 2: Inputs to the valuation methodology include quoted prices for similar assets and liabilities in active markets, and inputs that are observable for the asset or liability, either directly or indirectly, for substantially the full term of the financial instrument

Level 3: Inputs to the valuation methodology are unobservable and significant to the fair value measurement

Following is a description of the valuation methodologies used for securities measured at fair value, as well as the general classification of such securities pursuant to the valuation hierarchy.

The Company determines the existence of an active market based on its judgment as to whether transactions for the financial instrument occur in such market with sufficient frequency and volume to provide reliable pricing information. The independent pricing sources obtain market quotations and actual transaction prices for securities that

have quoted prices in active markets. The Company uses quoted values and other data provided by nationally recognized independent pricing sources as inputs into its process for determining fair values of its fixed maturity investments. To validate the techniques or models used by pricing sources, the Company's review process includes, but is not limited to: (i) quantitative analysis (e.g., comparing the quarterly return for each managed portfolio to its target benchmark, with significant differences identified and investigated); (ii) a review of the average number of prices obtained in the pricing process and the range of resulting fair values; (iii) initial and ongoing evaluation of methodologies used by outside parties to calculate fair value including a review of deep dive reports on selected securities which indicate the use of observable inputs in the pricing process; (iv) comparing the fair value estimates to its knowledge of the current market; (v) a comparison of the pricing services' fair values to other pricing services' fair values for the same investments; and (vi) back-testing, which includes randomly selecting purchased or sold securities and comparing the executed prices to the fair value estimates from the pricing service. For a majority of investments, the Company obtained multiple quotes. A price source hierarchy was maintained in order to determine which price source would be used (i.e., a price

obtained from a pricing service with more seniority in the hierarchy will be used over a less senior one in all cases). The hierarchy prioritizes pricing services based on availability and reliability and assigns the highest priority to index providers. Based on the above review, the Company will challenge any prices for a security or portfolio which are considered not to be representative of fair value. The Company did not adjust any of the prices obtained from the pricing services at March 31, 2014.

The independent pricing sources obtain market quotations and actual transaction prices for securities that have quoted prices in active markets. Each source has its own proprietary method for determining the fair value of securities that are not actively traded. In general, these methods involve the use of "matrix pricing" in which the independent pricing source uses observable market inputs including, but not limited to, investment yields, credit risks and spreads, benchmarking of like securities, broker-dealer quotes, reported trades and sector groupings to determine a reasonable fair value. In addition, pricing vendors use model processes, such as an Option Adjusted Spread model, to develop prepayment and interest rate scenarios. The Option Adjusted Spread model is commonly used to estimate fair value for securities such as mortgage backed and asset backed securities. In certain circumstances, when fair values are unavailable from these independent pricing sources, quotes are obtained directly from broker-dealers who are active in the corresponding markets. Such quotes are subject to the validation procedures noted above. Of the $13.64 billion of financial assets and liabilities measured at fair value at March 31, 2014, approximately $544.4 million, or 4.0%, were priced using non-binding broker-dealer quotes. Of the $13.37 billion of financial assets and liabilities measured at fair value at December 31, 2013, approximately $601.9 million, or 4.5%, were priced using non-binding broker-dealer quotes.

The Company reviews its securities measured at fair value and discusses the proper classification of such investments with investment advisers and others. No transfers were made in the periods presented. A discussion of the general classification of the Company's financial instruments follows:

Fixed maturities. The Company determined that all U.S. Treasuries would be classified as Level 1 securities due to observed levels of trading activity, the high number of strongly correlated pricing quotes received on U.S. Treasuries and other factors. Where the Company believes that quoted market prices are not available or that the market is not active, fair values are estimated by using quoted prices of securities with similar characteristics, pricing models or matrix pricing and are generally classified as Level 2 securities. The Company determined that Level 2 securities included corporate bonds, mortgage backed securities, municipal bonds, asset backed securities and non-U.S. government securities.

Equity securities. The Company determined that exchange-traded equity securities would be included in Level 1 as their fair values are based on quoted market prices in active markets. Other equity securities are included in Level 2 of the valuation hierarchy.

