

ARCH CAPITAL GROUP LTD.

Form 10-Q

May 08, 2015

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UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

WASHINGTON, D.C. 20549

FORM 10-Q

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

For the period ended March 31, 2015

Or

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

(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  No

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  No

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  Accelerated Filer  Non-accelerated Filer  Smaller reporting company

Indicate by check mark whether the Registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act).

Yes  No

As of May 5, 2015, there were 124,030,813 common shares, \$0.0033 par value per share, of the registrant outstanding.

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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 consolidated balance sheet of Arch Capital Group Ltd. and its subsidiaries (the “Company”) as of March 31, 2015, and the related consolidated statements of income and comprehensive income for the three-month periods ended March 31, 2015 and March 31, 2014, and the consolidated statements of changes in shareholders’ equity and cash flows for the three-month periods ended March 31, 2015 and March 31, 2014. 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 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, 2014, 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 February 27, 2015, 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, 2014, 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, New York  
May 8, 2015

Table of ContentsARCH CAPITAL GROUP LTD. AND SUBSIDIARIES  
CONSOLIDATED BALANCE SHEETS

(U.S. dollars in thousands, except share data)

|   | (Unaudited)<br>March 31,<br>2015 | December 31,<br>2014 |
|---|----------------------------------|----------------------|
| Assets  |                                  |                      |
| Investments:  |                                  |                      |
| Fixed maturities available for sale, at fair value (amortized cost: \$10,343,330 and \$10,701,557)            | \$ 10,427,810                    | \$ 10,750,770        |
| Short-term investments available for sale, at fair value (amortized cost: \$859,167 and \$801,758)            | 855,032                          | 797,226              |
| Investment of funds received under securities lending, at fair value (amortized cost: \$253,159 and \$40,473) | 257,059                          | 44,301               |
| Equity securities available for sale, at fair value (cost: \$578,520 and \$562,534)                           | 687,713                          | 658,182              |
| Other investments available for sale, at fair value (cost: \$292,287 and \$264,747)                           | 329,677                          | 296,224              |
| Investments accounted for using the fair value option   | 2,441,986                        | 2,435,532            |
| Investments accounted for using the equity method   | 412,367                          | 349,014              |
| Total investments   | 15,411,644                       | 15,331,249           |
| Cash  | 471,012                          | 485,702              |
| Accrued investment income   | 73,282                           | 74,316               |
| Investment in joint venture (cost: \$100,000)   | 90,724                           | 90,426               |
| Fixed maturities and short-term investments pledged under securities lending, at fair value                   | 253,115                          | 50,802               |
| Premiums receivable   | 1,116,389                        | 948,695              |
| Reinsurance recoverable on unpaid and paid losses and loss adjustment expenses                                | 1,788,619                        | 1,812,845            |
| Contractholder receivables  | 1,339,433                        | 1,309,192            |
| Prepaid reinsurance premiums  | 421,908                          | 377,078              |
| Deferred acquisition costs, net   | 442,775                          | 414,525              |
| Receivable for securities sold  | 400,113                          | 78,170               |
| Goodwill and intangible assets  | 106,745                          | 109,539              |
| Other assets  | 933,921                          | 927,004              |
| Total assets  | \$22,849,680                     | \$22,009,543         |
| Liabilities   |                                  |                      |
| Reserve for losses and loss adjustment expenses   | \$8,928,950                      | \$9,036,448          |
| Unearned premiums   | 2,400,834                        | 2,231,578            |
| Reinsurance balances payable  | 200,444                          | 219,312              |
| Contractholder payables   | 1,339,433                        | 1,309,192            |
| Deposit accounting liabilities  | 284,828                          | 327,384              |
| Senior notes  | 800,000                          | 800,000              |
| Revolving credit agreement borrowings   | 100,000                          | 100,000              |
| Securities lending payable  | 263,216                          | 50,529               |
| Payable for securities purchased  | 554,625                          | 128,413              |
| Other liabilities   | 679,450                          | 688,041              |
| Total liabilities   | 15,551,780                       | 14,890,897           |
| Commitments and Contingencies   |                                  |                      |

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|   |              |              |
|---|--------------|--------------|
| Redeemable noncontrolling interests   | 219,604      | 219,512      |
| Shareholders' Equity  |              |              |
| Non-cumulative preferred shares   | 325,000      | 325,000      |
| Common shares (\$0.0033 par, shares issued: 171,832,868 and 171,672,408)    | 573          | 572          |
| Additional paid-in capital  | 399,757      | 383,073      |
| Retained earnings   | 7,132,423    | 6,854,571    |
| Accumulated other comprehensive income, net of deferred income tax          | 158,023      | 128,856      |
| Common shares held in treasury, at cost (shares: 47,072,027 and 44,304,474) | (1,727,074 ) | (1,562,019 ) |
| Total shareholders' equity available to Arch                                | 6,288,702    | 6,130,053    |
| Non-redeemable noncontrolling interests                                     | 789,594      | 769,081      |
| Total shareholders' equity  | 7,078,296    | 6,899,134    |
| Total liabilities, noncontrolling interests and shareholders' equity        | \$22,849,680 | \$22,009,543 |

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,          |              |
|  | 2015               | 2014         |
| Revenues   |                    |              |
| Net premiums written   | \$ 1,066,995       | \$ 1,064,990 |
| Change in unearned premiums  | (156,731 )         | (205,210 )   |
| Net premiums earned  | 910,264            | 859,780      |
| Net investment income  | 78,994             | 66,994       |
| Net realized gains (losses)  | 83,348             | 19,697       |
| Other-than-temporary impairment losses   | (7,247 )           | (2,971 )     |
| Less investment impairments recognized in other comprehensive income, before taxes | 1,448              | —            |
| Net impairment losses recognized in earnings                                       | (5,799 )           | (2,971 )     |
| Other underwriting income  | 11,536             | 1,582        |
| Equity in net income of investment funds accounted for using the equity method     | 5,889              | 3,253        |
| Other income (loss)  | (1,888 )           | (2,104 )     |
| Total revenues   | 1,082,344          | 946,231      |
| Expenses   |                    |              |
| Losses and loss adjustment expenses  | 493,716            | 436,240      |
| Acquisition expenses   | 163,076            | 160,342      |
| Other operating expenses   | 157,882            | 145,799      |
| Interest expense   | 12,736             | 14,404       |
| Net foreign exchange (gains) losses  | (66,501 )          | 6,563        |
| Total expenses   | 760,909            | 763,348      |
| Income before income taxes   | 321,435            | 182,883      |
| Income tax expense   | (12,678 )          | (3,738 )     |
| Net income   | \$ 308,757         | \$ 179,145   |
| Amounts attributable to noncontrolling interests                                   | (25,421 )          | 3,355        |
| Net income available to Arch   | 283,336            | 182,500      |
| Preferred dividends  | (5,484 )           | (5,484 )     |
| Net income available to Arch common shareholders                                   | \$ 277,852         | \$ 177,016   |
| Net income per common share  |                    |              |
| Basic  | \$ 2.24            | \$ 1.34      |
| Diluted  | \$ 2.16            | \$ 1.30      |
| Weighted average common shares and common share equivalents outstanding            |                    |              |
| Basic  | 124,209,276        | 131,857,910  |
| Diluted  | 128,451,054        | 136,562,717  |

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,          |             |
|  | 2015               | 2014        |
| Comprehensive Income   |                    |             |
| Net income   | \$308,757          | \$179,145   |
| Other comprehensive income (loss), net of deferred income tax  |                    |             |
| Unrealized appreciation (decline) in value of available-for-sale investments:  |                    |             |
| Unrealized holding gains (losses) arising during period  | 84,304             | 71,353      |
| Portion of other-than-temporary impairment losses recognized in other comprehensive income, net of deferred income tax | (1,448             | ) —         |
| Reclassification of net realized (gains) losses, net of income taxes, included in net income                           | (30,932            | ) (21,249 ) |
| Foreign currency translation adjustments   | (22,757            | ) (1,349 )  |
| Comprehensive income   | 337,924            | 227,900     |
| Amounts attributable to noncontrolling interests   | (25,421            | ) 3,355     |
| Comprehensive income available to Arch   | \$312,503          | \$231,255   |

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)<br>Three Months Ended<br>March 31, |              |
|--|--|--------------|
|  | 2015   | 2014         |
| Non-cumulative preferred shares  |  |              |
| Balance at beginning and end of period   | \$325,000                                      | \$325,000    |
| Common shares  |  |              |
| Balance at beginning of year   | 572  | 565          |
| Common shares issued, net  | 1  | 2            |
| Balance at end of period   | 573  | 567          |
| Additional paid-in capital   |  |              |
| Balance at beginning of year   | 383,073  | 299,517      |
| Common shares issued, net  | —  | —            |
| Exercise of stock options  | 3,368  | 8,054        |
| Amortization of share-based compensation   | 13,238   | 14,175       |
| Other  | 78   | (1,243 )     |
| Balance at end of period   | 399,757  | 320,503      |
| Retained earnings  |  |              |
| Balance at beginning of year   | 6,854,571                                      | 6,042,154    |
| Net income   | 308,757  | 179,145      |
| Amounts attributable to noncontrolling interests   | (25,421 )                                      | 3,355        |
| Preferred share dividends  | (5,484 )                                       | (5,484 )     |
| Balance at end of period   | 7,132,423                                      | 6,219,170    |
| Accumulated other comprehensive income   |  |              |
| Balance at beginning of year   | 128,856  | 74,964       |
| Unrealized appreciation in value of available-for-sale investments, net of deferred income tax:                        |  |              |
| Balance at beginning of year   | 161,598  | 80,692       |
| Unrealized holding gains (losses) arising during period, net of reclassification adjustment                            | 53,372   | 50,104       |
| Portion of other-than-temporary impairment losses recognized in other comprehensive income, net of deferred income tax | (1,448 )                                       | —            |
| Balance at end of period   | 213,522  | 130,796      |
| Foreign currency translation adjustments:  |  |              |
| Balance at beginning of year   | (32,742 )                                      | (5,728 )     |
| Foreign currency translation adjustments   | (22,757 )                                      | (1,349 )     |
| Balance at end of period   | (55,499 )                                      | (7,077 )     |
| Balance at end of period   | 158,023  | 123,719      |
| Common shares held in treasury, at cost  |  |              |
| Balance at beginning of year   | (1,562,019 )                                   | (1,094,704 ) |
| Shares repurchased for treasury  | (165,055 )                                     | (2,122 )     |

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|  |              |              |
|--|--------------|--------------|
| Balance at end of period                     | (1,727,074 ) | (1,096,826 ) |
| Total shareholders' equity available to Arch | 6,288,702    | 5,892,133    |
| Non-redeemable noncontrolling interests      | 789,594      | 793,496      |
| Total shareholders' equity                   | \$7,078,296  | \$6,685,629  |

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,          |              |
|   | 2015               | 2014         |
| Operating Activities  |                    |              |
| Net income  | \$308,757          | \$179,145    |
| Adjustments to reconcile net income to net cash provided by operating activities:                               |                    |              |
| Net realized gains  | (87,907            | ) (22,367    |
| Net impairment losses recognized in earnings  | 5,799              | 2,971        |
| Equity in net income or loss of investment funds accounted for using the equity method and other income or loss | (1,970             | ) 9,559      |
| Share-based compensation  | 13,238             | 14,175       |
| Changes in:   |                    |              |
| Reserve for losses and loss adjustment expenses, net of unpaid losses and loss adjustment expenses recoverable  | 54,327             | 10,326       |
| Unearned premiums, net of prepaid reinsurance premiums  | 156,731            | 205,210      |
| Premiums receivable   | (192,247           | ) (242,616   |
| Deferred acquisition costs, net   | (36,304            | ) (41,988    |
| Reinsurance balances payable  | (16,022            | ) 5,428      |
| Other liabilities   | (48,856            | ) 59,285     |
| Other items   | (70,085            | ) 19,041     |
| Net Cash Provided By Operating Activities   | 85,461             | 198,169      |
| Investing Activities  |                    |              |
| Purchases of fixed maturity investments   | (7,030,731         | ) (7,131,071 |
| Purchases of equity securities  | (125,863           | ) (89,227    |
| Purchases of other investments  | (685,497           | ) (304,454   |
| Proceeds from sales of fixed maturity investments   | 6,857,459          | 7,014,281    |
| Proceeds from sales of equity securities  | 125,906            | 49,614       |
| Proceeds from sales, redemptions and maturities of other investments  | 605,263            | 331,176      |
| Proceeds from redemptions and maturities of fixed maturity investments  | 272,657            | 168,484      |
| Net sales (purchases) of short-term investments   | 66,283             | 156,262      |
| Change in cash collateral related to securities lending   | (5,529             | ) 4,669      |
| Purchase of business, net of cash acquired  | (2,432             | ) (235,578   |
| Purchases of furniture, equipment and other assets  | (32,897            | ) (5,382     |
| Net Cash Provided By (Used For) Investing Activities  | 44,619             | (41,226      |
| Financing Activities  |                    |              |
| Purchases of common shares under share repurchase program   | (162,898           | ) —          |
| Proceeds from common shares issued, net   | (412               | ) 3,021      |
| Change in cash collateral related to securities lending   | 5,529              | (4,669       |
| Third party investment in non-redeemable noncontrolling interests   | —                  | 796,903      |
| Third party investment in redeemable noncontrolling interests   | —                  | 186,893      |
| Dividends paid to redeemable noncontrolling interests   | (4,816             | ) —          |
| Other   | 29,779             | 1,700        |
| Preferred dividends paid  | (5,484             | ) (5,484     |

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|   |           |             |
|---|-----------|-------------|
| Net Cash Provided By (Used For) Financing Activities      | (138,302  | ) 978,364   |
| Effects of exchange rate changes on foreign currency cash | (6,468    | ) 241       |
| Increase (decrease) in cash                               | (14,690   | ) 1,135,548 |
| Cash beginning of year                                    | 485,702   | 434,057     |
| Cash end of period  | \$471,012 | \$1,569,605 |
| Income taxes paid   | \$3,569   | \$1,600     |
| Interest paid   | \$511     | \$404       |

See Notes to Consolidated Financial Statements

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ARCH CAPITAL GROUP LTD. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)

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”). The Company’s consolidated financial statements include the results of Watford Holdings Ltd., the parent of Watford Re Ltd. (see Note 3).

The interim consolidated financial statements have been prepared in conformity with accounting principles generally accepted in the United States of America (“GAAP”). 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, 2014 (“2014 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. Recent Accounting Pronouncements

A new accounting standard issued in the 2014 second quarter will change the manner in which most companies recognize revenue. The standard requires that revenue reflect the transfer of goods or services to customers based on the consideration or payment the company expects to be entitled to in exchange for those goods or services; however, the standard does not change the accounting for insurance contracts or financial instruments. The new standard also requires enhanced disclosures about revenue. This accounting guidance is effective in the 2017 first quarter and may be applied on a full retrospective or modified retrospective approach. However, there is currently a proposal to defer the effective date by one year. The Company is assessing the impact the implementation of this standard will have on its consolidated financial statements.

A new accounting standard was issued in the 2015 first quarter providing targeted improvements to consolidation guidance for limited partnerships and other similarly structured entities. The new standard addresses instances where a reporting entity consolidates another entity when the reporting entity is simply acting on the behalf of others, amongst other related issues. While the standard is targeted, the application is relevant for all companies that are required to assess whether or not to consolidate certain entities. The standard is effective in the 2016 first quarter and early adoption is permitted. The Company is assessing the impact the implementation of this standard will have on its consolidated financial statements.

In April 2015, new accounting guidance was issued relating to the presentation of debt issuance costs in the balance sheet. The new guidance requires that those costs be presented in the balance sheet as a deduction to the carrying amount of the related debt rather than as a separate asset. The new guidance is effective in the 2016 first quarter and early adoption is permitted. The Company is assessing the impact the implementation of this standard will have on its consolidated financial statements.

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## ARCH CAPITAL GROUP LTD. AND SUBSIDIARIES

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)

## 3. Variable Interest Entity and Noncontrolling Interests

## Variable interest entity

On March 20, 2014, 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. Watford Holdings Ltd. is the parent of Watford Re Ltd., a multi-line Bermuda reinsurance company (together with Watford Holdings Ltd., "Watford Re"). Watford Re is considered a variable interest entity ("VIE") and the Company concluded that it is the primary beneficiary of Watford Re. As such, the results of Watford Re are included in the Company's consolidated financial statements.

The Company concluded that Watford Re represents a separate operating segment and provides the income statement and total investable assets, total assets and total liabilities of Watford Re within Note 5. At March 31, 2015, Watford Re's liabilities included unearned premiums of \$233.0 million and reserves for losses and loss adjustment expenses of \$109.4 million, some of which is related to transactions with the Company. During the 2015 first quarter, Watford Re generated \$69.9 million of cash provided by operating activities and \$22.9 million of cash provided by financing activities, partially offset by \$35.3 million of cash used for investing activities.

Because Watford Re is an independent company, the assets of Watford Re can be used only to settle obligations of Watford Re and Watford Re is solely responsible for its own liabilities and commitments. The Company's financial exposure to Watford Re is limited to its investment in Watford Re'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 Re's common equity attributable to third party investors in the shareholders' equity section of its consolidated balance sheets. The noncontrolling ownership in Watford Re's common shares was approximately 89% at March 31, 2015. The portion of Watford Re's income or loss attributable to third party investors is recorded in the consolidated statements of income in 'amounts attributable to noncontrolling interests.' The following table sets forth activity in the non-redeemable noncontrolling interests:

|  | Three Months Ended<br>March 31, |           |
|--|---------------------------------|-----------|
|  | 2015                            | 2014      |
| Balance, beginning of period                     | \$769,081                       | \$—       |
| Sale of shares to noncontrolling interests       | —                               | 796,903   |
| Amounts attributable to noncontrolling interests | 20,513                          | (3,407 )  |
| Balance, end of period                           | \$789,594                       | \$793,496 |

## 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. Third party investors own 100% of the Watford Preference Shares at March 31, 2015. Preferred dividends, including the accretion of the discount and issuance costs, are included in 'amounts attributable to noncontrolling interests' in the Company's consolidated statements of income.



The portion of Watford Re's income or loss attributable to third party investors is recorded in the consolidated statements of income in 'amounts attributable to noncontrolling interests.' During the 2015 first quarter, amounts attributable to noncontrolling interests of \$25.4 million reflected the net impact of amounts attributable to non-redeemable noncontrolling interests of \$20.5 million and amounts attributable to redeemable noncontrolling interests of \$4.9 million, as described above.