Other investments. The fair values for certain of the Company's other investments are determined using net asset values ("NAV") as advised by external fund managers. The NAV is based on the fund manager's valuation of the underlying holdings in accordance with the fund's governing documents. Periodically, the Company performs a number of monitoring procedures in order to assess the quality of the NAVs, including regular review and discussion of each fund's performance, regular evaluation of fund performance against applicable benchmarks and the backtesting of the NAVs against audited and interim financial statements. Other investments with liquidity terms allowing the Company to substantially redeem its holdings in a short time frame at the applicable NAV are reflected in Level 2. Other investments with redemption restrictions that prevent the Company from redeeming in the near term are classified in Level 3 of the valuation hierarchy.

Short-term investments. The Company determined that certain of its short-term investments held in highly liquid money market-type funds would be included in Level 1 as their fair values are based on quoted market prices in active markets. Other short-term investments are classified in Level 2 of the valuation hierarchy.

In securities lending transactions, the Company receives collateral in excess of the fair value of the fixed maturities and short-term investments pledged under securities lending agreements. For purposes of the following tables, the Company has excluded the collateral received and reinvested and included the fixed maturities and short-term investments pledged under securities lending agreements, at fair value.

Contingent consideration liability. The contingent consideration liability (included in ‘other liabilities’ in the consolidated balance sheets) resulted from the acquisition of the CMG Entities and is remeasured at fair value at each balance sheet date. Changes in fair value are recognized in ‘net realized gains (losses).’ To determine the fair value of the contingent consideration liability, the Company estimates future payments using an income approach based on modeled inputs which include a weighted

average cost of capital. The Company determined that the contingent consideration liability would be included in Level 3 of the valuation hierarchy.

The following table presents the Company’s financial assets and liabilities measured at fair value by level at March 31, 2014:

	Fair Value	Fair Value Measurement Using: Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
Assets measured at fair value:				
Available for sale securities:				
Fixed maturities and fixed maturities pledged under securities lending agreements (1):				
Corporate bonds	$2,514,129	$—	$2,514,129	$—
Mortgage backed securities	1,087,840	—	1,087,840	—
Municipal bonds	1,410,043	—	1,410,043	—
Commercial mortgage backed securities	1,023,055	—	1,023,055	—
U.S. government and government agencies	1,153,120	1,153,120	—	—
Non-U.S. government securities	1,114,382	—	1,114,382	—
Asset backed securities	1,573,751	—	1,573,751	—
Total	9,876,320	1,153,120	8,723,200	—
Equity securities	548,168	548,099	69	—
Other investments	426,917	—	322,582	104,335
Short-term investments	1,484,280	1,457,349	26,931	—
Fair value option:				
Investments accounted for using the fair value option:				
Corporate bonds	353,644	—	353,644	—
Non-U.S. government bonds	63,538	—	63,538	—
Mortgage backed securities	39,644	—	39,644	—
Other investments	799,824	—	380,678	419,146
Total	1,256,650	—	837,504	419,146
Total assets measured at fair value	$13,592,335	$3,158,568	$9,910,286	$523,481
Liabilities measured at fair value:				
Contingent consideration liability	$43,156	$—	$—	$43,156
Total liabilities measured at fair value	$43,156	$—	$—	$43,156

(1) In securities lending transactions, the Company receives collateral in excess of the fair value of the fixed maturities and short-term investments pledged. For purposes of this table, the Company has excluded the collateral received and reinvested and included the fixed maturities and short-term investments pledged.

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The following table presents the Company's financial assets and liabilities measured at fair value by level at December 31, 2013:

	Fair Value	Fair Value Measurement Using: Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
Assets measured at fair value:				
Available for sale securities:				
Fixed maturities and fixed maturities pledged under securities lending agreements (1):				
Corporate bonds	$2,267,263	$—	$2,265,218	$2,045
Mortgage backed securities	1,133,095	—	1,133,095	—
Municipal bonds	1,481,738	—	1,481,738	—
Commercial mortgage backed securities	1,074,497	—	1,074,497	—
U.S. government and government agencies	1,301,809	1,301,809	—	—
Non-U.S. government securities	1,085,861	—	1,085,861	—
Asset backed securities	1,332,594	—	1,332,594	—
Total	9,676,857	1,301,809	8,373,003	2,045
Equity securities	496,824	496,738	86	—
Other investments	498,310	—	327,890	170,420
Short-term investments	1,478,367	1,427,744	50,623	—
Fair value option:				
Investments accounted for using the fair value option:				
Corporate bonds	334,065	—	334,065	—
Non-U.S. government bonds	73,156	—	73,156	—
Mortgage backed securities	41,033	—	41,033	—
Other investments	773,280	—	395,755	377,525
Total	1,221,534	—	844,009	377,525
Total assets measured at fair value	$13,371,892	$3,226,291	$9,595,611	$549,990

(1) In securities lending transactions, the Company receives collateral in excess of the fair value of the fixed maturities and short-term investments pledged. For purposes of this table, the Company has excluded the collateral received and reinvested and included the fixed maturities and short-term investments pledged.

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The following tables present a reconciliation of the beginning and ending balances for all financial assets and liabilities measured at fair value on a recurring basis using Level 3 inputs:

	Fair Value Measurements Using: Significant Unobservable Inputs (Level 3)				
	Assets				Liabilities
s	Available-For-Sale		Fair Value Option		
	Corporate Bonds	Other Investments	Other Investments	Total	Contingent Consideration Liability
Three Months Ended March 31, 2014					
Balance at beginning of period	$2,045	$ 170,420	$ 377,525	$549,990	$ —
Total gains or (losses) (realized/unrealized)					
Included in earnings (1)	—	2,275	6,310	8,585	(1,394)
Included in other comprehensive income	—	(2,196)	—	(2,196)	—
Purchases, issuances, sales and settlements					
Purchases	—	—	40,110	40,110	—
Issuances	—	—	—	—	(41,762)
Sales	(2,045)	(66,164)	—	(68,209)	—
Settlements	—	—	(4,799)	(4,799)	—
Transfers in and/or out of Level 3	—	—	—	—	—
Balance at end of period	$—	$ 104,335	$ 419,146	$523,481	$ (43,156)
Three Months Ended March 31, 2013					
Balance at beginning of period	$98,404	$ 184,202	$ 195,350	$477,956	$ —
Total gains or (losses) (realized/unrealized)					
Included in earnings (1)	1,492	4,762	373	6,627	—
Included in other comprehensive income	(1,688)	1,912	—	224	—
Purchases, issuances, sales and settlements					
Purchases	—	5,000	41,654	46,654	—
Issuances	—	—	—	—	—
Sales	—	—	—	—	—
Settlements	(910)	(9,942)	(58,007)	(68,859)	—
Transfers in and/or out of Level 3	—	—	—	—	—
Balance at end of period	$97,298	$ 185,934	$ 179,370	$462,602	$ —

(1) Gains or losses on corporate bonds were included in net realized gains (losses) while gains or losses on other investments were included in net realized gains (losses) or net investment income. Gains or losses on the contingent consideration liability were included in net realized gains (losses).

The amount of total gains for the 2014 first quarter included in earnings attributable to the change in unrealized gains or losses relating to assets still held at March 31, 2014 was $3.3 million, while the amount of total gains for the 2013 first quarter included in earnings attributable to the change in unrealized gains or losses relating to assets still held at March 31, 2013 was $6.6 million.

Financial Instruments Disclosed, But Not Carried, At Fair Value

The Company uses various financial instruments in the normal course of its business. The carrying values of cash, accrued investment income, receivable for securities sold, certain other assets, payable for securities purchased and certain other liabilities approximated their fair values at March 31, 2014, due to their respective short maturities. As these financial instruments are not actively traded, their respective fair values are classified within Level 2.

At March 31, 2014, the senior notes of ACGL were carried at their cost of $300.0 million and had a fair value of $394.7 million while the senior notes of Arch-U.S. were carried at their cost of $500.0 million and had a fair value of $530.3 million. The fair values of the senior notes were obtained from a third party pricing service and are based on observable market inputs. As such, the fair value of the senior notes is classified within Level 2.

9. Derivative Instruments

The Company's investment strategy allows for the use of derivative securities. The Company's derivative instruments are recorded on its consolidated balance sheets at fair value. The fair values of those derivatives are based on quoted market prices. All realized and unrealized contract gains and losses are reflected in the Company's results of operations. The Company utilizes exchange traded U.S. Treasury note, Eurodollar and other futures contracts and commodity futures to manage portfolio duration or replicate investment positions in its portfolios. Certain of the Company's corporate bonds are managed in a global bond portfolio which incorporates the use of foreign currency forward contracts which are intended to provide an economic hedge against foreign currency movements on the portfolio's non-U.S. Dollar denominated holdings. The Company routinely utilizes other foreign currency forward contracts, currency options, index futures contracts and other derivatives as part of its total return objective.