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## ARCH CAPITAL GROUP LTD. AND SUBSIDIARIES

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)

## 4. Earnings Per Common Share

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

|   | Three Months Ended<br>March 31, |             |
|---|---------------------------------|-------------|
|   | 2015                            | 2014        |
| Numerator:  |                                 |             |
| Net income  | \$308,757                       | \$179,145   |
| Amounts attributable to noncontrolling interests                                  | (25,421                         | ) 3,355     |
| Net income available to Arch  | 283,336                         | 182,500     |
| Preferred dividends   | (5,484                          | ) (5,484    |
| Net income available to Arch common shareholders                                  | \$277,852                       | \$177,016   |
| Denominator:  |                                 |             |
| Weighted average common shares outstanding — basic                                | 124,209,276                     | 131,857,910 |
| Effect of dilutive common share equivalents:                                      |                                 |             |
| Nonvested restricted shares   | 1,416,801                       | 1,346,401   |
| Stock options (1)   | 2,824,977                       | 3,358,406   |
| Weighted average common shares and common share equivalents outstanding — diluted | 128,451,054                     | 136,562,717 |
| Earnings per common share:  |                                 |             |
| Basic   | \$2.24                          | \$1.34      |
| Diluted   | \$2.16                          | \$1.30      |

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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 (1) 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 2015 first quarter and 2014 first quarter, the number of stock options excluded were 703,853 and 759,172, respectively.

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ARCH CAPITAL GROUP LTD. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)

5. Segment Information

The Company 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, with the exception of goodwill and intangible assets, and, accordingly, investment income is not allocated to each underwriting segment.

The insurance segment consists of the Company’s insurance underwriting units which offer specialty product lines on a worldwide basis. Product lines include: construction and national accounts; excess and surplus casualty; lenders products; professional lines; programs; property, energy, marine and aviation; travel, accident and health; and other (consisting of alternative markets, excess workers' compensation and surety business).

The reinsurance segment consists of the Company’s reinsurance underwriting units which offer specialty product lines on a worldwide basis. Product lines include: casualty; marine and aviation; other specialty; property catastrophe; property excluding property catastrophe (losses on a single risk, both excess of loss and pro rata); and other (consisting of life reinsurance, casualty clash and other).

The mortgage segment consists of the Company’s mortgage insurance and reinsurance business and includes the results of Arch Mortgage Insurance Company (“Arch MI U.S.”). Arch MI U.S. is approved as an eligible mortgage insurer by Federal National Mortgage Association and Federal Home Loan Mortgage Corporation (each a government sponsored enterprise, or “GSE”) and provides mortgage insurance to banks, credit unions and other lenders nationwide. The mortgage segment also provides reinsurance on a global basis, direct mortgage insurance in Europe and various risk-sharing products to government agencies and mortgage lenders.

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 Re (see Note 3). Watford Re 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.



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## ARCH CAPITAL GROUP LTD. AND SUBSIDIARIES

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)

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 |             |           |             |           |        | Total       |
|--|--------------------|-------------|-----------|-------------|-----------|--------|-------------|
|  | March 31, 2015     |             |           |             |           |        |             |
|  | Insurance          | Reinsurance | Mortgage  | Sub-Total   | Other     |        |             |
| Gross premiums written (1)   | \$766,153          | \$485,112   | \$60,541  | \$1,311,678 | \$128,633 |        | \$1,342,022 |
| Premiums ceded   | (224,150 )         | (136,569 )  | (8,670 )  | (369,261 )  | (4,055 )  |        | (275,027 )  |
| Net premiums written   | 542,003            | 348,543     | 51,871    | 942,417     | 124,578   |        | 1,066,995   |
| Change in unearned premiums  | (34,089 )          | (68,826 )   | (1,504 )  | (104,419 )  | (52,312 ) |        | (156,731 )  |
| Net premiums earned  | 507,914            | 279,717     | 50,367    | 837,998     | 72,266    |        | 910,264     |
| Other underwriting income  | 427                | 1,429       | 7,718     | 9,574       | 1,962     |        | 11,536      |
| Losses and loss adjustment expenses  | (317,896 )         | (112,532 )  | (13,809 ) | (444,237 )  | (49,479 ) |        | (493,716 )  |
| Acquisition expenses, net  | (75,078 )          | (56,604 )   | (10,418 ) | (142,100 )  | (20,976 ) |        | (163,076 )  |
| Other operating expenses   | (88,119 )          | (38,044 )   | (20,369 ) | (146,532 )  | (2,005 )  |        | (148,537 )  |
| Underwriting income (loss)   | \$27,248           | \$73,966    | \$13,489  | 114,703     | 1,768     |        | 116,471     |
| Net investment income  |                    |             |           | 70,288      | 8,706     |        | 78,994      |
| Net realized gains (losses)  |                    |             |           | 65,509      | 17,839    |        | 83,348      |
| Net impairment losses recognized in earnings                                   |                    |             |           | (5,799 )    | —         |        | (5,799 )    |
| Equity in net income of investment funds accounted for using the equity method |                    |             |           | 5,889       | —         |        | 5,889       |
| Other income (loss)  |                    |             |           | (1,888 )    | —         |        | (1,888 )    |
| Other expenses   |                    |             |           | (9,345 )    | —         |        | (9,345 )    |
| Interest expense   |                    |             |           | (12,736 )   | —         |        | (12,736 )   |
| Net foreign exchange gains (losses)  |                    |             |           | 66,853      | (352 )    |        | 66,501      |
| Income before income taxes   |                    |             |           | 293,474     | 27,961    |        | 321,435     |
| Income tax expense   |                    |             |           | (12,678 )   | —         |        | (12,678 )   |
| Net income   |                    |             |           | 280,796     | 27,961    |        | 308,757     |
| Dividends attributable to redeemable noncontrolling interests                  |                    |             |           | —           | (4,908 )  |        | (4,908 )    |
| Amounts attributable to noncontrolling interests                               |                    |             |           | —           | (20,513 ) |        | (20,513 )   |
| Net income available to Arch   |                    |             |           | 280,796     | 2,540     |        | 283,336     |
| Preferred dividends  |                    |             |           | (5,484 )    | —         |        | (5,484 )    |
| Net income available to Arch common shareholders                               |                    |             |           | \$275,312   | \$2,540   |        | \$277,852   |
| <b>Underwriting Ratios</b>   |                    |             |           |             |           |        |             |
| Loss ratio   | 62.6               | % 40.2      | % 27.4    | % 53.0      | % 68.5    | % 54.2 | %           |
| Acquisition expense ratio  | 14.8               | % 20.2      | % 20.7    | % 17.0      | % 29.0    | % 17.9 | %           |

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|                                |          |         |          |              |             |              |   |
|--------------------------------|----------|---------|----------|--------------|-------------|--------------|---|
| Other operating expense ratio  | 17.3     | % 13.6  | % 40.4   | % 17.5       | % 2.8       | % 16.3       | % |
| Combined ratio                 | 94.7     | % 74.0  | % 88.5   | % 87.5       | % 100.3     | % 88.4       | % |
| Goodwill and intangible assets | \$30,526 | \$2,687 | \$73,532 | \$106,745    | \$—         | \$106,745    |   |
| Total investable assets        |          |         |          | \$14,456,612 | \$1,267,588 | \$15,724,200 |   |
| Total assets                   |          |         |          | 21,227,143   | 1,622,537   | 22,849,680   |   |
| Total liabilities              |          |         |          | 15,036,245   | 515,535     | 15,551,780   |   |

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Certain amounts included in the gross premiums written of each segment are related to intersegment transactions. (1) 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.

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## ARCH CAPITAL GROUP LTD. AND SUBSIDIARIES

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)

|  | Three Months Ended<br>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  | \$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 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   |                                      |             |           | 182,849     | (3,704 )  | 179,145     |   |
| Dividends attributable to redeemable noncontrolling interests                  |                                      |             |           | —           | (52 )     | (52 )       |   |
| Amounts attributable to noncontrolling interests                               |                                      |             |           | —           | 3,407     | 3,407       |   |
| Net income available to Arch Preferred dividends                               |                                      |             |           | 182,849     | (349 )    | 182,500     |   |
| Net income available to Arch common shareholders                               |                                      |             |           | (5,484 )    | —         | (5,484 )    |   |
|  |                                      |             |           | \$177,365   | \$(349 )  | \$177,016   |   |
| <b>Underwriting Ratios</b>   |                                      |             |           |             |           |             |   |
| Loss ratio   | 60.1                                 | % 40.9      | % 21.9    | % 50.7      | % 62.6    | % 50.7      | % |
| Acquisition expense ratio  | 16.1                                 | % 21.5      | % 23.6    | % 18.6      | % 38.0    | % 18.6      | % |
| Other operating expense ratio  | 17.0                                 | % 10.6      | % 35.8    | % 15.3      | % 51.2    | % 15.4      | % |
| Combined ratio   | 93.2                                 | % 73.0      | % 81.3    | % 84.6      | % 151.8   | % 84.7      | % |
| Goodwill and intangible assets   | \$20,184                             | \$5,803     | \$94,888  | \$120,875   | \$—       | \$120,875   |   |

|                         |              |             |              |
|-------------------------|--------------|-------------|--------------|
| 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   |

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Certain amounts included in the gross premiums written of each segment are related to intersegment transactions.  
(1) 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.



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## ARCH CAPITAL GROUP LTD. AND SUBSIDIARIES

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)

## 6. Investment Information

At March 31, 2015, total investable assets of \$15.72 billion included \$14.46 billion managed by the Company and \$1.27 billion attributable to Watford Re.

## 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:

|  | Estimated<br>Fair<br>Value | Gross<br>Unrealized<br>Gains | Gross<br>Unrealized<br>Losses | Cost or<br>Amortized<br>Cost | OTTI<br>Unrealized<br>Losses (2) |
|--|----------------------------|------------------------------|-------------------------------|------------------------------|----------------------------------|
| March 31, 2015   |                            |                              |                               |                              |                                  |
| Fixed maturities and fixed maturities pledged under securities lending agreements (1): |                            |                              |                               |                              |                                  |
| Corporate bonds  | \$3,119,437                | \$62,922                     | \$(46,982)                    | ) \$3,103,497                | \$(1,143)                        |
| Mortgage backed securities   | 821,611                    | 20,996                       | (2,065)                       | ) 802,680                    | (3,557)                          |
| Municipal bonds  | 1,626,580                  | 33,377                       | (2,013)                       | ) 1,595,216                  | —                                |
| Commercial mortgage backed securities  | 1,106,332                  | 23,083                       | (2,497)                       | ) 1,085,746                  | —                                |
| U.S. government and government agencies  | 1,517,834                  | 16,821                       | (776)                         | ) 1,501,789                  | —                                |
| Non-U.S. government securities   | 831,200                    | 23,118                       | (52,685)                      | ) 860,767                    | —                                |
| Asset backed securities  | 1,657,931                  | 14,080                       | (3,563)                       | ) 1,647,414                  | (22)                             |
| Total  | 10,680,925                 | 194,397                      | (110,581)                     | ) 10,597,109                 | (4,722)                          |
| Equity securities  | 687,713                    | 121,660                      | (12,467)                      | ) 578,520                    | —                                |
| Other investments  | 329,677                    | 37,964                       | (574)                         | ) 292,287                    | (165)                            |
| Short-term investments   | 855,032                    | 16                           | (4,151)                       | ) 859,167                    | —                                |
| Total  | \$12,553,347               | \$354,037                    | \$(127,773)                   | ) \$12,327,083               | \$(4,887)                        |
| December 31, 2014  |                            |                              |                               |                              |                                  |
| Fixed maturities and fixed maturities pledged under securities lending agreements (1): |                            |                              |                               |                              |                                  |
| Corporate bonds  | \$3,108,513                | \$37,928                     | \$(38,974)                    | ) \$3,109,559                | \$(317)                          |
| Mortgage backed securities   | 943,343                    | 18,843                       | (3,842)                       | ) 928,342                    | (3,307)                          |
| Municipal bonds  | 1,494,122                  | 31,227                       | (1,044)                       | ) 1,463,939                  | —                                |
| Commercial mortgage backed securities  | 1,114,528                  | 14,594                       | (3,822)                       | ) 1,103,756                  | —                                |
| U.S. government and government agencies  | 1,447,972                  | 8,345                        | (1,760)                       | ) 1,441,387                  | —                                |
| Non-U.S. government securities   | 1,015,153                  | 21,311                       | (37,203)                      | ) 1,031,045                  | —                                |
| Asset backed securities  | 1,677,941                  | 8,425                        | (6,089)                       | ) 1,675,605                  | (22)                             |
| Total  | 10,801,572                 | 140,673                      | (92,734)                      | ) 10,753,633                 | (3,646)                          |
| Equity securities  | 658,182                    | 109,012                      | (13,364)                      | ) 562,534                    | —                                |
| Other investments  | 296,224                    | 31,839                       | (362)                         | ) 264,747                    | —                                |

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|                        |              |           |            |   |              |            |
|------------------------|--------------|-----------|------------|---|--------------|------------|
| Short-term investments | 797,226      | 738       | (5,270     | ) | 801,758      | —          |
| Total                  | \$12,553,204 | \$282,262 | \$(111,730 | ) | \$12,382,672 | \$(3,646 ) |

(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, 2015, the net unrealized loss related to securities for which a non-credit OTTI was recognized in AOCI was \$0.3 million, compared to a net unrealized gain of \$0.9 million at December 31, 2014.

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## ARCH CAPITAL GROUP LTD. AND SUBSIDIARIES

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)

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                |                         |
|--|----------------------|-------------------------|----------------------|-------------------------|----------------------|-------------------------|
|  | Estimated Fair Value | Gross Unrealized Losses | Estimated Fair Value | Gross Unrealized Losses | Estimated Fair Value | Gross Unrealized Losses |
| March 31, 2015   |                      |                         |                      |                         |                      |                         |
| Fixed maturities and fixed maturities pledged under securities lending agreements (1): |                      |                         |                      |                         |                      |                         |
| Corporate bonds  | \$810,064            | \$(40,337)              | \$60,249             | \$(6,645)               | \$870,313            | \$(46,982)              |
| Mortgage backed securities   | 142,833              | (1,333)                 | 29,939               | (732)                   | 172,772              | (2,065)                 |
| Municipal bonds  | 241,211              | (1,494)                 | 13,573               | (519)                   | 254,784              | (2,013)                 |
| Commercial mortgage backed securities  | 194,085              | (2,375)                 | 30,774               | (122)                   | 224,859              | (2,497)                 |
| U.S. government and government agencies  | 148,004              | (776)                   | —                    | —                       | 148,004              | (776)                   |
| Non-U.S. government securities   | 376,737              | (43,321)                | 38,091               | (9,364)                 | 414,828              | (52,685)                |
| Asset backed securities  | 331,543              | (2,072)                 | 157,748              | (1,491)                 | 489,291              | (3,563)                 |
| Total  | 2,244,477            | (91,708)                | 330,374              | (18,873)                | 2,574,851            | (110,581)               |
| Equity securities  | 226,711              | (12,467)                | —                    | —                       | 226,711              | (12,467)                |
| Other investments  | 128,867              | (574)                   | —                    | —                       | 128,867              | (574)                   |
| Short-term investments   | 55,615               | (4,151)                 | —                    | —                       | 55,615               | (4,151)                 |
| Total  | \$2,655,670          | \$(108,900)             | \$330,374            | \$(18,873)              | \$2,986,044          | \$(127,773)             |
| December 31, 2014  |                      |                         |                      |                         |                      |                         |
| Fixed maturities and fixed maturities pledged under securities lending agreements (1): |                      |                         |                      |                         |                      |                         |
| Corporate bonds  | \$1,309,637          | \$(32,903)              | \$148,963            | \$(6,071)               | \$1,458,600          | \$(38,974)              |
| Mortgage backed securities   | 293,624              | (1,476)                 | 59,107               | (2,366)                 | 352,731              | (3,842)                 |
| Municipal bonds  | 210,614              | (588)                   | 13,643               | (456)                   | 224,257              | (1,044)                 |
| Commercial mortgage backed securities  | 232,147              | (770)                   | 125,894              | (3,052)                 | 358,041              | (3,822)                 |
| U.S. government and government agencies  | 618,381              | (1,626)                 | 3,438                | (134)                   | 621,819              | (1,760)                 |
| Non-U.S. government securities   | 510,766              | (31,172)                | 46,910               | (6,031)                 | 557,676              | (37,203)                |
| Asset backed securities  | 612,950              | (2,486)                 | 243,452              | (3,603)                 | 856,402              | (6,089)                 |
| Total  | 3,788,119            | (71,021)                | 641,407              | (21,713)                | 4,429,526            | (92,734)                |
| Equity securities  | 181,002              | (13,364)                | —                    | —                       | 181,002              | (13,364)                |
| Other investments  | 59,638               | (362)                   | —                    | —                       | 59,638               | (362)                   |

|                        |             |           |             |           |               |            |   |
|------------------------|-------------|-----------|-------------|-----------|---------------|------------|---|
| Short-term investments | 79,271      | (5,270    | ) —         | —         | 79,271        | (5,270     | ) |
| Total                  | \$4,108,030 | \$(90,017 | ) \$641,407 | \$(21,713 | ) \$4,749,437 | \$(111,730 | ) |

(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, 2015, on a lot level basis, approximately 1,360 security lots out of a total of approximately 5,130 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 \$3.3 million. At December 31, 2014, on a lot level basis, approximately 1,900 security lots out of a total of approximately 4,790 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 \$2.9 million.