In addition, the Company purchases to-be-announced mortgage backed securities ("TBAs") as part of its investment strategy. TBAs represent commitments to purchase a future issuance of agency mortgage backed securities. For the period between purchase of a TBA and issuance of the underlying security, the Company's position is accounted for as a derivative. The Company purchases TBAs in both long and short positions to enhance investment performance and as part of its overall investment strategy. The Company did not hold any derivatives which were designated as hedging instruments at March 31, 2014 or December 31, 2013.

The following table summarizes information on the fair values and notional values of the Company's derivative instruments. The fair value of TBAs is included in 'fixed maturities available for sale, at fair value.'

	Asset Derivatives Fair Value	Liability Derivatives Fair Value	Net Derivatives Fair Value	Notional Value (1)
March 31, 2014				
Futures contracts	$469	$(769)	$(300)	$1,056,045
Foreign currency forward contracts	693	(1,565)	(872)	244,614
TBAs	216,548	(211,763)	4,785	412,800
Other	1,349	(844)	505	690,029
Total	$219,059	$(214,941)	$4,118	
December 31, 2013				
Futures contracts	$461	$(110)	$351	$475,967
Foreign currency forward contracts	5,023	(3,090)	1,933	330,746
TBAs	33,455	(21,731)	11,724	56,160
Other	920	(1,541)	(621)	347,916
Total	$39,859	$(26,472)	$13,387	

(1) Represents the absolute notional value of all outstanding contracts, consisting of long and short positions.

The Company's derivative instruments are generally traded under master netting agreements, which establish terms that apply to all derivative transactions with a counterparty. In the event of a bankruptcy or other stipulated event of default, such agreements provide that the non-defaulting party may elect to terminate all outstanding derivative transactions, in which case all individual derivative positions (loss or gain) with a counterparty are closed out and netted and replaced with a single amount, usually referred to as the termination amount, which is expressed in a

single currency. The resulting single net amount, where positive, is payable to the party “in-the-money” regardless of whether or not it is the defaulting party, unless the parties have agreed that only the non-defaulting party is entitled to receive a termination payment where the net amount is positive and is in its favor. Effectively, contractual close-out netting reduces derivatives credit exposure from gross to net exposure. At March 31, 2014, asset derivatives and liability derivatives of $147.7 million and $143.0 million, respectively, were subject to a master netting agreement, compared to $28.0 million and $14.6 million, respectively, at December 31, 2013. The remaining derivatives included in the table above were not subject to a master netting agreement.

The following table summarizes net realized gains (losses) recorded on the Company's derivative instruments in the consolidated statements of income:

Derivatives not designated as hedging instruments	Three Months Ended March 31,	
	2014	2013
Futures contracts	$(9,862)	$(829)
Foreign currency forward contracts	(2,257)	(725)
TBAs	(37)	541
Other	(612)	635
Total	$(12,768)	$(378)

10. Commitments and Contingencies

Letter of Credit and Revolving Credit Facilities

As of March 31, 2014, the Company had a $300 million unsecured revolving loan and letter of credit facility and a $500 million secured letter of credit facility (the "Credit Agreement"). The Credit Agreement expires on August 18, 2014. In addition, the Company had access to secured letter of credit facilities of approximately $192.0 million as of March 31, 2014, which are available on a limited basis and for limited purposes (together with the secured portion of the Credit Agreement and these letter of credit facilities, the "LOC Facilities"). At March 31, 2014, the Company had $430.0 million in outstanding letters of credit under the LOC Facilities, which were secured by investments with a fair value of $493.1 million, and had $100.0 million of borrowings outstanding under the Credit Agreement. The Company was in compliance with all covenants contained in the LOC Facilities at March 31, 2014.

Investment Commitments

The Company's investment commitments, which are primarily related to agreements entered into by the Company to invest in funds and separately managed accounts when called upon, were approximately $966.1 million at March 31, 2014.

11. Share Transactions

Share Repurchases

The board of directors of ACGL has authorized the investment in ACGL's common shares through a share repurchase program. Repurchases under the program may be effected from time to time in open market or privately negotiated transactions through December 2014. Since the inception of the share repurchase program, ACGL has repurchased approximately 109.9 million common shares for an aggregate purchase price of $2.79 billion. During the 2014 first quarter, ACGL did not repurchase any common shares, compared to 930,759 common shares for an aggregate purchase price of $41.0 million for the 2013 period. At March 31, 2014, $712.1 million of share repurchases were available under the program. The timing and amount of the repurchase transactions under this program will depend on a variety of factors, including market conditions and corporate and regulatory considerations.

12. Income Taxes

ACGL is incorporated under the laws of Bermuda and, under current Bermuda law, is not obligated to pay any taxes in Bermuda based upon income or capital gains. The Company has received a written undertaking from the Minister of Finance in Bermuda under the Exempted Undertakings Tax Protection Act 1966 that, in the event that any legislation is enacted in Bermuda imposing any tax computed on profits, income, gain or appreciation on any capital asset, or any tax in the nature of estate duty or inheritance tax, such tax will not be applicable to ACGL or any of its operations until March 31, 2035. This undertaking does not, however, prevent the imposition of taxes on any person ordinarily resident in Bermuda or any company in respect of its ownership of real property or leasehold interests in Bermuda.

ACGL and its non-U.S. subsidiaries will be subject to U.S. federal income tax only to the extent that they derive U.S. source income that is subject to U.S. withholding tax or income that is effectively connected with the conduct of a trade or business within the U.S. and is not exempt from U.S. tax under an applicable income tax treaty with the U.S. ACGL and its

non-U.S. subsidiaries will be subject to a withholding tax on dividends from U.S. investments and interest from certain U.S. payors (subject to reduction by any applicable income tax treaty). ACGL and its non-U.S. subsidiaries intend to conduct their operations in a manner that will not cause them to be treated as engaged in a trade or business in the United States and, therefore, will not be required to pay U.S. federal income taxes (other than U.S. excise taxes on insurance and reinsurance premium and withholding taxes on dividends and certain other U.S. source investment income). However, because there is uncertainty as to the activities which constitute being engaged in a trade or business within the United States, there can be no assurances that the U.S. Internal Revenue Service will not contend successfully that ACGL or its non-U.S. subsidiaries are engaged in a trade or business in the United States. If ACGL or any of its non-U.S. subsidiaries were subject to U.S. income tax, ACGL's shareholders' equity and earnings could be materially adversely affected. ACGL has subsidiaries and branches that operate in various jurisdictions around the world that are subject to tax in the jurisdictions in which they operate. The significant jurisdictions in which ACGL's subsidiaries and branches are subject to tax are the United States, United Kingdom, Ireland, Canada, Switzerland and Denmark.

The Company's income tax provision on income before income taxes resulted in an expense of 2.0% for the three months ended March 31, 2014, compared to an expense of 1.9% for the 2013 period. The Company's effective tax rate, which is based upon the expected annual effective tax rate, may fluctuate from period to period based on the relative mix of income or loss reported by jurisdiction and the varying tax rates in each jurisdiction. The Company had a net deferred tax asset of $151.2 million at March 31, 2014, compared to $128.6 million at December 31, 2013. In addition, the Company paid $1.6 million in income taxes for the three months ended March 31, 2014, while the Company paid $1.3 million for the 2013 period.

13. Other Comprehensive Income (Loss)

The following table presents details about amounts reclassified from accumulated other comprehensive income:

Details About AOCI Components	Consolidated Statement of Income Line Item That Includes Reclassification	Amounts Reclassed from AOCI Three Months Ended March 31, 2014	2013
Unrealized appreciation on available-for-sale investments			
	Net realized gains	$26,038	$44,367
	Other-than-temporary impairment losses	(2,971)	(2,248)
	Total before tax	23,067	42,119
	Income tax expense	(1,818)	(3,418)
	Net of tax	$21,249	$38,701

The following table presents the tax effects allocated to each component of other comprehensive income (loss):