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## ARCH CAPITAL GROUP LTD. AND SUBSIDIARIES

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)

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.

| Maturity                              | March 31, 2015       |                | December 31, 2014    |                |
|---------------------------------------|----------------------|----------------|----------------------|----------------|
|                                       | Estimated Fair Value | Amortized Cost | Estimated Fair Value | Amortized Cost |
| Due in one year or less               | \$267,975            | \$268,219      | \$235,930            | \$233,794      |
| Due after one year through five years | 3,824,832            | 3,819,036      | 4,074,562            | 4,077,408      |
| Due after five years through 10 years | 2,651,327            | 2,630,130      | 2,475,726            | 2,461,356      |
| Due after 10 years                    | 350,917              | 343,884        | 279,542              | 273,372        |
|                                       | 7,095,051            | 7,061,269      | 7,065,760            | 7,045,930      |
| Mortgage backed securities            | 821,611              | 802,680        | 943,343              | 928,342        |
| Commercial mortgage backed securities | 1,106,332            | 1,085,746      | 1,114,528            | 1,103,756      |
| Asset backed securities               | 1,657,931            | 1,647,414      | 1,677,941            | 1,675,605      |
| Total                                 | \$10,680,925         | \$10,597,109   | \$10,801,572         | \$10,753,633   |

## 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 \$253.1 million and \$253.8 million, respectively, at March 31, 2015, compared to \$50.8 million and \$52.1 million, respectively, at December 31, 2014. At March 31, 2015, the fair value of the cash collateral received on securities lending was \$49.9 million and the fair value of non-cash collateral received was \$207.2 million. At December 31, 2014, the fair value of the cash collateral received on securities lending was \$44.3 million and the fair value of non-cash collateral received was nil. Such amounts included approximately \$5.7 million of sub-prime securities at March 31, 2015, compared to \$5.8 million at December 31, 2014. 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, 2015 | December 31, 2014 |
|--|----------------|-------------------|
| Available for sale:  |                |                   |
| Asian and emerging markets                                     | \$270,087      | \$236,586         |
| Investment grade fixed income                                  | 59,590         | 59,638            |
| Total available for sale                                       | 329,677        | 296,224           |
| Fair value option:   |                |                   |
| Term loan investments (par value: \$1,055,264 and \$1,094,337) | 1,044,762      | 1,073,649         |
| Mezzanine debt funds   | 121,570        | 121,341           |

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|                               |             |              |
|-------------------------------|-------------|--------------|
| Credit related funds          | 138,576     | 114,436      |
| Investment grade fixed income | 63,162      | 69,108       |
| Asian and emerging markets    | 26,846      | 25,800       |
| Other (1)                     | 162,908     | 147,573      |
| Total fair value option       | 1,557,824   | 1,551,907    |
| Total                         | \$1,887,501 | \$ 1,848,131 |

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(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

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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,<br>2015 | December 31,<br>2014 |
|---|-------------------|----------------------|
| Fixed maturities                                      | \$757,467         | \$ 632,024           |
| Other investments                                     | 1,557,824         | 1,551,907            |
| Short-term investments                                | 125,788           | 251,601              |
| Equity securities                                     | 907               | —                    |
| Investments accounted for using the fair value option | \$2,441,986       | \$ 2,435,532         |

## Net Investment Income

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

|                               | Three Months Ended<br>March 31, |          |
|-------------------------------|---------------------------------|----------|
|                               | 2015                            | 2014     |
| Fixed maturities              | \$68,596                        | \$62,449 |
| Term loan investments         | 14,744                          | 5,669    |
| Equity securities (dividends) | 2,679                           | 2,921    |
| Short-term investments        | 196                             | 405      |
| Other (1)                     | 12,747                          | 4,719    |
| Gross investment income       | 98,962                          | 76,163   |
| Investment expenses           | (19,968                         | ) (9,169 |
| Net investment income         | \$78,994                        | \$66,994 |

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

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## Net Realized Gains (Losses)

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

|   | Three Months Ended<br>March 31, |           |
|---|---------------------------------|-----------|
|   | 2015                            | 2014      |
| Available for sale securities:  |                                 |           |
| Gross gains on investment sales   | \$97,591                        | \$66,051  |
| Gross losses on investment sales  | (55,160 )                       | (40,013 ) |
| Change in fair value of assets and liabilities accounted for using the fair value option: |                                 |           |
| Fixed maturities  | (3,302 )                        | (1,643 )  |
| Other investments   | 6,287                           | 10,776    |
| Equity securities   | (2 )                            | —         |
| Short-term investments  | 5,846                           | —         |
| Derivative instruments (1)  | 36,676                          | (12,768 ) |
| Other (2)   | (4,588 )                        | (2,706 )  |
| Net realized gains (losses)   | \$83,348                        | \$19,697  |

(1) See Note 8 for information on the Company's derivative instruments.

(2) Includes accretion of contingent consideration liability amounts related to the 2014 acquisition of CMG Mortgage Insurance Company and its affiliated mortgage insurance companies.

## 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<br>March 31, |            |
|--|---------------------------------|------------|
|  | 2015                            | 2014       |
| Fixed maturities:                            |                                 |            |
| Mortgage backed securities                   | \$(1,072 )                      | \$—        |
| Corporate bonds                              | (1,976 )                        | —          |
| Asset backed securities                      | —                               | (6 )       |
| Total  | (3,048 )                        | (6 )       |
| Short-term investments                       | (2,341 )                        | —          |
| Equity securities                            | (129 )                          | —          |
| Other investments                            | (281 )                          | (2,965 )   |
| Net impairment losses recognized in earnings | \$(5,799 )                      | \$(2,971 ) |

A description of the methodology and significant inputs used to measure the amount of net impairment losses recognized in earnings 2015 first quarter is as follows:

Short-term investments — net impairment losses for the 2015 first quarter related to a reduction in the carrying value of a Euro-denominated investment in an unrealized loss position due to the decline of the Euro against the U.S. Dollar. Due to the short time to maturity, the Company recorded an OTTI on such security;



Corporate bonds — the Company reviewed the business prospects, credit ratings, estimated loss given default factors and information received from asset managers and rating agencies for certain corporate bonds. The amortized cost basis of the corporate bonds were adjusted down, if required, to the expected recovery value calculated in the OTTI review process;

Mortgage backed securities — the Company utilized underlying data provided by asset managers, cash flow projections and additional information from credit agencies in order to determine an expected recovery value for each security. The analysis includes expected cash flow projections under base case and stress case scenarios

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## ARCH CAPITAL GROUP LTD. AND SUBSIDIARIES

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which modify the expected default expectations and loss severities and slow down prepayment assumptions. The significant inputs in the models include the expected default rates, delinquency rates and foreclosure costs. Net impairment losses for the 2015 first quarter primarily resulted from a revised analysis of prepayment assumptions on one interest only mortgage backed security and small adjustments in other holdings. The amortized cost basis of the mortgage backed securities were adjusted down, if required, to the expected recovery value calculated in the OTTI review process.

The Company believes that the \$4.9 million of OTTI included in accumulated other comprehensive income at March 31, 2015 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, 2015, 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,          |           |
|   | 2015               | 2014      |
| Balance at start of period  | \$20,196           | \$60,062  |
| Credit loss impairments recognized on securities not previously impaired  | 4,489              | —         |
| Credit loss impairments recognized on securities previously impaired  | 79                 | 6         |
| 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  | (420               | ) (12,812 |
| Balance at end of period  | \$24,344           | \$47,256  |

## 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 9 for further details. The following table details the value of the Company's restricted assets:

|   | March 31,<br>2015 | December 31,<br>2014 |
|---|-------------------|----------------------|
| Assets used for collateral or guarantees: |                   |                      |
| Affiliated transactions                   | \$4,054,848       | \$ 4,138,527         |
| Third party agreements                    | 1,010,214         | 970,120              |
| Deposits with U.S. regulatory authorities | 407,190           | 337,981              |
| Trust funds                               | 64,673            | 72,461               |
| Total restricted assets                   | \$5,536,925       | \$ 5,519,089         |

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7. 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, 2015.

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 \$15.06 billion of financial assets and liabilities measured at fair value at March 31, 2015, approximately \$241.0 million, or 1.6%, were priced using non-binding broker-dealer quotes. Of the \$15.05 billion of financial assets and liabilities measured at fair value at December 31, 2014, approximately \$260.8 million, or 1.7%, were priced using non-binding broker-dealer quotes.

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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. The Company determined that certain corporate bonds and asset backed securities for which there is a low level of transparency around inputs to the valuation process should be classified within Level 3 of the valuation hierarchy.

**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. Other investments also include term loan investments for which fair values are estimated by using quoted prices of term loan investments with similar characteristics, pricing models or matrix pricing. Such investments are generally classified as Level 2 securities.

**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 CMG Mortgage Insurance Company and its affiliated mortgage insurance companies 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.



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## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)

The following table presents the Company's financial assets and liabilities measured at fair value by level at March 31, 2015:

|  | Estimated<br>Fair<br>Value | Estimated Fair Value Measurement Using:  |  |  |
|--|----------------------------|--|--|--|
|  |                            | Quoted Prices in Significant<br>Active Markets<br>for Identical<br>Assets<br>(Level 1) | Other<br>Observable<br>Inputs<br>(Level 2) | Significant<br>Unobservable<br>Inputs<br>(Level 3) |
| Assets measured at fair value:   |                            |  |  |  |
| Available for sale securities:   |                            |  |  |  |
| Fixed maturities and fixed maturities pledged under securities lending agreements (1): |                            |  |  |  |
| Corporate bonds  | \$3,119,437                | \$—  | \$3,119,437                                | \$—  |
| Mortgage backed securities   | 821,611                    | —  | 821,611                                    | —  |
| Municipal bonds  | 1,626,580                  | —  | 1,626,580                                  | —  |
| Commercial mortgage backed securities  | 1,106,332                  | —  | 1,106,332                                  | —  |
| U.S. government and government agencies  | 1,517,834                  | 1,517,834  | —  | —  |
| Non-U.S. government securities   | 831,200                    | —  | 831,200                                    | —  |
| Asset backed securities  | 1,657,931                  | —  | 1,600,431                                  | 57,500   |
| Total  | 10,680,925                 | 1,517,834  | 9,105,591                                  | 57,500   |
| Equity securities  | 687,713                    | 685,714  | 1,999                                      | —  |
| Other investments  | 329,677                    | —  | 201,943                                    | 127,734  |
| Short-term investments   | 855,032                    | 835,065  | 19,967                                     | —  |
| Fair value option:   |                            |  |  |  |
| Corporate bonds  | 636,762                    | —  | 636,762                                    | —  |
| Non-U.S. government bonds  | 77,903                     | —  | 77,903                                     | —  |
| Mortgage backed securities   | 18,010                     | —  | 18,010                                     | —  |
| Asset backed securities  | 24,792                     | —  | 24,792                                     | —  |
| Other investments  | 1,557,824                  | —  | 1,088,930                                  | 468,894  |
| Short-term investments   | 125,788                    | 125,788  | —  | —  |
| Equity securities  | 907                        | 907  | —  | —  |
| Total  | 2,441,986                  | 126,695  | 1,846,397                                  | 468,894  |
| Total assets measured at fair value  | \$14,995,333               | \$3,165,308  | \$11,175,897                               | \$654,128  |
| Liabilities measured at fair value:  |                            |  |  |  |
| Contingent consideration liability   | \$(66,461)                 | ) \$—  | \$—  | \$(66,461)   |
| Total liabilities measured at fair value   | \$(66,461)                 | ) \$—  | \$—  | \$(66,461)   |

In securities lending transactions, the Company receives collateral in excess of the fair value of the fixed maturities (1) 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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## ARCH CAPITAL GROUP LTD. AND SUBSIDIARIES

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

|  | Estimated<br>Fair<br>Value | Estimated Fair Value Measurement Using:  |  |  |
|--|----------------------------|--|--|--|
|  |                            | Quoted Prices in Significant<br>Active Markets<br>for Identical<br>Assets<br>(Level 1) | Other<br>Observable<br>Inputs<br>(Level 2) | Significant<br>Unobservable<br>Inputs<br>(Level 3) |
| Assets measured at fair value:   |                            |  |  |  |
| Available for sale securities:   |                            |  |  |  |
| Fixed maturities and fixed maturities pledged under securities lending agreements (1): |                            |  |  |  |
| Corporate bonds  | \$3,108,513                | \$—  | \$3,108,513                                | \$—  |
| Mortgage backed securities   | 943,343                    | —  | 943,343                                    | —  |
| Municipal bonds  | 1,494,122                  | —  | 1,494,122                                  | —  |
| Commercial mortgage backed securities  | 1,114,528                  | —  | 1,114,528                                  | —  |
| U.S. government and government agencies  | 1,447,972                  | 1,447,972  | —  | —  |
| Non-U.S. government securities   | 1,015,153                  | —  | 1,015,153                                  | —  |
| Asset backed securities  | 1,677,941                  | —  | 1,620,441                                  | 57,500   |
| Total  | 10,801,572                 | 1,447,972  | 9,296,100                                  | 57,500   |
| Equity securities  | 658,182                    | 658,182  | —  | —  |
| Other investments  | 296,224                    | —  | 192,687                                    | 103,537  |
| Short-term investments   | 797,226                    | 759,621  | 37,605                                     | —  |
| Fair value option:   |                            |  |  |  |
| Corporate bonds  | 497,101                    | —  | 497,101                                    | —  |
| Non-U.S. government bonds  | 88,411                     | —  | 88,411                                     | —  |
| Mortgage backed securities   | 22,190                     | —  | 22,190                                     | —  |
| Asset backed securities  | 24,322                     | —  | 24,322                                     | —  |
| Other investments  | 1,551,907                  | —  | 1,085,557                                  | 466,350  |
| Short-term investments   | 251,601                    | 250,580  | 1,021                                      | —  |
| Total  | 2,435,532                  | 250,580  | 1,718,602                                  | 466,350  |
| Total assets measured at fair value  | \$14,988,736               | \$3,116,355  | \$11,244,994                               | \$627,387  |
| Liabilities measured at fair value:  |                            |  |  |  |
| Fair value option:   |                            |  |  |  |
| Contingent consideration liability   | \$(61,845                  | ) \$—  | \$—  | \$(61,845 )  |
| Total liabilities measured at fair value   | \$(61,845                  | ) \$—  | \$—  | \$(61,845 )  |

In securities lending transactions, the Company receives collateral in excess of the fair value of the fixed maturities (1) 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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## ARCH CAPITAL GROUP LTD. AND SUBSIDIARIES

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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:

Estimated Fair Value Measurements Using:  
Significant Unobservable Inputs (Level 3)

| s   | Assets                  |                 |                   |                   |           | Liabilities                        |
|---|-------------------------|-----------------|-------------------|-------------------|-----------|------------------------------------|
|   | Available-For-Sale      |                 |                   | Fair Value Option |           | Contingent Consideration Liability |
|   | Asset Backed Securities | Corporate Bonds | Other Investments | Other Investments | Total     |                                    |
| <b>Three Months Ended March 31, 2015</b>      |                         |                 |                   |                   |           |                                    |
| Balance at beginning of period                | \$57,500                | \$—             | \$103,537         | \$466,350         | \$627,387 | \$ (61,845 )                       |
| Total gains or (losses) (realized/unrealized) |                         |                 |                   |                   |           |                                    |
| Included in earnings (1)                      | —                       | —               | (281 )            | (851 )            | (1,132 )  | (3,548 )                           |
| Included in other comprehensive income        | —                       | —               | (522 )            | —                 | (522 )    | —                                  |
| Purchases, issuances, sales and settlements   |                         |                 |                   |                   |           |                                    |
| Purchases                                     | —                       | —               | 25,000            | 22,925            | 47,925    | —                                  |
| Issuances                                     | —                       | —               | —                 | —                 | —         | (1,068 )                           |
| Sales   | —                       | —               | —                 | —                 | —         | —                                  |
| Settlements                                   | —                       | —               | —                 | (19,530 )         | (19,530 ) | —                                  |
| Transfers in and/or out of Level 3            | —                       | —               | —                 | —                 | —         | —                                  |
| Balance at end of period                      | \$57,500                | \$—             | \$127,734         | \$468,894         | \$654,128 | \$ (66,461 )                       |
| <b>Three Months Ended March 31, 2014</b>      |                         |                 |                   |                   |           |                                    |
| 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 )                       |

Gains or losses on corporate bonds were included in net realized gains (losses) while gains or losses on other (1) 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 losses for the 2015 first quarter included in earnings attributable to the change in unrealized gains or losses relating to assets still held at March 31, 2015 was \$1.1 million. 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.

#### 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, 2015, 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, 2015, the senior notes of ACGL were carried at their cost of \$300.0 million and had a fair value of \$410.5 million while the senior notes of Arch-U.S. were carried at their cost of \$500.0 million and had a fair value of \$559.1 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.

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## ARCH CAPITAL GROUP LTD. AND SUBSIDIARIES

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)

## 8. 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 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 investments are managed in portfolios which incorporate the use of foreign currency forward contracts which are intended to provide an economic hedge against foreign currency movements. In addition, the Company routinely utilizes 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 fair value of TBAs is included in 'fixed maturities available for sale, at fair value.' The Company did not hold any derivatives which were designated as hedging instruments at March 31, 2015 or December 31, 2014.

The following table summarizes information on the fair values and notional values of the Company's derivative instruments.

|                                    | Asset<br>Derivatives<br>Estimated<br>Fair Value | Liability<br>Derivatives<br>Estimated<br>Fair Value | Net<br>Derivatives<br>Estimated<br>Fair Value | Notional<br>Value (1) |
|------------------------------------|---|---|---|-----------------------|
| March 31, 2015                     |   |   |   |                       |
| Futures contracts                  | \$2,534   | \$(3,148)   | \$(614)                                       | \$2,398,085           |
| Foreign currency forward contracts | 23,327  | (6,751)   | 16,576  | 1,848,503             |
| TBAs                               | 350,576   | (245,150)   | 105,426                                       | 562,031               |
| Other                              | 8,810   | (4,327)   | 4,483   | 1,252,273             |
| Total                              | \$385,247                                       | \$(259,376)   | \$125,871                                     |                       |
| December 31, 2014                  |   |   |   |                       |
| Futures contracts                  | \$2,156   | \$(1,907)   | \$249   | \$2,549,027           |
| Foreign currency forward contracts | 10,511  | (1,145)   | 9,366   | 397,106               |
| TBAs                               | 10,592  | —   | 10,592  | 10,056                |
| Other                              | 3,209   | (2,345)   | 864   | 735,684               |
| Total                              | \$26,468  | \$(5,397)   | \$21,071                                      |                       |

(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, 2015, asset derivatives and liability derivatives of \$160.5 million and \$131.1 million, respectively, were subject to a master netting agreement, compared to \$25.3 million and \$5.4 million, respectively, at December 31, 2014. The remaining derivatives included in the table above were not subject to a master netting agreement.

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## ARCH CAPITAL GROUP LTD. AND SUBSIDIARIES

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)

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

|  | Three Months Ended |             |
|--|--------------------|-------------|
|  | March 31,          |             |
| Derivatives not designated as hedging instruments: | 2015               | 2014        |
| Futures contracts                                  | \$19,326           | \$(9,862 )  |
| Foreign currency forward contracts                 | 16,819             | (2,257 )    |
| TBAs   | 486                | (37 )       |
| Other  | 45                 | (612 )      |
| Total  | \$36,676           | \$(12,768 ) |

## 9. Commitments and Contingencies

## Letter of Credit and Revolving Credit Facilities

As of March 31, 2015, 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 June 30, 2019. In addition, the Company had access to secured letter of credit facilities of approximately \$180.0 million as of March 31, 2015, 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, 2015, the Company had \$415.9 million in outstanding letters of credit under the LOC Facilities, which were secured by investments with a fair value of \$488.4 million, and had \$100.0 million of borrowings outstanding under the Credit Agreement which are due on June 30, 2019. The Company was in compliance with all covenants contained in the LOC Facilities at March 31, 2015. As of March 31, 2015, Watford Re had a \$200 million line of credit facility that expires on May 19, 2015. At March 31, 2015, Watford Re had \$32.1 million in outstanding letters of credit under that credit facility. Watford Re was in compliance with all covenants contained in its credit facility at March 31, 2015.

## 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 \$1.22 billion at March 31, 2015.

## 10. Share Transactions

## Share Repurchases

The board of directors of ACGL has authorized the investment in ACGL's common shares through a share repurchase program. Since the inception of the share repurchase program, ACGL has repurchased approximately 120.9 million common shares for an aggregate purchase price of \$3.40 billion. For the 2015 first quarter, ACGL repurchased 2.7 million common shares for an aggregate purchase price of \$162.9 million. For the 2014 first quarter, ACGL did not repurchase any common shares. At March 31, 2015, \$724.2 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.