	Before Tax Amount	Tax Expense (Benefit)	Net of Tax Amount
Three Months Ended March 31, 2014			
Unrealized appreciation (decline) in value of investments:			
Unrealized holding gains (losses) arising during period	$75,400	$4,047	$71,353
Portion of other-than-temporary impairment losses recognized in other comprehensive income (loss)	—	—	—
Less reclassification of net realized gains included in net income	23,067	1,818	21,249

Foreign currency translation adjustments	(1,349)	—	(1,349)
Other comprehensive income (loss)	$50,984	$2,229	$48,755
Three Months Ended March 31, 2013			
Unrealized appreciation (decline) in value of investments:			
Unrealized holding gains (losses) arising during period	$10,347	$876	$9,471
Portion of other-than-temporary impairment losses recognized in other comprehensive income (loss)	(2)	—	(2)
Less reclassification of net realized gains included in net income	42,119	3,418	38,701
Foreign currency translation adjustments	(28,222)	—	(28,222)
Other comprehensive income (loss)	$(59,996)	$(2,542)	$(57,454)

14. Guarantor Financial Information

The following tables present condensed financial information for ACGL, Arch Capital Group (U.S.) Inc. ("Arch-U.S."), a 100% owned subsidiary of ACGL, and ACGL's other subsidiaries.

	March 31, 2014				
Condensed Consolidating Balance Sheet	ACGL (Parent Guarantor)	Arch-U.S. (Subsidiary Issuer)	Other ACGL Subsidiaries	Consolidating Adjustments and Eliminations	ACGL Consolidated
Assets					
Total investments	$2,546	$48,689	$13,792,262	$—	$13,843,497
Cash	12,353	45,472	1,511,780	—	1,569,605
Investments in subsidiaries	6,288,035	1,598,732	—	(7,886,767)	—
Due from subsidiaries and affiliates	503	—	401,987	(402,490)	—
Premiums receivable	—	—	1,399,825	(391,450)	1,008,375
Reinsurance recoverable on unpaid and paid losses and loss adjustment expenses	—	—	5,617,877	(3,827,852)	1,790,025
Contractholder receivables	—	—	1,118,991	—	1,118,991
Prepaid reinsurance premiums	—	—	1,293,460	(944,383)	349,077
Deferred acquisition costs, net	—	—	384,294	—	384,294
Other assets	6,309	62,500	2,211,353	(543,668)	1,736,494
Total assets	$6,309,746	$1,755,393	$27,731,829	$(13,996,610)	$21,800,358
Liabilities					
Reserve for losses and loss adjustment expenses	$—	$—	$12,749,908	$(3,810,950)	$8,938,958
Unearned premiums	—	—	3,092,858	(944,383)	2,148,475
Reinsurance balances payable	—	—	742,630	(540,836)	201,794
Contractholder payables	—	—	1,118,991	—	1,118,991
Deposit accounting liabilities	—	—	735,993	(326,913)	409,080
Senior notes	300,000	500,000	—	—	800,000
Revolving credit agreement borrowings	100,000	—	—	—	100,000
Due to subsidiaries and affiliates	2,091	1,167	399,232	(402,490)	—
Other liabilities	15,522	46,040	1,200,906	(84,271)	1,178,197
Total liabilities	417,613	547,207	20,040,518	(6,109,843)	14,895,495
Redeemable noncontrolling interests (1)	—	—	219,234	—	219,234
Shareholders' Equity					
Total shareholders' equity available to Arch	5,892,133	1,208,186	6,678,581	(7,886,767)	5,892,133
Non-redeemable noncontrolling interests (1)	—	—	793,496	—	793,496
Total shareholders' equity	5,892,133	1,208,186	7,472,077	(7,886,767)	6,685,629
Total liabilities, noncontrolling interests and shareholders' equity	$6,309,746	$1,755,393	$27,731,829	$(13,996,610)	$21,800,358

(1) See Note 4.