## 11. 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

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## ARCH CAPITAL GROUP LTD. AND SUBSIDIARIES

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)

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 4.3% for the 2015 first quarter, compared to an expense of 2.0% for the 2014 first quarter. 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 \$124.7 million at March 31, 2015, compared to \$131.0 million at December 31, 2014. In addition, the Company paid \$3.6 million in income taxes for the 2015 first quarter, while the Company paid \$1.6 million for the 2014 first quarter.

## 12. Other Comprehensive Income (Loss)

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

| Details About<br>AOCI Components                             | Consolidated Statement of Income<br>Line Item That Includes<br>Reclassification | Amounts Reclassified from<br>AOCI       |          |
|--|---|---|----------|
|  |   | Three Months Ended<br>March 31,<br>2015 | 2014     |
| Unrealized appreciation on available-for-sale<br>investments | Net realized gains (losses)   | \$42,431                                | \$26,038 |
|  | Other-than-temporary impairment<br>losses                                       | (7,247 )                                | (2,971 ) |
|  | Total before tax  | 35,184                                  | 23,067   |
|  | Income tax (expense) benefit  | (4,252 )                                | (1,818 ) |
|  | Net of tax  | \$30,932                                | \$21,249 |

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

|  | Before Tax<br>Amount | Tax Expense<br>(Benefit) | Net of Tax<br>Amount |
|--|----------------------|--------------------------|----------------------|
| Three Months Ended March 31, 2015                          |                      |                          |                      |
| Unrealized appreciation (decline) in value of investments: |                      |                          |                      |
| Unrealized holding gains (losses) arising during period    | \$94,387             | \$10,083                 | \$84,304             |

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|   |          |         |           |   |
|---|----------|---------|-----------|---|
| Portion of other-than-temporary impairment losses recognized in other comprehensive income (loss) | (1,448   | ) —     | (1,448    | ) |
| Less reclassification of net realized gains included in net income                                | 35,184   | 4,252   | 30,932    |   |
| Foreign currency translation adjustments  | (23,626  | ) (869  | ) (22,757 | ) |
| Other comprehensive income (loss)   | \$34,129 | \$4,962 | \$29,167  |   |

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 (losses) 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 |   |

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## ARCH CAPITAL GROUP LTD. AND SUBSIDIARIES

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)

## 13. 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, 2015

| Condensed Consolidating Balance Sheet  | ACGL<br>(Parent<br>Guarantor) | Arch-U.S.<br>(Subsidiary<br>Issuer) | Other ACGL<br>Subsidiaries | Consolidating<br>Adjustments<br>and<br>Eliminations | ACGL<br>Consolidated |
|--|-------------------------------|-------------------------------------|----------------------------|---|----------------------|
| <b>Assets</b>  |                               |                                     |                            |   |                      |
| Total investments  | \$24                          | \$53,890                            | \$15,357,730               | \$—   | \$15,411,644         |
| Cash   | 7,992                         | 2,822                               | 460,198                    | —   | 471,012              |
| Investments in subsidiaries  | 6,688,930                     | 1,710,358                           | —                          | (8,399,288 )  | —                    |
| Due from subsidiaries and affiliates   | 31                            | 15,144                              | 380,577                    | (395,752 )  | —                    |
| Premiums receivable  | —                             | —                                   | 1,575,230                  | (458,841 )  | 1,116,389            |
| Reinsurance recoverable on unpaid and paid losses and loss adjustment expenses | —                             | —                                   | 5,545,517                  | (3,756,898 )  | 1,788,619            |
| Contractholder receivables   | —                             | —                                   | 1,339,433                  | —   | 1,339,433            |
| Prepaid reinsurance premiums   | —                             | —                                   | 1,545,190                  | (1,123,282 )  | 421,908              |
| Deferred acquisition costs, net  | —                             | —                                   | 442,775                    | —   | 442,775              |
| Other assets   | 6,998                         | 50,869                              | 2,138,959                  | (338,926 )  | 1,857,900            |
| Total assets   | \$6,703,975                   | \$1,833,083                         | \$28,785,609               | \$(14,472,987)                                      | \$22,849,680         |
| <b>Liabilities</b>   |                               |                                     |                            |   |                      |
| Reserve for losses and loss adjustment expenses                                | \$—                           | \$—                                 | \$12,656,904               | \$(3,727,954 )                                      | \$8,928,950          |
| Unearned premiums  | —                             | —                                   | 3,524,116                  | (1,123,282 )  | 2,400,834            |
| Reinsurance balances payable   | —                             | —                                   | 645,723                    | (445,279 )  | 200,444              |
| Contractholder payables  | —                             | —                                   | 1,339,433                  | —   | 1,339,433            |
| Deposit accounting liabilities   | —                             | —                                   | 508,592                    | (223,764 )  | 284,828              |
| Senior notes   | 300,000                       | 500,000                             | —                          | —   | 800,000              |
| Revolving credit agreement borrowings  | 100,000                       | —                                   | —                          | —   | 100,000              |
| Due to subsidiaries and affiliates   | 1,305                         | 15,022                              | 379,425                    | (395,752 )  | —                    |
| Other liabilities  | 13,968                        | 47,944                              | 1,593,048                  | (157,669 )  | 1,497,291            |
| Total liabilities  | 415,273                       | 562,966                             | 20,647,241                 | (6,073,700 )  | 15,551,780           |
| Redeemable noncontrolling interests  | —                             | —                                   | 219,604                    | —   | 219,604              |
| <b>Shareholders' Equity</b>  |                               |                                     |                            |   |                      |
| Total shareholders' equity available to Arch                                   | 6,288,702                     | 1,270,117                           | 7,129,170                  | (8,399,287 )  | 6,288,702            |
| Non-redeemable noncontrolling interests  | —                             | —                                   | 789,594                    | —   | 789,594              |
| Total shareholders' equity   | 6,288,702                     | 1,270,117                           | 7,918,764                  | (8,399,287 )  | 7,078,296            |
| Total liabilities, noncontrolling interests and shareholders' equity           | \$6,703,975                   | \$1,833,083                         | \$28,785,609               | \$(14,472,987)                                      | \$22,849,680         |



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## ARCH CAPITAL GROUP LTD. AND SUBSIDIARIES

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)

| Condensed Consolidating Balance Sheet  | December 31, 2014             |                                     |                            |   |                      |
|--|-------------------------------|-------------------------------------|----------------------------|---|----------------------|
|  | ACGL<br>(Parent<br>Guarantor) | Arch-U.S.<br>(Subsidiary<br>Issuer) | Other ACGL<br>Subsidiaries | Consolidating<br>Adjustments<br>and<br>Eliminations | ACGL<br>Consolidated |
| <b>Assets</b>  |                               |                                     |                            |   |                      |
| Total investments  | \$ 107                        | \$ 62,867                           | \$ 15,268,275              | \$—   | \$ 15,331,249        |
| Cash   | 3,218                         | 2,787                               | 479,697                    | —   | 485,702              |
| Investments in subsidiaries  | 6,536,644                     | 1,685,185                           | —                          | (8,221,829 )  | —                    |
| Due from subsidiaries and affiliates   | 48                            | 7,517                               | 370,429                    | (377,994 )  | —                    |
| Premiums receivable  | —                             | —                                   | 1,331,511                  | (382,816 )  | 948,695              |
| Reinsurance recoverable on unpaid and paid losses and loss adjustment expenses | —                             | —                                   | 5,584,973                  | (3,772,128 )  | 1,812,845            |
| Contractholder receivables   | —                             | —                                   | 1,309,192                  | —   | 1,309,192            |
| Prepaid reinsurance premiums   | —                             | —                                   | 1,373,008                  | (995,930 )  | 377,078              |
| Deferred acquisition costs, net  | —                             | —                                   | 414,525                    | —   | 414,525              |
| Other assets   | 7,590                         | 49,576                              | 1,689,670                  | (416,579 )  | 1,330,257            |
| Total assets   | \$ 6,547,607                  | \$ 1,807,932                        | \$ 27,821,280              | \$ (14,167,276)                                     | \$ 22,009,543        |
| <b>Liabilities</b>   |                               |                                     |                            |   |                      |
| Reserve for losses and loss adjustment expenses                                | \$—                           | \$—                                 | \$ 12,784,030              | \$(3,747,582 )                                      | \$ 9,036,448         |
| Unearned premiums  | —                             | —                                   | 3,227,508                  | (995,930 )  | 2,231,578            |
| Reinsurance balances payable   | —                             | —                                   | 589,289                    | (369,977 )  | 219,312              |
| Contractholder payables  | —                             | —                                   | 1,309,192                  | —   | 1,309,192            |
| Deposit accounting liabilities   | —                             | —                                   | 587,050                    | (259,666 )  | 327,384              |
| Senior notes   | 300,000                       | 500,000                             | —                          | —   | 800,000              |
| Revolving credit agreement borrowings  | 100,000                       | —                                   | —                          | —   | 100,000              |
| Due to subsidiaries and affiliates   | 417                           | 7,505                               | 370,072                    | (377,994 )  | —                    |
| Other liabilities  | 17,137                        | 49,403                              | 994,741                    | (194,298 )  | 866,983              |
| Total liabilities  | 417,554                       | 556,908                             | 19,861,882                 | (5,945,447 )  | 14,890,897           |
| Redeemable noncontrolling interests  | —                             | —                                   | 219,512                    | —   | 219,512              |
| <b>Shareholders' Equity</b>  |                               |                                     |                            |   |                      |
| Total shareholders' equity available to Arch                                   | 6,130,053                     | 1,251,024                           | 6,970,805                  | (8,221,829 )  | 6,130,053            |
| Non-redeemable noncontrolling interests  | —                             | —                                   | 769,081                    | —   | 769,081              |
| Total shareholders' equity   | 6,130,053                     | 1,251,024                           | 7,739,886                  | (8,221,829 )  | 6,899,134            |
| Total liabilities, noncontrolling interests and shareholders' equity           | \$ 6,547,607                  | \$ 1,807,932                        | \$ 27,821,280              | \$ (14,167,276)                                     | \$ 22,009,543        |



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## ARCH CAPITAL GROUP LTD. AND SUBSIDIARIES

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)

| Condensed Consolidating Statement of<br>Income and Comprehensive Income           | Three Months Ended March 31, 2015 |                                     |                            | Consolidating<br>Adjustments<br>and<br>Eliminations | ACGL<br>Consolidated |
|---|-----------------------------------|-------------------------------------|----------------------------|---|----------------------|
|   | ACGL<br>(Parent<br>Guarantor)     | Arch-U.S.<br>(Subsidiary<br>Issuer) | Other ACGL<br>Subsidiaries |   |                      |
| <b>Revenues</b>   |                                   |                                     |                            |   |                      |
| Net premiums earned   | \$—                               | \$—                                 | \$910,264                  | \$—   | \$910,264            |
| Net investment income   | —                                 | 5                                   | 86,010                     | (7,021)   | 78,994               |
| Net realized gains  | —                                 | —                                   | 83,348                     | —   | 83,348               |
| Net impairment losses recognized in earnings                                      | —                                 | —                                   | (5,799)                    | —   | (5,799)              |
| Other underwriting income   | —                                 | —                                   | 11,536                     | —   | 11,536               |
| Equity in net income of investment funds<br>accounted for using the equity method | —                                 | —                                   | 5,889                      | —   | 5,889                |
| Other income (loss)   | —                                 | —                                   | (1,888)                    | —   | (1,888)              |
| Total revenues  | —                                 | 5                                   | 1,089,360                  | (7,021)   | 1,082,344            |
| <b>Expenses</b>   |                                   |                                     |                            |   |                      |
| Losses and loss adjustment expenses   | —                                 | —                                   | 493,716                    | —   | 493,716              |
| Acquisition expenses  | —                                 | —                                   | 163,076                    | —   | 163,076              |
| Other operating expenses  | 8,632                             | 1,259                               | 147,991                    | —   | 157,882              |
| Interest expense  | 5,856                             | 6,366                               | 7,535                      | (7,021)   | 12,736               |
| Net foreign exchange gains  | —                                 | —                                   | (39,630)                   | (26,871)  | (66,501)             |
| Total expenses  | 14,488                            | 7,625                               | 772,688                    | (33,892)  | 760,909              |
| Income (loss) before income taxes   | (14,488)                          | (7,620)                             | 316,672                    | 26,871  | 321,435              |
| Income tax benefit (expense)  | —                                 | 1,413                               | (14,091)                   | —   | (12,678)             |
| Income (loss) before equity in net income of<br>subsidiaries                      | (14,488)                          | (6,207)                             | 302,581                    | 26,871  | 308,757              |
| Equity in net income of subsidiaries  | 297,824                           | 14,495                              | —                          | (312,319)   | —                    |
| Net income  | 283,336                           | 8,288                               | 302,581                    | (285,448)   | 308,757              |
| Amounts attributable to noncontrolling<br>interests                               | —                                 | —                                   | (25,421)                   | —   | (25,421)             |
| Net income available to Arch  | 283,336                           | 8,288                               | 277,160                    | (285,448)   | 283,336              |
| Preferred dividends   | (5,484)                           | —                                   | —                          | —   | (5,484)              |
| Net income available to Arch common<br>shareholders                               | \$277,852                         | \$8,288                             | \$277,160                  | \$(285,448)   | \$277,852            |
| Comprehensive income available to Arch  | \$312,503                         | \$11,750                            | \$333,193                  | \$(344,943)   | \$312,503            |

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## ARCH CAPITAL GROUP LTD. AND SUBSIDIARIES

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)

| Condensed Consolidating Statement of<br>Income and Comprehensive Income           | Three Months Ended March 31, 2014 |                                     |                            |   |                      |
|---|-----------------------------------|-------------------------------------|----------------------------|---|----------------------|
|   | ACGL<br>(Parent<br>Guarantor)     | Arch-U.S.<br>(Subsidiary<br>Issuer) | Other ACGL<br>Subsidiaries | Consolidating<br>Adjustments<br>and<br>Eliminations | ACGL<br>Consolidated |
| <b>Revenues</b>   |                                   |                                     |                            |   |                      |
| 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<br>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              |
| <b>Expenses</b>   |                                   |                                     |                            |   |                      |
| 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 expense  | —                                 | 2,788                               | (6,526 )                   | —   | (3,738 )             |
| Income (loss) before equity in net income of<br>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              |
| Amounts attributable to noncontrolling<br>interests                               | —                                 | —                                   | 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<br>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            |



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## ARCH CAPITAL GROUP LTD. AND SUBSIDIARIES

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)

| Condensed Consolidating Statement<br>of Cash Flows                        | Three Months Ended March 31, 2015 |                                     |                            |   |                      |
|---|-----------------------------------|-------------------------------------|----------------------------|---|----------------------|
|   | ACGL<br>(Parent<br>Guarantor)     | Arch-U.S.<br>(Subsidiary<br>Issuer) | Other ACGL<br>Subsidiaries | Consolidating<br>Adjustments<br>and<br>Eliminations | ACGL<br>Consolidated |
| <b>Operating Activities</b>   |                                   |                                     |                            |   |                      |
| Net Cash Provided By (Used For)<br>Operating Activities                   | \$173,508                         | \$(8,950 )                          | \$106,903                  | \$(186,000 )  | \$85,461             |
| <b>Investing Activities</b>   |                                   |                                     |                            |   |                      |
| Purchases of fixed maturity investments                                   | —                                 | —                                   | (7,030,731 )               | —   | (7,030,731 )         |
| Purchases of equity securities  | —                                 | —                                   | (125,863 )                 | —   | (125,863 )           |
| Purchases of other investments  | —                                 | —                                   | (685,497 )                 | —   | (685,497 )           |
| Proceeds from the sales of fixed maturity<br>investments                  | —                                 | 9,001                               | 6,848,458                  | —   | 6,857,459            |
| Proceeds from the sales of equity<br>securities                           | —                                 | —                                   | 125,906                    | —   | 125,906              |
| Proceeds from the sales of other<br>investments                           | —                                 | —                                   | 605,263                    | —   | 605,263              |
| Proceeds from redemptions and<br>maturities of fixed maturity investments | —                                 | —                                   | 272,657                    | —   | 272,657              |
| Net purchases (sales) of short-term<br>investments                        | 83                                | (16 )                               | 66,216                     | —   | 66,283               |
| Change in cash collateral related to<br>securities lending                | —                                 | —                                   | (5,529 )                   | —   | (5,529 )             |
| Contributions to subsidiaries   | —                                 | —                                   | (5,500 )                   | 5,500   | —                    |
| Intercompany loans issued   | —                                 | (7,500 )                            | (7,500 )                   | 15,000  | —                    |
| Purchase of business, net of cash<br>acquired                             | —                                 | —                                   | (2,432 )                   | —   | (2,432 )             |
| Purchases of furniture, equipment and<br>other assets                     | (23 )                             | —                                   | (32,874 )                  | —   | (32,897 )            |
| Net Cash Provided By (Used For)<br>Investing Activities                   | 60                                | 1,485                               | 22,574                     | 20,500  | 44,619               |
| <b>Financing Activities</b>   |                                   |                                     |                            |   |                      |
| Purchases of common shares under share<br>repurchase program              | (162,898 )                        | —                                   | —                          | —   | (162,898 )           |
| Proceeds from common shares issued, net                                   | (412 )                            | —                                   | 5,500                      | (5,500 )  | (412 )               |
| Proceeds from intercompany borrowings                                     | —                                 | 7,500                               | 7,500                      | (15,000 )   | —                    |
| Change in cash collateral related to<br>securities lending                | —                                 | —                                   | 5,529                      | —   | 5,529                |
| Dividends paid to redeemable<br>noncontrolling interests                  | —                                 | —                                   | (4,816 )                   | —   | (4,816 )             |
| Dividends paid to parent  | —                                 | —                                   | (186,000 )                 | 186,000   | —                    |
| Other   | —                                 | —                                   | 29,779                     | —   | 29,779               |
| Preferred dividends paid  | (5,484 )                          | —                                   | —                          | —   | (5,484 )             |
| Net Cash Provided By (Used For)<br>Financing Activities                   | (168,794 )                        | 7,500                               | (142,508 )                 | 165,500   | (138,302 )           |



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|   |         |         |           |     |           |   |
|---|---------|---------|-----------|-----|-----------|---|
| Effects of exchange rates changes on<br>foreign currency cash | —       | —       | (6,468    | ) — | (6,468    | ) |
| Increase (decrease) in cash                                   | 4,774   | 35      | (19,499   | ) — | (14,690   | ) |
| Cash beginning of year  | 3,218   | 2,787   | 479,697   | —   | 485,702   |   |
| Cash end of period  | \$7,992 | \$2,822 | \$460,198 | \$— | \$471,012 |   |

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## ARCH CAPITAL GROUP LTD. AND SUBSIDIARIES

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)

| Condensed Consolidating Statement<br>of Cash Flows                        | Three Months Ended March 31, 2014 |                                     |                            |   |                      |
|---|-----------------------------------|-------------------------------------|----------------------------|---|----------------------|
|   | ACGL<br>(Parent<br>Guarantor)     | Arch-U.S.<br>(Subsidiary<br>Issuer) | Other ACGL<br>Subsidiaries | Consolidating<br>Adjustments<br>and<br>Eliminations | ACGL<br>Consolidated |
| Operating Activities  |                                   |                                     |                            |   |                      |
| Net Cash Provided By (Used For)<br>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<br>investments                  | —                                 | —                                   | 7,014,281                  | —   | 7,014,281            |
| Proceeds from the sales of equity<br>securities                           | —                                 | —                                   | 49,614                     | —   | 49,614               |
| Proceeds from the sales of other<br>investments                           | —                                 | —                                   | 331,176                    | —   | 331,176              |
| Proceeds from redemptions and<br>maturities of fixed maturity investments | —                                 | —                                   | 168,484                    | —   | 168,484              |
| Net (purchases) sales of short-term<br>investments                        | (16 )                             | 360,269                             | (203,991 )                 | —   | 156,262              |
| Change in cash collateral related to<br>securities lending                | —                                 | —                                   | 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<br>acquired                             | —                                 | —                                   | (235,578 )                 | —   | (235,578 )           |
| Purchases of furniture, equipment and<br>other assets                     | (76 )                             | —                                   | (5,306 )                   | —   | (5,382 )             |
| Net Cash Provided By (Used For)<br>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 cash collateral related to<br>securities lending                | —                                 | —                                   | (4,669 )                   | —   | (4,669 )             |
| Third party investment in<br>non-redeemable noncontrolling interests      | —                                 | —                                   | 796,903                    | —   | 796,903              |
| Third party investment in redeemable<br>noncontrolling interests          | —                                 | —                                   | 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)<br>Financing Activities                   | (2,463 )                          | (10,250 )                           | 1,377,534                  | (386,457 )  | 978,364              |

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|   |          |          |             |     |             |
|---|----------|----------|-------------|-----|-------------|
| Effects of exchange rates changes on<br>foreign currency cash | —        | —        | 241         | —   | 241         |
| Increase in cash  | 9,130    | 44,963   | 1,081,455   | —   | 1,135,548   |
| Cash beginning of year  | 3,223    | 509      | 430,325     | —   | 434,057     |
| Cash end of period  | \$12,353 | \$45,472 | \$1,511,780 | \$— | \$1,569,605 |

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ARCH CAPITAL GROUP LTD. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)

14. Legal Proceedings

The Company, in common with the insurance industry in general, is subject to litigation and arbitration in the normal course of its business. As of March 31, 2015, the Company was not a party to any litigation or arbitration which is expected by management to have a material adverse effect on the Company's results of operations and financial condition and liquidity.