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Condensed Consolidating Balance Sheet	December 31, 2013 ACGL (Parent Guarantor)	Arch-U.S. (Subsidiary Issuer)	Other ACGL Subsidiaries	Consolidating Adjustments and Eliminations	ACGL Consolidated
Assets					
Total investments	$2,530	$408,957	$13,200,247	$—	$13,611,734
Cash	3,223	509	430,325	—	434,057
Investments in subsidiaries	6,046,060	1,258,889	—	(7,304,949)	—
Due from subsidiaries and affiliates	2,251	—	405,110	(407,361)	—
Premiums receivable	—	—	1,085,369	(331,445)	753,924
Reinsurance recoverable on unpaid and paid losses and loss adjustment expenses	—	—	5,645,156	(3,840,826)	1,804,330
Contractholder receivables	—	—	1,064,246	—	1,064,246
Prepaid reinsurance premiums	—	—	1,109,312	(780,969)	328,343
Deferred acquisition costs, net	—	—	342,314	—	342,314
Other assets	6,598	60,342	1,714,651	(554,445)	1,227,146
Total assets	$6,060,662	$1,728,697	$24,996,730	$(13,219,995)	$19,566,094
Liabilities					
Reserve for losses and loss adjustment expenses	$—	$—	$12,625,766	$(3,801,070)	$8,824,696
Unearned premiums	—	—	2,677,334	(780,969)	1,896,365
Reinsurance balances payable	—	—	662,394	(466,227)	196,167
Contractholder payables	—	—	1,064,246	—	1,064,246
Deposit accounting liabilities	—	—	758,490	(337,193)	421,297
Senior notes	300,000	500,000	—	—	800,000
Revolving credit agreement borrowings	100,000	—	—	—	100,000
Due to subsidiaries and affiliates	18	10,250	397,093	(407,361)	—
Other liabilities	13,148	33,206	691,699	(122,226)	615,827
Total liabilities	413,166	543,456	18,877,022	(5,915,046)	13,918,598
Redeemable noncontrolling interests	—	—	—	—	—
Shareholders' Equity					
Total shareholders' equity available to Arch	5,647,496	1,185,241	6,119,708	(7,304,949)	5,647,496
Non-redeemable noncontrolling interests	—	—	—	—	—
Total shareholders' equity	5,647,496	1,185,241	6,119,708	(7,304,949)	5,647,496
Total liabilities, noncontrolling interests and shareholders' equity	$6,060,662	$1,728,697	$24,996,730	$(13,219,995)	$19,566,094

Condensed Consolidating Statement of Income and Comprehensive Income	Three Months Ended March 31, 2014				
	ACGL (Parent Guarantor)	Arch-U.S. (Subsidiary Issuer)	Other ACGL Subsidiaries	Consolidating Adjustments and Eliminations	ACGL Consolidated
Revenues					
Net premiums earned	$—	$—	$859,780	$—	$859,780
Net investment income	—	—	77,001	(10,007)	66,994
Net realized gains	—	—	19,697	—	19,697
Net impairment losses recognized in earnings	—	—	(2,971)	—	(2,971)
Other underwriting income	—	—	1,582	—	1,582
Equity in net income of investment funds accounted for using the equity method	—	—	3,253	—	3,253
Other income (loss)	—	—	(2,104)	—	(2,104)
Total revenues	—	—	956,238	(10,007)	946,231
Expenses					
Losses and loss adjustment expenses	—	—	436,240	—	436,240
Acquisition expenses	—	—	160,342	—	160,342
Other operating expenses	10,307	977	134,515	—	145,799
Interest expense	5,853	6,514	12,044	(10,007)	14,404
Net foreign exchange losses	—	—	5,741	822	6,563
Total expenses	16,160	7,491	748,882	(9,185)	763,348
Income (loss) before income taxes	(16,160)	(7,491)	207,356	(822)	182,883
Income tax benefit (expense)	—	2,788	(6,526)	—	(3,738)
Income (loss) before equity in net income of subsidiaries	(16,160)	(4,703)	200,830	(822)	179,145
Equity in net income of subsidiaries	198,660	22,152	—	(220,812)	—
Net income	182,500	17,449	200,830	(221,634)	179,145
Net (income) loss attributable to noncontrolling interests (1)	—	—	3,355	—	3,355
Net income available to Arch	182,500	17,449	204,185	(221,634)	182,500
Preferred dividends	(5,484)	—	—	—	(5,484)
Net income available to Arch common shareholders	$177,016	$17,449	$204,185	$(221,634)	$177,016
Comprehensive income available to Arch	$231,255	$17,220	$252,119	$(269,339)	$231,255

(1) See Note 4.