15. Transactions with Related Parties

As part of its investment philosophy, the Company invests a portion of its investment portfolio in alternative investment funds. As of March 31, 2015, the Company had aggregate commitments of \$545.9 million to funds managed by The Carlyle Group ("Carlyle"). Of such amount, \$393.8 million was unfunded as of March 31, 2015. The Company may make additional commitments to funds managed by Carlyle from time to time. During the 2015 first quarter and 2014 first quarter, the Company made aggregate capital contributions to funds managed by Carlyle of \$23.4 million and \$19.1 million, respectively, and received aggregate cash distributions from funds managed by Carlyle of \$7.1 million and \$35.1 million, respectively. Kewsong Lee, a director of ACGL, joined Carlyle as Managing Director and Deputy Chief Investment Officer for Corporate Private Equity on December 31, 2013.

16. Subsequent Events

In May 2008, the Company provided \$100.0 million of funding to Gulf Reinsurance Limited ("Gulf Re"), a newly formed reinsurer based in the Dubai International Financial Centre, pursuant to the joint venture agreement with Gulf Investment Corporation GSC ("GIC"). Under the agreement, Arch Re Bermuda and GIC each own 50% of Gulf Re, which commenced underwriting activities in June 2008. Gulf Re provides property and casualty reinsurance primarily in the member states of the Gulf Cooperation Council, which include Bahrain, Kuwait, Oman, Qatar, Saudi Arabia and the United Arab Emirates. The initial capital of the joint venture consisted of \$200.0 million. The Company accounts for its investment in Gulf Re, shown as "Investment in joint venture," using the equity method and records its equity in the operating results of Gulf Re in "Other income (loss)." The Company entered into a number of strategic initiatives related to Gulf Re in the 2014 fourth quarter, including an agreement to acquire complete ownership of Gulf Re. Such agreement was approved by the Dubai Financial Services Authority in April 2015.

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ITEM 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

The following is a discussion and analysis of our financial condition and results of operations. This should be read in conjunction with our consolidated financial statements included in Item 1 of this report and also our Management's Discussion and Analysis of Financial Condition and Results of Operations contained in our Annual Report on Form 10-K for the year ended December 31, 2014 ("2014 Form 10-K"). In addition, readers should review "Risk Factors" set forth in Item 1A of Part I of our 2014 Form 10-K. Tabular amounts are in U.S. Dollars in thousands, except share amounts, unless otherwise noted.

The consolidated financial statements included in this Quarterly Report on Form 10-Q differ from those included in our earnings press release and financial supplement submitted on Form 8-K on April 28, 2015, reflecting an immaterial revision regarding the reporting of non-cash collateral in our securities lending program. As a result, our total assets and total liabilities were understated by \$147.0 million at March 31, 2015. Additionally, cash flows from investing activities were understated by \$60.2 million while cash flows from financing activities were overstated by \$60.2 million for the 2015 first quarter. There was no impact on our net income, comprehensive income or shareholders' equity. See note 6, "Investment Information—Securities Lending Agreements" for additional information on our securities lending program.

Arch Capital Group Ltd. ("ACGL" and, together with its subsidiaries, "we" or "us") is a Bermuda public limited liability company with approximately \$7.19 billion in capital at March 31, 2015 and, through operations in Bermuda, the United States, Europe and Canada, writes specialty lines of property and casualty insurance and reinsurance, as well as mortgage insurance and reinsurance, on a worldwide basis.

Current Outlook

The broad market environment continues to be competitive in our reinsurance business reflecting a continuation of softening in pricing and broadening pressures on terms and conditions. In the primary markets in which our insurance business participates our insurance business continued to obtain rate increases during the 2015 first quarter in most lines of business, at approximately the same levels observed in the 2014 fourth quarter. Competitive conditions in the property sector have negatively impacted primary property rates and, accordingly, our premium volume in those lines. In our reinsurance business, softening pricing and continued pressure on terms and conditions led us to reduce writings in the 2015 first quarter. With the continued low interest rate environment, additional increases are needed in many lines in order for us to achieve our return requirements. Our underwriting teams continue to execute a disciplined strategy by emphasizing small and medium-sized accounts over large accounts.

Arch Mortgage Insurance Company ("Arch MI U.S.") continues to expand into the U.S. mortgage insurance marketplace. As of March 31, 2015, Arch MI U.S. reviewed and approved 644 master policy applications from banks and more than 190 of these banks have submitted loans for approval. In addition, Arch MI U.S. has approved master policy applications from 21 of the top 25 mortgage originators for conforming mortgages sold to the GSEs with mortgage insurance.

Our objective is to achieve an average operating return on average equity of 15% or greater over the insurance cycle, which we believe to be an attractive return to our common shareholders given the risks we assume. We continue to look for opportunities to find acceptable books of business to underwrite without sacrificing underwriting discipline and continue to write a portion of our overall book in catastrophe-exposed business which has the potential to increase the volatility of our operating results.

Changing economic conditions could have a material impact on the frequency and severity of claims and, therefore, could negatively impact our underwriting returns. In addition, volatility in the financial markets could continue to significantly affect our investment returns, reported results and shareholders' equity. We consider the potential impact of economic trends in the estimation process for establishing unpaid losses and loss adjustment expenses and in determining our investment strategies. In addition, weakness of the U.S., European countries and other key economies, projected budget deficits for the U.S., European countries and other governments and the consequences associated with potential downgrades of securities of the U.S., European countries and other governments by credit rating agencies is inherently unpredictable and could have a material adverse effect on financial markets and economic conditions in the U.S. and throughout the world. In turn, this could have a material adverse effect on our business, financial condition and results of operations and, in particular, this could have a material adverse effect on the value and liquidity of securities in our investment portfolio.

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### Natural Catastrophe Risk

We monitor our natural catastrophe risk globally for all perils and regions, in each case, where we believe there is significant exposure. Our models employ both proprietary and vendor-based systems and include cross-line correlations for property, marine, offshore energy, aviation, workers compensation and personal accident. Currently, we seek to limit our 1-in-250 year return period net probable maximum pre-tax loss from a severe catastrophic event in any geographic zone to approximately 25% of total shareholders' equity available to Arch. We reserve the right to change this threshold at any time. Based on in-force exposure estimated as of April 1, 2015, our modeled peak zone catastrophe exposure was a windstorm affecting the Northeastern U.S., with a net probable maximum pre-tax loss of \$550 million, followed by windstorms affecting the Gulf of Mexico and Florida Tri-County with net probable maximum pre-tax losses of \$495 million and \$396 million, respectively. Based on in-force exposure estimated as of January 1, 2015, our modeled peak zone exposure was a windstorm affecting the Northeastern U.S., with a net probable maximum pre-tax loss of \$544 million, followed by windstorms affecting the Gulf of Mexico and Florida Tri-County with net probable maximum pre-tax losses of \$527 million and \$419 million, respectively. Our exposures to other perils, such as U.S. earthquake and international events, was less than the exposures arising from U.S. windstorms and hurricanes in both periods. As of April 1, 2015, our modeled peak zone earthquake exposure (Los Angeles earthquake) represented approximately 56% of our peak zone catastrophe exposure, and our modeled peak zone international exposure (Japan earthquake) was substantially less than both our peak zone windstorm and earthquake exposures. Net probable maximum pre-tax loss estimates are net of expected reinsurance recoveries, before income tax and before excess reinsurance reinstatement premiums. Loss estimates are reflective of the zone indicated and not the entire portfolio. Since hurricanes and windstorms can affect more than one zone and make multiple landfalls, our loss estimates include clash estimates from other zones.

The loss estimates shown above do not represent our maximum exposures and it is highly likely that our actual incurred losses would vary materially from the modeled estimates. There can be no assurances that we will not suffer a net loss greater than 25% of total shareholders' equity available to Arch from one or more catastrophic events due to several factors, including the inherent uncertainties in estimating the frequency and severity of such events and the margin of error in making such determinations resulting from potential inaccuracies and inadequacies in the data provided by clients and brokers, the modeling techniques and the application of such techniques or as a result of a decision to change the percentage of shareholders' equity exposed to a single catastrophic event. Actual losses may also increase if our reinsurers fail to meet their obligations to us or the reinsurance protections purchased by us are exhausted or are otherwise unavailable. See "Risk Factors—Risk Relating to Our Industry" and "Management's Discussion and Analysis of Financial Condition and Results of Operations—Natural and Man-Made Catastrophic Events" in our 2014 Form 10-K.

### Financial Measures

Management uses the following three key financial indicators in evaluating our performance and measuring the overall growth in value generated for ACGL's common shareholders:

#### Book Value per Common Share

Book value per common share represents total common shareholders' equity available to Arch divided by the number of common shares outstanding. Management uses growth in book value per common share as a key measure of the value generated for our common shareholders each period and believes that book value per common share is the key driver of ACGL's share price over time. Book value per common share is impacted by, among other factors, our underwriting results, investment returns and share repurchase activity, which has an accretive or dilutive impact on book value per common share depending on the purchase price. Book value per common share was \$47.80 at March 31, 2015, compared to \$45.58 at December 31, 2014 and \$41.52 at March 31, 2014. The 4.9% increase in the 2015

first quarter reflected strong investment and underwriting returns.



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## Operating Return on Average Common Equity

Operating return on average common equity (“Operating ROAE”) represents annualized after-tax operating income available to Arch common shareholders divided by the average of beginning and ending common shareholders’ equity available to Arch during the period. After-tax operating income available to Arch common shareholders, a “non-GAAP measure” as defined in the SEC rules, represents net income available to Arch common shareholders, excluding net realized gains or losses, net impairment losses recognized in earnings, equity in net income or loss of investment funds accounted for using the equity method and net foreign exchange gains or losses, net of income taxes.

Management uses Operating ROAE as a key measure of the return generated to common shareholders and has set an objective to achieve an average Operating ROAE of 15% or greater over the insurance cycle, which it believes to be an attractive return to common shareholders given the risks we assume. See “Comment on Non-GAAP Financial Measures.” Our Operating ROAE was 10.2% for the 2015 first quarter, compared to 12.1% for the 2014 first quarter. Operating ROAE for the 2015 first quarter reflected a lower level of underwriting income, reflecting market conditions and changes in mix of business, and a higher level of average common equity compared to the 2014 first quarter.

## Total Return on Investments

Total return on investments includes investment income, equity in net income or loss of investment funds accounted for using the equity method, net realized gains and losses and the change in unrealized gains and losses generated by Arch’s investment portfolio. Total return is calculated on a pre-tax basis and before investment expenses, excluding amounts reflected in the ‘other’ segment, and reflects the effect of financial market conditions along with foreign currency fluctuations. Management uses total return on investments as a key measure of the return generated to Arch common shareholders on the capital held in the business, and compares the return generated by our investment portfolio against benchmark returns which we measured our portfolio against during the periods.

The benchmark return index is a customized combination of indices intended to approximate a target portfolio by asset mix and average credit quality while also matching the approximate estimated duration and currency mix of our insurance and reinsurance liabilities. Although the estimated duration and average credit quality of this index will move as the duration and rating of its constituent securities change, generally we do not adjust the composition of the benchmark return index except to incorporate the currency mix as noted above. The benchmark return index should not be interpreted as expressing a preference for or aversion to any particular sector or sector weight. The index is intended solely to provide, unlike many master indices that change based on the size of their constituent indices, a relatively stable basket of investable indices.

At March 31, 2015, the benchmark return index had an average credit quality of “Aa2” by Moody’s Investors Service (“Moody’s”), an estimated duration of 3.39 years and included weightings to the following indices:

|  | Weighting |   |
|--|-----------|---|
|  |           | % |
| The Bank of America Merrill Lynch 1-10 Year AA U.S. Corporate & Yankees Index    | 21.250    |   |
| The Bank of America Merrill Lynch 1-5 Year U.S. Treasury Index                   | 13.000    |   |
| The Bank of America Merrill Lynch U.S. Mortgage Backed Securities Index          | 11.875    |   |
| Barclays Capital CMBS, AAA Index   | 10.000    |   |
| The Bank of America Merrill Lynch 1-10 Year U.S. Municipal Securities Index      | 7.125     |   |
| The Bank of America Merrill Lynch 1-10 Year EMU Governments Index                | 5.500     |   |
| The Bank of America Merrill Lynch U.S. High Yield Constrained Index              | 5.500     |   |
| The Bank of America Merrill Lynch U.S. Bullet Agency Securities 1-10 Years Index | 5.000     |   |
| MSCI All Country World Gross Total Return Index                                  | 5.000     |   |
| The Bank of America Merrill Lynch 0-3 Month U.S. Treasury Bill Index             | 5.000     |   |

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|  |         |   |
|--|---------|---|
| The Bank of America Merrill Lynch 5-10 Year U.S. Treasury Index          | 3.250   |   |
| The Bank of America Merrill Lynch 1-5 Year U.K. Gilt Index               | 3.000   |   |
| The Bank of America Merrill Lynch 1-10 Year Australian Governments Index | 2.500   |   |
| The Bank of America Merrill Lynch 1-5 Year CAD Governments Index         | 2.000   |   |
| Total  | 100.000 | % |

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The following table summarizes the pre-tax total return (before investment expenses) of investments managed by Arch compared to the benchmark return against which we measured our portfolio during the periods:

|  | Arch<br>Portfolio | Benchmark<br>Return |  |   |
|--|-------------------|---------------------|--|---|
| Pre-tax total return (before investment expenses): |                   |                     |  |   |
| 2015 first quarter                                 | 1.11              | % 0.29              |  | % |
| 2014 first quarter                                 | 1.00              | % 1.19              |  | % |

Total return for the 2015 first quarter reflected favorable returns in equities, high yield and term loan investments, partially offset by the impact of the U.S. Dollar strengthening against the Euro, British Pound Sterling and other major currencies on non-U.S. Dollar denominated investments. Excluding the effects of foreign exchange, total return was 2.05% for the 2015 first quarter, compared to 1.02% for the 2014 first quarter.

#### Comment on Non-GAAP Financial Measures

Throughout this filing, we present our operations in the way we believe will be the most meaningful and useful to investors, analysts, rating agencies and others who use our financial information in evaluating the performance of our company. This presentation includes the use of after-tax operating income available to Arch common shareholders, which is defined as net income available to Arch common shareholders, excluding net realized gains or losses, net impairment losses recognized in earnings, equity in net income or loss of investment funds accounted for using the equity method and net foreign exchange gains or losses, net of income taxes. The presentation of after-tax operating income available to Arch common shareholders is a “non-GAAP financial measure” as defined in Regulation G. The reconciliation of such measure to net income available to Arch common shareholders (the most directly comparable GAAP financial measure) in accordance with Regulation G is included under “Results of Operations” below.

We believe that net realized gains or losses, net impairment losses recognized in earnings, equity in net income or loss of investment funds accounted for using the equity method and net foreign exchange gains or losses in any particular period are not indicative of the performance of, or trends in, our business. Although net realized gains or losses, net impairment losses recognized in earnings, equity in net income or loss of investment funds accounted for using the equity method and net foreign exchange gains or losses are an integral part of our operations, the decision to realize investment gains or losses, the recognition of the change in the carrying value of investments accounted for using the fair value option in net realized gains or losses, the recognition of net impairment losses, the recognition of equity in net income or loss of investment funds accounted for using the equity method and the recognition of foreign exchange gains or losses are independent of the insurance underwriting process and result, in large part, from general economic and financial market conditions. Furthermore, certain users of our financial information believe that, for many companies, the timing of the realization of investment gains or losses is largely opportunistic. In addition, net impairment losses recognized in earnings on our investments represent other-than-temporary declines in expected recovery values on securities without actual realization. The use of the equity method on certain of our investments in certain funds that invest in fixed maturity securities is driven by the ownership structure of such funds (either limited partnerships or limited liability companies). In applying the equity method, these investments are initially recorded at cost and are subsequently adjusted based on our proportionate share of the net income or loss of the funds (which include changes in the market value of the underlying securities in the funds). This method of accounting is different from the way we account for our other fixed maturity securities and the timing of the recognition of equity in net income or loss of investment funds accounted for using the equity method may differ from gains or losses in the future upon sale or maturity of such investments. Due to these reasons, we exclude net realized gains or losses, net impairment losses recognized in earnings, equity in net income or loss of investment funds accounted for using the equity method and net foreign exchange gains or losses from the calculation of after-tax operating income available to Arch common shareholders.

We believe that showing net income available to Arch common shareholders exclusive of the items referred to above reflects the underlying fundamentals of our business since we evaluate the performance of and manage our business to produce an underwriting profit. In addition to presenting net income available to Arch common shareholders, we believe that this presentation enables investors and other users of our financial information to analyze our performance in a manner similar to how management analyzes performance. We also believe that this measure follows industry practice and, therefore, allows the users of financial information to compare our performance with our industry peer group. We believe that the equity analysts and certain rating agencies which follow us and the insurance industry as a whole generally exclude these items from their analyses for the same reasons.

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## RESULTS OF OPERATIONS

The following table summarizes, on an after-tax basis, our consolidated financial data, including a reconciliation of after-tax operating income available to Arch common shareholders to net income available to Arch common shareholders:

|  | Three Months Ended |            |
|--|--------------------|------------|
|  | March 31,          |            |
|  | 2015               | 2014       |
| After-tax operating income available to Arch common shareholders                           | \$ 149,846         | \$ 164,404 |
| Net realized gains, net of tax   | 61,934             | 18,273     |
| Net impairment losses recognized in earnings, net of tax                                   | (5,799             | ) (2,971   |
| Equity in net income of investment funds accounted for using the equity method, net of tax | 5,532              | 3,164      |
| Net foreign exchange gains (losses), net of tax  | 66,339             | (5,854     |
| Net income available to Arch common shareholders   | \$ 277,852         | \$ 177,016 |

## Segment Information

We classify our businesses into three underwriting segments — insurance, reinsurance and mortgage — and two other operating segments — ‘other’ and corporate (non-underwriting). Our 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 our 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 our three underwriting segments based on underwriting income or loss. We do not manage our assets by underwriting segment, with the exception of goodwill and intangible assets, and, accordingly, investment income is not allocated to each underwriting segment.

We determined our 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 our consolidated financial statements. Intersegment business is allocated to the segment accountable for the underwriting results. The corporate (non-underwriting) segment results include net investment income, other income (loss), other expenses incurred by us, 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 our non-cumulative preferred shares. Such amounts exclude the results of the ‘other’ segment.

The mortgage segment consists of our mortgage insurance and reinsurance business and includes the results of Arch MI U.S. Arch MI U.S. is approved as an eligible mortgage insurer by Federal National Mortgage Association (“Fannie Mae”) and Federal Home Loan Mortgage Corporation (“Freddie Mac”), each a government sponsored enterprise, or “GSE.” Arch MI US provides mortgage insurance to banks, credit unions and other lenders nationwide. The mortgage segment also provides reinsurance on a global basis, direct mortgage insurance in Europe and various risk-sharing products to government agencies and mortgage lenders.

In March 2014, we invested \$100.0 million and acquired approximately 11% of Watford Holdings Ltd.’s common equity and a warrant to purchase additional common equity. Watford Holdings Ltd. is the parent of Watford Re Ltd., a multi-line Bermuda reinsurance company (together with Watford Holdings Ltd., “Watford Re”). Watford Re is considered a variable interest entity (“VIE”) and we concluded that we are the primary beneficiary of Watford Re. As such, the results of Watford Re are included in our consolidated financial statements. The ‘other’ segment includes the

results of Watford Re. Watford Re has its own management and board of directors that is responsible for the overall profitability of its results. The portion of Watford Re's earnings attributable to third party investors is recorded in the consolidated statements of income as 'amounts attributable to noncontrolling interests.' For the 'other' segment, performance is measured based on net income or loss.

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## Insurance Segment

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

|                                     | Three Months Ended March 31, |            |                |
|-------------------------------------|------------------------------|------------|----------------|
|                                     | 2015                         | 2014       | % Change       |
| Gross premiums written              | \$766,153                    | \$730,646  | 4.9            |
| Premiums ceded                      | (224,150 )                   | (185,044 ) |                |
| Net premiums written                | 542,003                      | 545,602    | (0.7 )         |
| Change in unearned premiums         | (34,089 )                    | (68,101 )  |                |
| Net premiums earned                 | 507,914                      | 477,501    | 6.4            |
| Other underwriting income           | 427                          | 500        |                |
| Losses and loss adjustment expenses | (317,896 )                   | (286,770 ) |                |
| Acquisition expenses, net           | (75,078 )                    | (76,932 )  |                |
| Other operating expenses            | (88,119 )                    | (81,144 )  |                |
| Underwriting income                 | \$27,248                     | \$33,155   | (17.8 )        |
|                                     |                              |            | % Point Change |
| Underwriting Ratios                 |                              |            |                |
| Loss ratio                          | 62.6                         | % 60.1     | % 2.5          |
| Acquisition expense ratio           | 14.8                         | % 16.1     | % (1.3 )       |
| Other operating expense ratio       | 17.3                         | % 17.0     | % 0.3          |
| Combined ratio                      | 94.7                         | % 93.2     | % 1.5          |

The insurance segment consists of our insurance underwriting units which offer specialty product lines on a worldwide basis. Product lines include:

**Construction and national accounts:** primary and excess casualty coverages to middle and large accounts in the construction industry and a wide range of products for middle and large national accounts, specializing in loss sensitive primary casualty insurance programs (including large deductible, self-insured retention and retrospectively rated programs).

**Excess and surplus casualty:** primary and excess casualty insurance coverages, including middle market energy business, and contract binding, which primarily provides casualty coverage through a network of appointed agents to small and medium risks.

**Lenders products:** collateral protection, debt cancellation and service contract reimbursement products to banks, credit unions, automotive dealerships and original equipment manufacturers and other specialty programs that pertain to automotive lending and leasing.

**Professional lines:** directors' and officers' liability, errors and omissions liability, employment practices liability, fiduciary liability, crime, professional indemnity and other financial related coverages for corporate, private equity, venture capital, real estate investment trust, limited partnership, financial institution and not-for-profit clients of all sizes and medical professional and general liability insurance coverages for the healthcare industry. The business is predominately written on a claims-made basis.

**Programs:** primarily package policies, underwriting workers' compensation and umbrella liability business in support of desirable package programs, targeting program managers with unique expertise and niche products offering general liability, commercial automobile, inland marine and property business with minimal catastrophe exposure.

**Property, energy, marine and aviation:** primary and excess general property insurance coverages, including catastrophe-exposed property coverage, for commercial clients. Coverages for marine include hull, war, specie and liability. Aviation and stand alone terrorism are also offered.

**Travel, accident and health:** specialty travel and accident and related insurance products for individual, group travelers, travel agents and suppliers, as well as accident and health, which provides accident, disability and medical

plan insurance coverages for employer groups, medical plan members, students and other participant groups. Other: includes alternative market risks (including captive insurance programs), excess workers' compensation and employer's liability insurance coverages for qualified self-insured groups, associations and trusts, and contract and commercial surety coverages, including contract bonds (payment and performance bonds) primarily for medium and large contractors and commercial surety bonds for Fortune 1,000 companies and smaller transaction business programs.



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## Premiums Written.

The following table sets forth our insurance segment's net premiums written by major line of business:

|                                       | Three Months Ended March 31, |     |           |     |
|---------------------------------------|------------------------------|-----|-----------|-----|
|                                       | 2015                         |     | 2014      |     |
|                                       | Amount                       | %   | Amount    | %   |
| Programs                              | \$118,197                    | 22  | \$122,240 | 22  |
| Professional lines                    | 111,178                      | 20  | 122,908   | 23  |
| Construction and national accounts    | 96,503                       | 18  | 95,497    | 18  |
| Property, energy, marine and aviation | 58,667                       | 11  | 62,756    | 12  |
| Excess and surplus casualty           | 49,370                       | 9   | 43,940    | 8   |
| Travel, accident and health           | 38,912                       | 7   | 40,838    | 7   |
| Lenders products                      | 22,816                       | 4   | 22,006    | 4   |
| Other                                 | 46,360                       | 9   | 35,417    | 6   |
| Total                                 | \$542,003                    | 100 | \$545,602 | 100 |

2015 First Quarter versus 2014 First Quarter. Gross premiums written by the insurance segment in the 2015 first quarter were 4.9% higher than in the 2014 first quarter, while net premiums written were 0.7% lower than in the 2014 first quarter. The differential in gross versus net premiums written primarily reflects growth in alternative markets business which is subject to a high level of cessions to captives. Changes in foreign currency rates resulted in a decrease in net premiums written in the 2015 first quarter of approximately \$9 million compared to the 2014 first quarter. The change in net premiums written primarily resulted from reductions in professional lines, energy and marine and program business, partially offset by growth in alternative markets and excess and surplus casualty business. The decrease in professional lines and energy and marine business was primarily due to a strategic reduction in exposure to international business while the lower level of program business reflected the termination of one account. The increase in alternative markets primarily reflected new accounts resulting from a renewal rights agreement entered into in the 2014 second quarter while growth in excess and surplus casualty primarily resulted from contract binding business.

## Net Premiums Earned.

The following table sets forth our insurance segment's net premiums earned by major line of business:

|                                       | Three Months Ended March 31, |     |           |     |
|---------------------------------------|------------------------------|-----|-----------|-----|
|                                       | 2015                         |     | 2014      |     |
|                                       | Amount                       | %   | Amount    | %   |
| Programs                              | \$115,964                    | 23  | \$109,181 | 23  |
| Professional lines                    | 107,872                      | 21  | 112,744   | 24  |
| Construction and national accounts    | 72,230                       | 14  | 68,989    | 14  |
| Property, energy, marine and aviation | 55,081                       | 11  | 61,589    | 13  |
| Excess and surplus casualty           | 52,347                       | 10  | 39,107    | 8   |
| Travel, accident and health           | 33,732                       | 7   | 28,065    | 6   |
| Lenders products                      | 22,859                       | 5   | 23,832    | 5   |
| Other                                 | 47,829                       | 9   | 33,994    | 7   |
| Total                                 | \$507,914                    | 100 | \$477,501 | 100 |

Net premiums written are primarily earned on a pro rata basis over the terms of the policies for all products, usually 12 months. Net premiums earned in the 2015 first quarter were 6.4% higher than in the 2014 first quarter. Net premiums earned reflect changes in net premiums written over the previous five quarters.

Losses and Loss Adjustment Expenses.

The table below shows the components of the insurance segment's loss ratio:

|                                  | Three Months Ended |    |      |    |
|----------------------------------|--------------------|----|------|----|
|                                  | March 31,          |    | 2014 |    |
|                                  | 2015               | %  | 2014 | %  |
| Current year                     | 64.3               | %  | 63.4 | %  |
| Prior period reserve development | (1.7               | )% | (3.3 | )% |
| Loss ratio                       | 62.6               | %  | 60.1 | %  |

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## Current Year Loss Ratio.

The insurance segment's current year loss ratio in the 2015 first quarter was 0.9 points higher than in the 2014 first quarter. The 2015 first quarter loss ratio reflected 0.6 points of current year catastrophic activity, compared to 0.5 points in the 2014 first quarter. The loss ratios for the 2015 first quarter also reflected the impact of changes in the mix of business.

## Prior Period Reserve Development.

2015 First Quarter: The insurance segment's net favorable development of \$8.8 million, or 1.7 points, consisted of \$12.0 million of net favorable development in short-tailed lines and \$3.2 million of net adverse development in medium-tailed and long-tailed lines. Favorable development in short-tailed lines primarily consisted of reductions in property (including special risk other than marine) reserves from the 2010 to 2013 accident years (i.e., the year in which a loss occurred), primarily due to varying levels of reported claims activity. Development on the 2005 to 2014 named catastrophic events was favorable by \$3.7 million in the quarter. Net adverse development in medium-tailed and long-tailed lines reflected an increase in programs of \$8.4 million, primarily resulting from higher reported losses in the 2012 to 2014 accident years, partially offset by reductions in the 2006 to 2010 accident years. In addition, the insurance segment's results reflected net favorable development in professional lines of \$2.4 million, including favorable development in executive assurance and healthcare reserves across most accident years, partially offset by an increase in professional liability reserves on international business.

2014 First Quarter: The insurance segment's net favorable development of \$15.6 million, or 3.3 points, consisted of \$14.4 million of net favorable development in short-tailed lines and \$1.2 million of net favorable development in medium-tailed and long-tailed lines. Favorable development in short-tailed lines primarily consisted of reductions in property (including special risk other than marine) reserves from the 2010 and 2012 accident years, primarily due to varying levels of reported claims activity. Development on the 2005 to 2013 named catastrophic events was favorable by \$1.8 million in the quarter. Net favorable development in medium-tailed and long-tailed lines reflected reductions in professional lines of \$14.5 million, spread across most accident years, partially offset by an increase of \$11.0 million in program reserves and \$2.6 million in casualty reserves.

## Underwriting Expenses.

2015 First Quarter versus 2014 First Quarter: The insurance segment's underwriting expense ratio was 32.1% in the 2015 first quarter, compared to 33.1% in the 2014 first quarter. The acquisition expense ratio was 14.8% in the 2015 first quarter, compared to 16.1% in the 2014 first quarter. The lower 2015 first quarter ratio primarily resulted from an increase in ceding commission rates. The other operating expense ratio was 17.3% for the 2015 first quarter, compared to 17.0% for the 2014 first quarter, as a higher level of aggregate expenses was substantially offset by growth in net premiums earned.

## Reinsurance Segment

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

|                             | Three Months Ended March 31, |            |          |
|-----------------------------|------------------------------|------------|----------|
|                             | 2015                         | 2014       | % Change |
| Gross premiums written      | \$485,112                    | \$517,053  | (6.2 )   |
| Premiums ceded              | (136,569 )                   | (73,127 )  |          |
| Net premiums written        | 348,543                      | 443,926    | (21.5 )  |
| Change in unearned premiums | (68,826 )                    | (102,578 ) |          |
| Net premiums earned         | 279,717                      | 341,348    | (18.1 )  |

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|                                     |          |   |          |         |
|-------------------------------------|----------|---|----------|---------|
| Other underwriting income           | 1,429    |   | 316      |         |
| Losses and loss adjustment expenses | (112,532 | ) | (139,636 | )       |
| Acquisition expenses, net           | (56,604  | ) | (73,433  | )       |
| Other operating expenses            | (38,044  | ) | (36,195  | )       |
| Underwriting income                 | \$73,966 |   | \$92,400 | (20.0 ) |

| Underwriting Ratios           |      |   | %    | Point<br>Change |
|-------------------------------|------|---|------|-----------------|
| Loss ratio                    | 40.2 | % | 40.9 | % (0.7 )        |
| Acquisition expense ratio     | 20.2 | % | 21.5 | % (1.3 )        |
| Other operating expense ratio | 13.6 | % | 10.6 | % 3.0           |
| Combined ratio                | 74.0 | % | 73.0 | % 1.0           |

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The reinsurance segment consists of our reinsurance underwriting units which offer specialty product lines on a worldwide basis. Product lines include:

**Casualty:** provides coverage to ceding company clients on third party liability and workers' compensation exposures from ceding company clients, primarily on a treaty basis. Exposures include, among others, executive assurance, professional liability, workers' compensation, excess and umbrella liability, excess motor and healthcare business.

**Marine and aviation:** provides coverage for energy, hull, cargo, specie, liability and transit, and aviation business, including airline and general aviation risks. Business written may also include space business, which includes coverages for satellite assembly, launch and operation for commercial space programs.

**Other specialty:** provides coverage to ceding company clients for non-excess motor, including U.K. business primarily emanating from one client, and other lines including surety, accident and health, workers' compensation catastrophe, agriculture, trade credit and political risk.

**Property catastrophe:** provides protection for most catastrophic losses that are covered in the underlying policies written by reinsureds, including hurricane, earthquake, flood, tornado, hail and fire, and coverage for other perils on a case-by-case basis. Property catastrophe reinsurance provides coverage on an excess of loss basis when aggregate losses and loss adjustment expense from a single occurrence of a covered peril exceed the retention specified in the contract.

**Property excluding property catastrophe:** provides coverage for both personal lines and commercial property exposures and principally covers buildings, structures, equipment and contents. The primary perils in this business include fire, explosion, collapse, riot, vandalism, wind, tornado, flood and earthquake. Business is assumed on both a proportional and excess of loss basis. In addition, facultative business is written which focuses on commercial property risks on an excess of loss basis.

**Other.** includes life reinsurance business on both a proportional and non-proportional basis, casualty clash business and, in limited instances, non-traditional business which is intended to provide insurers with risk management solutions that complement traditional reinsurance.

Premiums Written.

The following table sets forth our reinsurance segment's net premiums written by major line of business:

|   | Three Months Ended March 31, |     |           |     |
|---|------------------------------|-----|-----------|-----|
|   | 2015                         |     | 2014      |     |
|   | Amount                       | %   | Amount    | %   |
| Casualty                                | \$117,858                    | 34  | \$126,713 | 29  |
| Other specialty                         | 101,148                      | 29  | 147,609   | 33  |
| Property excluding property catastrophe | 89,924                       | 26  | 95,127    | 21  |
| Marine and aviation                     | 20,844                       | 6   | 16,911    | 4   |
| Property catastrophe                    | 15,443                       | 4   | 52,512    | 12  |
| Other                                   | 3,326                        | 1   | 5,054     | 1   |
| Total                                   | \$348,543                    | 100 | \$443,926 | 100 |
| Pro rata                                | \$130,235                    | 37  | \$174,197 | 39  |
| Excess of loss                          | 218,308                      | 63  | 269,729   | 61  |
| Total                                   | \$348,543                    | 100 | \$443,926 | 100 |

2015 First Quarter versus 2014 First Quarter. Gross premiums written by the reinsurance segment in the 2015 first quarter were 6.2% lower than in the 2014 first quarter, while net premiums written were 21.5% lower than in the 2014 first quarter. The difference in gross versus net premiums written primarily reflects an increase in cessions to Watford Re in the 2015 first quarter compared to the 2014 first quarter. Changes in foreign currency rates resulted in a decrease in net premiums written in the 2015 first quarter of approximately \$23 million compared to the 2014 first quarter. The lower level of net premiums written reflected decreases in other specialty, property catastrophe and casualty lines. The

decrease in other specialty reflected non-renewals and share decreases in response to current market conditions. The lower level of property catastrophe business reflected non-renewals and share decreases in response to current market conditions and a higher usage of retrocessional coverage. The decrease in casualty premiums primarily resulted from cessions to Watford Re.

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## Net Premiums Earned.

The following table sets forth our reinsurance segment's net premiums earned by major line of business:

|   | Three Months Ended March 31, |     |           |     |
|---|------------------------------|-----|-----------|-----|
|   | 2015                         |     | 2014      |     |
|   | Amount                       | %   | Amount    | %   |
| Casualty                                | \$73,381                     | 26  | \$78,746  | 23  |
| Other specialty                         | 83,798                       | 30  | 114,938   | 34  |
| Property excluding property catastrophe | 79,764                       | 28  | 75,374    | 22  |
| Marine and aviation                     | 12,613                       | 5   | 18,895    | 5   |
| Property catastrophe                    | 27,270                       | 10  | 49,794    | 15  |
| Other                                   | 2,891                        | 1   | 3,601     | 1   |
| Total                                   | \$279,717                    | 100 | \$341,348 | 100 |
| Pro rata                                | \$153,515                    | 55  | \$187,437 | 55  |
| Excess of loss                          | 126,202                      | 45  | 153,911   | 45  |
| Total                                   | \$279,717                    | 100 | \$341,348 | 100 |

Net 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. Net premiums earned for the 2015 first quarter were 18.1% lower than in the 2014 first quarter. Net premiums earned reflect changes in net premiums written over the previous five quarters.