Condensed Consolidating Statement of Income and Comprehensive Income	Three Months Ended March 31, 2013 ACGL (Parent Guarantor)	Arch-U.S. (Subsidiary Issuer)	Other ACGL Subsidiaries	Consolidating Adjustments and Eliminations	ACGL Consolidated
Revenues					
Net premiums earned	$—	$—	$752,770	$—	$752,770
Net investment income	—	—	72,322	(6,650)	65,672
Net realized gains	—	—	58,340	—	58,340
Net impairment losses recognized in earnings	—	—	(2,246)	—	(2,246)
Other underwriting income	—	—	538	—	538
Equity in net income of investment funds accounted for using the equity method	—	—	13,823	—	13,823
Other income	—	—	1,244	—	1,244
Total revenues	—	—	896,791	(6,650)	890,141
Expenses					
Losses and loss adjustment expenses	—	—	399,403	—	399,403
Acquisition expenses	—	—	127,592	—	127,592
Other operating expenses	9,942	777	109,464	—	120,183
Interest expense	5,820	3	6,725	(6,650)	5,898
Net foreign exchange (gains) losses	—	—	(12,772)	(11,492)	(24,264)
Total expenses	15,762	780	630,412	(18,142)	628,812
Income (loss) before income taxes	(15,762)	(780)	266,379	11,492	261,329
Income tax benefit (expense)	—	235	(5,088)	—	(4,853)
Income (loss) before equity in net income of subsidiaries	(15,762)	(545)	261,291	11,492	256,476
Equity in net income (loss) of subsidiaries	272,238	18,482	—	(290,720)	—
Net income	256,476	17,937	261,291	(279,228)	256,476
Net (income) loss attributable to noncontrolling interests	—	—	—	—	—
Net income available to Arch	256,476	17,937	261,291	(279,228)	256,476
Preferred dividends	(5,484)	—	—	—	(5,484)
Net income available to Arch common shareholders	$250,992	$17,937	$261,291	$(279,228)	$250,992
Comprehensive income available to Arch	$199,022	$6,152	$215,329	$(221,481)	$199,022

Condensed Consolidating Statement of Cash Flows	Three Months Ended March 31, 2014 ACGL (Parent Guarantor)	Arch-U.S. (Subsidiary Issuer)	Other ACGL Subsidiaries	Consolidating Adjustments and Eliminations	ACGL Consolidated
Operating Activities					
Net Cash Provided By Operating Activities	$11,685	$7,151	$194,833	$(15,500)	$198,169
Investing Activities					
Purchases of fixed maturity investments	—	—	(7,131,071)	—	(7,131,071)
Purchases of equity securities	—	—	(89,227)	—	(89,227)
Purchases of other investments	—	—	(304,454)	—	(304,454)
Proceeds from the sales of fixed maturity investments	—	—	7,014,281	—	7,014,281
Proceeds from the sales of equity securities	—	—	49,614	—	49,614
Proceeds from the sales of other investments	—	—	331,176	—	331,176
Proceeds from redemptions and maturities of fixed maturity investments	—	—	168,484	—	168,484
Net (purchases) sales of short-term investments	(16)	360,269	(203,991)	—	156,262
Change in investment of securities lending collateral	—	—	4,669	—	4,669
Contributions to subsidiaries	—	(312,207)	(100,000)	412,207	—
Intercompany loans issued	—	—	10,250	(10,250)	—
Purchase of business, net of cash acquired	—	—	(235,578)	—	(235,578)
Purchases of furniture, equipment and other assets	(76)	—	(5,306)	—	(5,382)
Net Cash Provided By (Used For) Investing Activities	(92)	48,062	(491,153)	401,957	(41,226)
Financing Activities					
Proceeds from common shares issued, net	3,021	—	412,207	(412,207)	3,021
Repayments of intercompany borrowings	—	(10,250)	—	10,250	—
Change in securities lending collateral	—	—	(4,669)	—	(4,669)
Third party investment in non-redeemable noncontrolling interests (1)	—	—	796,903	—	796,903
Third party investment in redeemable noncontrolling interests (1	—	—	186,893	—	186,893
Dividends paid to parent	—	—	(15,500)	15,500	—
Other	—	—	1,700	—	1,700
Preferred dividends paid	(5,484)	—	—	—	(5,484)
Net Cash Provided By (Used For) Financing Activities	(2,463)	(10,250)	1,377,534	(386,457	