## Losses and Loss Adjustment Expenses.

The table below shows the components of the reinsurance segment's loss ratio:

|                                  | Three Months Ended March 31, |    |        |    |
|----------------------------------|------------------------------|----|--------|----|
|                                  | 2015                         |    | 2014   |    |
|                                  |                              | %  |        | %  |
| Current year                     | 60.9                         | %  | 61.5   | %  |
| Prior period reserve development | (20.7)                       | )% | (20.6) | )% |
| Loss ratio                       | 40.2                         | %  | 40.9   | %  |

## Current Year Loss Ratio.

The reinsurance segment's current year loss ratio in the 2015 first quarter was 0.6 points lower than in the 2014 first quarter. The 2015 first quarter loss ratio reflected 0.6 points of current year catastrophic activity, compared to 1.0 points in the 2014 first quarter. The current year loss ratio for the 2015 first quarter also reflects changes in the mix of business earned due, in part, to a lower contribution from property catastrophe business.

## Prior Period Reserve Development.

2015 First Quarter: The reinsurance segment's net favorable development of \$58.0 million, or 20.7 points, consisted of \$39.2 million from short-tailed lines and \$18.8 million from long-tailed and medium-tailed lines. Favorable development in short-tailed lines included \$27.5 million from property catastrophe and property other than property catastrophe reserves, primarily from the 2012 to 2014 underwriting years (i.e., all premiums and losses attributable to contracts having an inception or renewal date within the given twelve-month period). Contained within this release was favorable development from the 2005 to 2014 named catastrophic events of \$2.1 million. The net reduction of loss estimates for the reinsurance segment's short-tailed lines primarily resulted from varying levels of reported and

paid claims activity than previously anticipated which led to decreases in certain loss ratio selections during the period. Favorable development in long-tailed lines reflected reductions in casualty reserves of \$16.3 million and a reduction of \$3.0 million in marine and aviation reserves based on varying levels of reported and paid claims activity, across all underwriting years.

2014 First Quarter: The reinsurance segment's net favorable development of \$70.4 million, or 20.6 points, consisted of \$51.1 million from short-tailed lines, \$19.3 million from long-tailed and medium-tailed lines. Favorable development in short-tailed lines included \$38.6 million from property catastrophe and property other than property catastrophe reserves, primarily from the 2011 to 2013 underwriting years. The net reduction of loss estimates for the reinsurance segment's short-tailed lines primarily resulted from varying levels of reported and paid claims activity than previously anticipated which led to decreases in certain loss ratio selections during the period. Favorable development in long-tailed lines reflected reductions in casualty



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reserves of \$15.4 million, primarily from the 2003 to 2005 underwriting years based on varying levels of reported and paid claims activity, and a reduction of \$4.3 million in marine and aviation reserves, across all underwriting years.

## Underwriting Expenses.

2015 First Quarter versus 2014 First Quarter: The underwriting expense ratio for the reinsurance segment was 33.8% in the 2015 first quarter, compared to 32.1% in the 2014 first quarter. The acquisition expense ratio for the 2015 first quarter was 20.2%, compared to 21.5% for the 2014 first quarter. The acquisition expense ratio was impacted by changes in development of prior year loss reserves which increased the 2015 first quarter acquisition expense ratio by 0.2 points. In addition, the comparison of the acquisition expense ratios is influenced by, among other things, the mix and type of business written and earned and the level of ceding commissions. The operating expense ratio for the 2015 first quarter was 13.6%, compared to 10.6% in the 2014 first quarter, primarily reflecting the lower level of net premiums earned.

## Mortgage Segment

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

|                                     | Three Months Ended March 31, |           |          |
|-------------------------------------|------------------------------|-----------|----------|
|                                     | 2015                         | 2014      | % Change |
| Gross premiums written              | \$60,541                     | \$47,907  | 26.4     |
| Premiums ceded                      | (8,670 )                     | (4,639 )  |          |
| Net premiums written                | 51,871                       | 43,268    | 19.9     |
| Change in unearned premiums         | (1,504 )                     | (4,503 )  |          |
| Net premiums earned                 | 50,367                       | 38,765    | 29.9     |
| Other underwriting income           | 7,718                        | 766       |          |
| Losses and loss adjustment expenses | (13,809 )                    | (8,478 )  |          |
| Acquisition expenses, net           | (10,418 )                    | (9,154 )  |          |
| Other operating expenses            | (20,369 )                    | (13,876 ) |          |
| Underwriting income                 | \$13,489                     | \$8,023   | 68.1     |

| Underwriting Ratios           | % Point Change |        |          |
|-------------------------------|----------------|--------|----------|
| Loss ratio                    | 27.4           | % 21.9 | % 5.5    |
| Acquisition expense ratio     | 20.7           | % 23.6 | % (2.9 ) |
| Other operating expense ratio | 40.4           | % 35.8 | % 4.6    |
| Combined ratio                | 88.5           | % 81.3 | % 7.2    |

## Premiums Written.

The following table sets forth our mortgage segment's net premiums written by client location and underwriting location (i.e., where the business is underwritten):

|  | Three Months Ended March 31, |     |          |     |
|--|------------------------------|-----|----------|-----|
|  | 2015                         |     | 2014     |     |
|  | Amount                       | %   | Amount   | %   |
| Net premiums written by client location: |                              |     |          |     |
| United States                            | \$45,822                     | 88  | \$36,556 | 85  |
| Other                                    | 6,049                        | 12  | 6,712    | 15  |
| Total                                    | \$51,871                     | 100 | \$43,268 | 100 |

Net premiums written by underwriting location:

|               |          |     |          |     |
|---------------|----------|-----|----------|-----|
| United States | \$27,956 | 54  | \$16,731 | 39  |
| Other         | 23,915   | 46  | 26,537   | 61  |
| Total         | \$51,871 | 100 | \$43,268 | 100 |

2015 First Quarter versus 2014 First Quarter. Net premiums written in the 2015 first quarter included \$27.9 million of business underwritten by Arch MI U.S., compared to \$16.7 million in the 2014 first quarter. The 2015 first quarter amount reflected \$23.7 million from credit union clients and \$4.2 million from banks and other mortgage originators while the 2014 first quarter amount reflected two months of activity due to the acquisition of Arch MI U.S. effective January 30, 2014. Premiums written on reinsurance treaties covering U.S. and international mortgages were lower by \$2.6 million compared to the 2014 first quarter. The persistency rate represents the percentage of mortgage insurance in force at the beginning of a 12-

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month period that remains in force at the end of such period. The persistency rate of the Arch MI U.S. portfolio of mortgage loans was 79.6% at March 31, 2015, compared to 80.9% at December 31, 2014. The decline in persistency was due to policy terminations resulting from low interest rates and associated mortgage refinance activity.

Arch MI U.S. generated \$1.81 billion of new insurance written (“NIW”) during the 2015 first quarter, of which approximately 50% was from credit union clients. NIW represents the original principal balance of all loans that received coverage during the period.

The following table provides details on the NIW generated by Arch MI U.S. for the last four quarters:

| (U.S. Dollars in millions)                | Three Months Ended |     |                   |     |                    |     |               |     |
|---|--------------------|-----|-------------------|-----|--------------------|-----|---------------|-----|
|   | March 31, 2015     |     | December 31, 2014 |     | September 30, 2014 |     | June 30, 2014 |     |
|   | Amount             | %   | Amount            | %   | Amount             | %   | Amount        | %   |
| Total new insurance written (NIW)         | \$1,808            |     | \$1,359           |     | \$1,982            |     | \$941         |     |
| Total NIW by credit quality (FICO score): |                    |     |                   |     |                    |     |               |     |
| >=740                                     | \$1,064            | 59  | \$730             | 54  | \$1,279            | 64  | \$534         | 57  |
| 680-739                                   | 602                | 33  | 480               | 35  | 629                | 32  | 339           | 36  |
| 620-679                                   | 142                | 8   | 149               | 11  | 74                 | 4   | 68            | 7   |
| Total                                     | \$1,808            | 100 | \$1,359           | 100 | \$1,982            | 100 | \$941         | 100 |
| Total NIW by LTV:                         |                    |     |                   |     |                    |     |               |     |
| 95.01% and above                          | \$86               | 5   | \$79              | 6   | \$81               | 4   | \$70          | 8   |
| 90.01% to 95.00%                          | 682                | 38  | 620               | 46  | 904                | 45  | 500           | 53  |
| 85.01% to 90.00%                          | 583                | 32  | 389               | 28  | 646                | 33  | 265           | 28  |
| 85.01% and below                          | 457                | 25  | 271               | 20  | 351                | 18  | 106           | 11  |
| Total                                     | \$1,808            | 100 | \$1,359           | 100 | \$1,982            | 100 | \$941         | 100 |
| Total NIW purchase vs. refinance:         |                    |     |                   |     |                    |     |               |     |
| Purchase                                  | \$918              | 51  | \$950             | 70  | \$1,234            | 62  | \$786         | 84  |
| Refinance                                 | 890                | 49  | 409               | 30  | 748                | 38  | 155           | 16  |
| Total                                     | \$1,808            | 100 | \$1,359           | 100 | \$1,982            | 100 | \$941         | 100 |

## Net Premiums Earned.

The following table sets forth our mortgage segment’s net premiums earned by underwriting location:

| Net premiums earned by underwriting location: | Three Months Ended March 31, |     |          |     |
|---|------------------------------|-----|----------|-----|
|   | 2015                         |     | 2014     |     |
|   | Amount                       | %   | Amount   | %   |
| United States                                 | \$25,519                     | 51  | \$16,856 | 43  |
| Other   | 24,848                       | 49  | 21,909   | 57  |
| Total   | \$50,367                     | 100 | \$38,765 | 100 |

Net premiums earned for the 2015 periods were substantially higher than in the 2014 periods, primarily due to the acquisition of Arch MI U.S. along with a higher earned contribution from the mortgage segment’s quota share reinsurance business.

Losses and Loss Adjustment Expenses.

The table below shows the components of the mortgage segment's loss ratio:

|                                  | Three Months Ended<br>March 31, |    |      |    |
|----------------------------------|---------------------------------|----|------|----|
|                                  | 2015                            |    | 2014 |    |
| Current year                     | 32.6                            | %  | 24.8 | %  |
| Prior period reserve development | (5.2                            | )% | (2.9 | )% |
| Loss ratio                       | 27.4                            | %  | 21.9 | %  |

Unlike property and casualty business for which we estimate ultimate losses on premiums earned, losses on mortgage insurance business are only recorded at the time a borrower is delinquent on their mortgage, in accordance with mortgage insurance industry practice. Because our mortgage insurance reserving process does not take into account the impact of future losses from loans that are not in default, mortgage insurance loss reserves are not an estimate of ultimate losses. In addition to

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establishing loss reserves for loans in default, under GAAP, we are required to establish a premium deficiency reserve for our mortgage insurance products if the amount of expected future losses for a particular product and maintenance costs for such product exceeds expected future premiums, existing reserves and the anticipated investment income for such product. We evaluate whether a premium deficiency exists quarterly. No such reserve was established for the 2015 first quarter.

The mortgage segment's current year loss ratio was 7.8 points higher in the 2015 first quarter compared to the 2014 first quarter. The current year loss ratio for the 2015 first quarter reflects changes in the mix of business earned when compared to the 2014 first quarter. The mortgage segment's net favorable development for the 2015 first quarter of \$2.6 million, or 5.2 points, was spread across a number of underwriting years.

## Underwriting Expenses.

2015 First Quarter versus 2014 First Quarter. The underwriting expense ratio for the mortgage segment was 61.1% in the 2015 first quarter, compared to 59.4% in the 2014 first quarter. The acquisition expense ratio was 20.7% for the 2015 first quarter, compared to 23.6% for the 2014 first quarter. The operating expense ratio was 40.4% for the 2015 first quarter, compared to 35.8% in the 2014 first quarter. As the mortgage segment's mix is expected to shift more towards U.S. mortgage insurance business, the underwriting expense ratio is expected to stay at an elevated rate until Arch MI U.S. reaches scale with respect to non-credit union clientele.

## Other Segment

As noted earlier, the 'other' segment includes the results of Watford Re. See note 3, "Variable Interest Entity and Noncontrolling Interests" and note 5, "Segment Information," of the notes accompanying our consolidated financial statements for additional information. The following table sets forth the results of our 'other' segment:

|  | Three Months Ended |           |
|--|--------------------|-----------|
|  | March 31,          |           |
|  | 2015               | 2014      |
| Gross premiums written   | \$128,633          | \$32,194  |
| Premiums ceded   | (4,055 )           | —         |
| Net premiums written   | 124,578            | 32,194    |
| Change in unearned premiums  | (52,312 )          | (30,028 ) |
| Net premiums earned  | 72,266             | 2,166     |
| Other underwriting income  | 1,962              | —         |
| Losses and loss adjustment expenses                                | (49,479 )          | (1,356 )  |
| Acquisition expenses, net  | (20,976 )          | (823 )    |
| Other operating expenses   | (2,005 )           | (1,109 )  |
| Underwriting income (loss)   | 1,768              | (1,122 )  |
| Net investment income  | 8,706              | 1         |
| Other expenses   | —                  | (2,676 )  |
| Net realized gains   | 17,839             | —         |
| Net foreign exchange (losses) gains                                | (352 )             | 93        |
| Net income (loss)  | 27,961             | (3,704 )  |
| Dividends attributable to redeemable noncontrolling interests (1)  | (4,908 )           | (52 )     |
| Net income (loss) attributable to common interests                 | 23,053             | (3,756 )  |
| Amounts attributable to nonredeemable noncontrolling interests (1) | (20,513 )          | 3,407     |
| Net income (loss) available to Arch                                | \$2,540            | \$(349 )  |
| Underwriting Ratios  |                    |           |

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|                               |             |   |             |   |
|-------------------------------|-------------|---|-------------|---|
| Loss ratio                    | 68.5        | % | 62.6        | % |
| Acquisition expense ratio     | 29.0        | % | 38.0        | % |
| Other operating expense ratio | 2.8         | % | 51.2        | % |
| Combined ratio                | 100.3       | % | 151.8       | % |
| <br>                          |             |   |             |   |
| Total investable assets       | \$1,267,588 |   | \$1,083,280 |   |
| Total assets                  | 1,622,537   |   | 1,146,461   |   |
| Total liabilities             | 515,535     |   | 35,371      |   |

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(1) Recorded as 'amounts attributable to noncontrolling interests' in the consolidated statements of income.

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Other Income or Expense Items (excluding amounts related to the ‘other’ segment)

Net Investment Income. The components of net investment income were derived from the following sources:

|                         | Three Months Ended |          |
|-------------------------|--------------------|----------|
|                         | March 31,          |          |
|                         | 2015               | 2014     |
| Fixed maturities        | \$62,368           | \$62,449 |
| Term loan investments   | 4,275              | 5,669    |
| Equity securities       | 2,679              | 2,921    |
| Short-term investments  | 195                | 405      |
| Other (1)               | 12,737             | 4,718    |
| Gross investment income | 82,254             | 76,162   |
| Investment expenses (2) | (11,966 )          | (9,169 ) |
| Net investment income   | \$70,288           | \$66,993 |

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

(2) Investment expenses were approximately 0.42% of average invested assets for the 2015 first quarter, compared to 0.29% for the 2014 first quarter.

The pre-tax investment income yield, calculated based on amortized cost and on an annualized basis, was 2.09% for the 2015 first quarter, compared to 2.08% for the 2014 first quarter. The comparability of net investment income between the periods was influenced by our share repurchase program, as well as the effects of low prevailing interest rates available in the market. Yields in the future may vary based on financial market conditions, investment allocation decisions and other factors.

Other Income (Loss). We record income or loss from our investments in Gulf Reinsurance Limited (“Gulf Re”) and certain other investments using the equity method on a three month lag basis based on the availability of their financial statements. In addition, other income (loss) from time to time includes certain non-recurring items. We recorded a loss of \$1.9 million in the 2015 first quarter, compared to income of \$2.1 million in the 2014 first quarter. In the 2014 fourth quarter, we entered into a number of strategic initiatives related to Gulf Re, including an agreement to acquire complete ownership of Gulf Re, which was approved by the Dubai Financial Services Authority in April 2015. To further support Gulf Re’s business, we entered into a 90% whole account quota share retrocession arrangement of Gulf Re’s net liabilities and a portfolio transfer of all of Gulf Re’s existing business on a funds withheld basis, effective as of October 1, 2014. Such amounts are reflected in our reinsurance segment results.

Equity in Net Income of Investment Funds Accounted for Using the Equity Method. We recorded \$5.9 million of equity in net income related to investment funds accounted for using the equity method in the 2015 first quarter, compared to \$3.3 million for the 2014 first quarter. We use the equity method on certain investments (which primarily invest in fixed maturity securities) due to the ownership structure of these investment funds, where we do not have a controlling interest and are not the primary beneficiary. In applying the equity method, these investments are initially recorded at cost and are subsequently adjusted based on our proportionate share of the net income or loss of the funds (which include changes in the market value of the underlying securities in the funds). Such investments, which are typically structured as limited partnerships, are generally recorded on a one to three month lag based on the availability of reports from the investment funds. Certain of these funds employ leverage to achieve a higher rate of return on their assets under management. While leverage presents opportunities for increasing the total return of such investments, it may increase losses as well. Fluctuations in the carrying value of the investment funds accounted for using the equity method may increase the volatility of our reported results of operations. Investment funds accounted for using the equity method totaled \$412.4 million at March 31, 2015, compared to \$349.0 million at December 31,

2014.

Net Realized Gains or Losses. We recorded net realized gains of \$65.5 million for the 2015 first quarter, compared to net realized gains of \$19.7 million for the 2014 first quarter. Currently, our portfolio is actively managed to maximize total return within certain guidelines. In assessing returns under this approach, we include net investment income, net realized gains and losses and the change in unrealized gains and losses generated by our investment portfolio. The effect of financial market movements on the investment portfolio will directly impact net realized gains and losses as the portfolio is adjusted and rebalanced. Net realized gains or losses from the sale of fixed maturities primarily resulted from our decisions to reduce credit exposure, to change duration targets, to rebalance our portfolios or due to relative value determinations. Net realized gains or losses also included changes in the fair value of assets and liabilities accounted for using the fair value option along with re-measurement of the contingent consideration liability related to our 2014 acquisition of the CMG Mortgage Insurance

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Company and its affiliated mortgage insurance companies. See note 6, “Investment Information—Net Realized Gains (Losses),” of the notes accompanying our consolidated financial statements for additional information.

**Net Impairment Losses Recognized in Earnings.** On a quarterly basis, we perform reviews of our available for sale investments to determine whether declines in fair value below the cost basis are considered other-than-temporary in accordance with applicable accounting guidance regarding the recognition and presentation of other-than-temporary impairments. The process of determining whether a security is other-than-temporarily impaired requires judgment and involves analyzing many factors. These factors include (i) an analysis of the liquidity, business prospects and overall financial condition of the issuer, (ii) the time period in which there was a significant decline in value, (iii) the significance of the decline, and (iv) the analysis of specific credit events. We evaluate the unrealized losses of our equity securities by issuer and determine if we can forecast a reasonable period of time by which the fair value of the securities would increase and we would recover our cost. If we are unable to forecast a reasonable period of time in which to recover the cost of our equity securities, we record a net impairment loss in earnings equivalent to the entire unrealized loss. We recorded \$5.8 million of OTTI for the 2015 first quarter, compared to \$3.0 million for the 2014 first quarter. The OTTI recorded for the 2015 first quarter included impairments on a short-term investment due to the decline of the Euro against the U.S. Dollar, a small number of corporate bonds based on information received from external investment managers and other items. See note 6, “Investment Information—Other-Than-Temporary Impairments,” of the notes accompanying our consolidated financial statements for additional information.

**Other Expenses.** Other expenses, which are included in our other operating expenses and part of corporate and other (non-underwriting), were \$9.3 million for the 2015 first quarter, compared to \$10.8 million for the 2014 first quarter. The lower level primarily resulted from an adjustment to compensation-related expenses which is not expected to recur in the remainder of 2015. Such amounts primarily represent certain holding company costs necessary to support our worldwide insurance and reinsurance operations, share based compensation expense and costs associated with operating as a publicly traded company.

**Interest expense.** Interest expense was \$12.7 million for the 2015 first quarter, compared to \$14.4 million for the 2014 first quarter. The lower level of interest expense primarily resulted from a lower rate of accretion recorded on certain deposit accounting liabilities than in the 2014 first quarter. In the 2014 third quarter, we reassessed the estimated ultimate liability on certain deposit accounting liabilities due to a determination that paid losses were expected to be lower than initially anticipated. Because the contract does not pass risk transfer under GAAP, it is accounted for similar to a borrowing with accretion and changes in expectations surrounding the estimated ultimate liability impacting interest expense. The reduction of the estimated ultimate liability in the 2014 third quarter of \$8.2 million also reduced the rate of accretion recorded in interest expense for subsequent periods.

**Net Foreign Exchange Gains or Losses.** Net foreign exchange gains for the 2015 first quarter were \$66.9 million, compared to net foreign exchange losses for the 2014 first quarter of \$6.7 million. Amounts in both periods were primarily unrealized and resulted from the effects of revaluing our net insurance liabilities required to be settled in foreign currencies at each balance sheet date. Changes in the value of investments held in foreign currencies due to foreign currency rate movements are reflected as a direct increase or decrease to shareholders’ equity and are not included in the consolidated statements of income. We have not matched a portion of our projected liabilities in foreign currencies with investments in the same currencies and may not match such amounts in future periods, which could increase our exposure to foreign currency fluctuations and increase the volatility of our shareholders’ equity.

**Income tax expense.** Our income tax provision on income before income taxes resulted in an expense of 4.3% for the 2015 first quarter, compared to 2.0% for the 2014 first quarter. Our 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.

CRITICAL ACCOUNTING POLICIES, ESTIMATES AND RECENT ACCOUNTING PRONOUNCEMENTS

Critical accounting policies, estimates and recent accounting pronouncements are discussed in Management's Discussion and Analysis of Financial Condition and Results of Operations contained in our 2014 Form 10-K, updated where applicable in the notes accompanying our consolidated financial statements.

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## FINANCIAL CONDITION, LIQUIDITY AND CAPITAL RESOURCES

## Financial Condition

## Investable Assets Managed by Arch

The finance and investment committee of our board of directors establishes our investment policies and sets the parameters for creating guidelines for our investment managers. The finance and investment committee reviews the implementation of the investment strategy on a regular basis. Our current approach stresses preservation of capital, market liquidity and diversification of risk. While maintaining our emphasis on preservation of capital and liquidity, we expect our portfolio to become more diversified and, as a result, we may expand into areas which are not currently part of our investment strategy. Our Chief Investment Officer administers the investment portfolio, oversees our investment managers, formulates investment strategy in conjunction with our finance and investment committee and directly manages certain portions of our fixed income and equity portfolios.

At March 31, 2015, total investable assets of \$15.72 billion included \$14.46 billion managed by Arch and \$1.27 billion included in the 'other' segment (i.e., attributable to Watford Re), summarized as follows:

|  | March 31, 2015 |            | December 31, 2014 |            |
|--|----------------|------------|-------------------|------------|
|  | Amount         | % of Total | Amount            | % of Total |
| Investable assets (1) (2):   |                |            |                   |            |
| Fixed maturities available for sale, at fair value                             | \$10,427,810   | 72.1       | \$10,750,770      | 73.6       |
| Fixed maturities, at fair value (3)  | 348,689        | 2.4        | 377,053           | 2.6        |
| Fixed maturities pledged under securities lending agreements, at fair value    | 253,115        | 1.8        | 50,802            | 0.3        |
| Total fixed maturities   | 11,029,614     | 76.3       | 11,178,625        | 76.5       |
| Short-term investments available for sale, at fair value                       | 855,032        | 5.9        | 797,226           | 5.5        |
| Cash   | 402,314        | 2.8        | 474,247           | 3.2        |
| Equity securities available for sale, at fair value                            | 687,713        | 4.8        | 658,182           | 4.5        |
| Equity securities, at fair value (3)   | 907            | —          | —                 | —          |
| Other investments available for sale, at fair value                            | 329,677        | 2.3        | 296,224           | 2.0        |
| Other investments, at fair value (3)   | 901,124        | 6.2        | 889,253           | 6.1        |
| Investments accounted for using the equity method (4)                          | 412,367        | 2.8        | 349,014           | 2.4        |
| Securities transactions entered into but not settled at the balance sheet date | (162,136 )     | (1.1 )     | (32,802 )         | (0.2 )     |
| Total investable assets managed by Arch  | \$14,456,612   | 100.0      | \$14,609,969      | 100.0      |

(1) The table above excludes investable assets attributable to the 'other' segment. Such amounts are summarized as follows:

| (U.S. dollars in thousands)  | March 31, 2015 | December 31, 2014 |
|--|----------------|-------------------|
| Investable assets in 'other' segment:  |                |                   |
| Cash   | \$68,698       | \$11,455          |
| Investments accounted for using the fair value option (3)                      | 1,191,266      | 1,169,226         |
| Securities transactions entered into but not settled at the balance sheet date | 7,624          | (17,441 )         |
| Total investable assets included in 'other' segment                            | \$1,267,588    | \$1,163,240       |

(2) This table excludes the collateral received and reinvested and includes the fixed maturities and short-term investments pledged under securities lending agreements, at fair value.

(3) Represents investments which are carried at fair value under the fair value option and reflected as “investments accounted for using the fair value option” on our balance sheet. Changes in the carrying value of such investments are recorded in net realized gains or losses.

(4) Changes in the carrying value of investment funds accounted for using the equity method are recorded as “equity in net income (loss) of investment funds accounted for using the equity method” rather than as an unrealized gain or loss component of accumulated other comprehensive income.

At March 31, 2015, our fixed income portfolio, which includes fixed maturity securities and short-term investments, had average credit quality ratings from Standard & Poor’s Rating Services (“S&P”)/Moody’s of “AA/Aa2” and an average yield to maturity (embedded book yield), before investment expenses, of 2.21%. At December 31, 2014, our fixed income portfolio had average credit quality ratings from S&P/Moody’s of “AA/Aa2” and an average yield to maturity of 2.18%. Our investment portfolio had an average effective duration of 3.35 years at March 31, 2015, compared to 3.34 years at December 31, 2014. At March 31, 2015, approximately \$9.58 billion, or 66%, of total investable assets managed by Arch were internally managed, compared to \$9.87 billion, or 68%, at December 31, 2014.

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The following table summarizes our fixed maturities and fixed maturities pledged under securities lending agreements (“Fixed Maturities”) by type:

|   | Estimated<br>Fair<br>Value | Gross<br>Unrealized<br>Gains | Gross<br>Unrealized<br>Losses | Cost or<br>Amortized<br>Cost |
|---|----------------------------|------------------------------|-------------------------------|------------------------------|
| March 31, 2015                          |                            |                              |                               |                              |
| Corporate bonds                         | \$3,379,536                | \$62,922                     | \$(46,982)                    | ) \$3,363,596                |
| Mortgage backed securities              | 839,621                    | 20,996                       | (2,065)                       | ) 820,690                    |
| Municipal bonds                         | 1,626,580                  | 33,377                       | (2,013)                       | ) 1,595,216                  |
| Commercial mortgage backed securities   | 1,106,332                  | 23,083                       | (2,497)                       | ) 1,085,746                  |
| U.S. government and government agencies | 1,517,834                  | 16,821                       | (776)                         | ) 1,501,789                  |
| Non-U.S. government securities          | 901,780                    | 23,118                       | (52,685)                      | ) 931,347                    |
| Asset backed securities                 | 1,657,931                  | 14,080                       | (3,563)                       | ) 1,647,414                  |
| Total                                   | \$11,029,614               | \$194,397                    | \$(110,581)                   | ) \$10,945,798               |
| December 31, 2014                       |                            |                              |                               |                              |
| Corporate bonds                         | \$3,379,139                | \$37,928                     | \$(38,974)                    | ) \$3,380,185                |
| Mortgage backed securities              | 965,533                    | 18,843                       | (3,842)                       | ) 950,532                    |
| Municipal bonds                         | 1,494,122                  | 31,227                       | (1,044)                       | ) 1,463,939                  |
| Commercial mortgage backed securities   | 1,114,528                  | 14,594                       | (3,822)                       | ) 1,103,756                  |
| U.S. government and government agencies | 1,447,972                  | 8,345                        | (1,760)                       | ) 1,441,387                  |
| Non-U.S. government securities          | 1,099,390                  | 21,311                       | (37,203)                      | ) 1,115,282                  |
| Asset backed securities                 | 1,677,941                  | 8,425                        | (6,089)                       | ) 1,675,605                  |
| Total                                   | \$11,178,625               | \$140,673                    | \$(92,734)                    | ) \$11,130,686               |

The following table provides the credit quality distribution of our Fixed Maturities:

| Rating (1)                                  | March 31, 2015          |               | December 31, 2014       |               |
|---|-------------------------|---------------|-------------------------|---------------|
|   | Estimated<br>Fair Value | % of<br>Total | Estimated<br>Fair Value | % of<br>Total |
| U.S. government and government agencies (2) | \$2,199,182             | 19.9          | \$2,245,489             | 20.1          |
| AAA   | 4,166,106               | 37.8          | 4,299,060               | 38.5          |
| AA  | 2,000,435               | 18.1          | 1,917,392               | 17.2          |
| A   | 1,603,861               | 14.5          | 1,739,922               | 15.6          |
| BBB   | 410,147                 | 3.7           | 339,395                 | 3.0           |
| BB  | 195,163                 | 1.8           | 157,232                 | 1.4           |
| B   | 176,590                 | 1.6           | 184,869                 | 1.7           |
| Lower than B                                | 150,000                 | 1.4           | 154,823                 | 1.4           |
| Not rated                                   | 128,130                 | 1.2           | 140,443                 | 1.1           |
| Total                                       | \$11,029,614            | 100.0         | \$11,178,625            | 100.0         |

(1) For individual fixed maturities, S&P ratings are used. In the absence of an S&P ratings, ratings from Moody’s are used, followed by ratings from Fitch Ratings.

(2) Includes U.S. government-sponsored agency mortgage backed securities and agency commercial mortgage backed securities.

At March 31, 2015, below-investment grade securities comprised approximately 6% of our Fixed Maturities, compared to 6% at December 31, 2014. In accordance with our investment strategy, we invest in high yield fixed income securities which are included in “Corporate bonds.” Upon issuance, these securities are typically rated below

investment grade (i.e., rating assigned by the major rating agencies of “BB+” or less). At March 31, 2015, corporate bonds represented 61% of the total below investment grade securities at fair value, mortgage backed securities represented 24% of the total and 15% were in other classes. At December 31, 2014, corporate bonds represented 69% of the total below investment grade securities at fair value, mortgage backed securities represented 22% of the total and 9% were in other classes. Unrealized losses include the impact of foreign exchange movements on certain securities denominated in foreign currencies and, as such, the amount of securities in an unrealized loss position fluctuates due to foreign currency movements.

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The following table provides information on the severity of the unrealized loss position as a percentage of amortized cost for all Fixed Maturities which were in an unrealized loss position:

| Severity of Unrealized Loss | March 31, 2015       |                         |                                    | December 31, 2014    |                         |                                    |
|-----------------------------|----------------------|-------------------------|------------------------------------|----------------------|-------------------------|------------------------------------|
|                             | Estimated Fair Value | Gross Unrealized Losses | % of Total Gross Unrealized Losses | Estimated Fair Value | Gross Unrealized Losses | % of Total Gross Unrealized Losses |
| 0-10%                       | \$2,152,026          | \$(31,233 )             | 28.2                               | \$4,181,313          | \$(55,498 )             | 59.8                               |
| 10-20%                      | 328,877              | (53,213 )               | 48.1                               | 239,158              | (33,111 )               | 35.7                               |
| 20-30%                      | 93,163               | (25,255 )               | 22.8                               | 5,618                | (1,990 )                | 2.1                                |
| Greater than 30%            | 785                  | (880 )                  | 0.9                                | 3,437                | (2,135 )                | 2.4                                |
| Total                       | \$2,574,851          | \$(110,581 )            | 100.0                              | \$4,429,526          | \$(92,734 )             | 100.0                              |

The following table provides information on the severity of the unrealized loss position as a percentage of amortized cost for non-investment grade Fixed Maturities which were in an unrealized loss position:

| Severity of Unrealized Loss | March 31, 2015       |                         |                                    | December 31, 2014    |                         |                                    |
|-----------------------------|----------------------|-------------------------|------------------------------------|----------------------|-------------------------|------------------------------------|
|                             | Estimated Fair Value | Gross Unrealized Losses | % of Total Gross Unrealized Losses | Estimated Fair Value | Gross Unrealized Losses | % of Total Gross Unrealized Losses |
| 0-10%                       | \$105,808            | \$(2,505 )              | 2.3                                | \$141,986            | \$(3,728 )              | 4.0                                |
| 10-20%                      | 15,542               | (2,156 )                | 1.9                                | 20,127               | (3,530 )                | 3.8                                |
| 20-30%                      | 3,950                | (1,211 )                | 1.1                                | 5,618                | (1,990 )                | 2.1                                |
| Greater than 30%            | 783                  | (879 )                  | 0.8                                | 3,434                | (2,133 )                | 2.3                                |
| Total                       | \$126,083            | \$(6,751 )              | 6.1                                | \$171,165            | \$(11,381 )             | 12.2                               |

We determine estimated recovery values for our Fixed Maturities following a review of the business prospects, credit ratings, estimated loss given default factors and information received from asset managers and rating agencies for each security. For structured securities, we utilize underlying data, where available, for each security provided by asset managers and additional information from credit agencies in order to determine an expected recovery value for each security. The analysis provided by the asset managers includes expected cash flow projections under base case and stress case scenarios which modify expected default expectations and loss severities and slow down prepayment assumptions.

The following table summarizes our top ten exposures to fixed income corporate issuers by fair value at March 31, 2015, excluding guaranteed amounts and covered bonds:

|                                       | Estimated Fair Value | Credit Rating (1) |
|---------------------------------------|----------------------|-------------------|
| Apple Inc.                            | \$101,848            | AA+/Aa1           |
| Exxon Mobil Corp.                     | 86,321               | AAA/Aaa           |
| General Electric Co.                  | 80,670               | AA+/A1            |
| Microsoft Corporation                 | 73,963               | AAA/Aaa           |
| International Business Machines Corp. | 70,340               | AA-/Aa3           |
| Daimler AG                            | 57,298               | A-/A3             |
| Chevron Corp.                         | 55,323               | AA/Aa1            |
| Toyota Motor Corporation              | 54,996               | AA-/Aa3           |
| Honda Motor Co Ltd.                   | 50,281               | A+/A1             |
| Wells Fargo & Company                 | 44,836               | A+/A2             |
| Total                                 | \$675,876            |                   |

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(1) Average credit ratings as assigned by S&P and Moody's, respectively.

Our portfolio includes investments, such as mortgage-backed securities, which are subject to prepayment risk. At March 31, 2015, our investments in residential mortgage-backed securities ("MBS") amounted to approximately \$839.6 million, or 5.8% of total investable assets managed by Arch, compared to \$965.5 million, or 6.6%, at December 31, 2014. As with other fixed income investments, the fair value of these securities fluctuates depending on market and other general economic conditions and the interest rate environment. Changes in interest rates can expose us to changes in the prepayment rate on these investments. In periods of declining interest rates, mortgage prepayments generally increase and MBS are prepaid more quickly, requiring us to reinvest the proceeds at the then current market rates. Conversely, in periods of rising rates, mortgage prepayments generally fall, preventing us from taking full advantage of the higher level of rates. However, economic conditions may curtail prepayment activity if refinancing becomes more difficult, thus limiting prepayments on MBS. Our portfolio also



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includes commercial mortgage backed securities (“CMBS”). At March 31, 2015, CMBS constituted approximately \$1.11 billion, or 7.7% of total investable assets managed by Arch, compared to \$1.11 billion, or 7.6%, at December 31, 2014.

Delinquencies and losses with respect to residential mortgage loans from certain vintage years have increased since 2007 and may continue to increase, particularly in the sub-prime sector. In addition, during this period, residential property values in many states have declined or remained stable, after extended periods during which those values appreciated. A continued decline or an extended flattening in those values may result in additional increases in delinquencies and losses on residential mortgage loans generally, especially with respect to second homes and investment properties, and with respect to any residential mortgage loans where the aggregate loan amounts (including any subordinated loans) are close to or greater than the related property values. These developments may have a significant adverse effect on the prices of loans and securities, including those in our investment portfolio. The situation continues to have wide ranging consequences, including downward pressure on economic growth and the potential for increased insurance and reinsurance exposures, which could have an adverse impact on our results of operations, financial condition, business and operations. In addition, the commercial real estate market has experienced price deterioration, which could lead to increased delinquencies and defaults on commercial real estate mortgages.

The following table provides information on our MBS and CMBS at March 31, 2015, excluding amounts guaranteed by the U.S. government:

|                                      | Issuance Year | Amortized Cost | Average Credit Quality | Estimated Fair Value |                     | % of Investable Assets Managed by Arch |   |
|--------------------------------------|---------------|----------------|------------------------|----------------------|---------------------|--|---|
|                                      |               |                |                        | Total                | % of Amortized Cost |  |   |
| Non-agency MBS:                      | 2003-2008     | \$ 123,170     | CC+                    | \$ 132,942           | 107.9               | % 0.9                                  | % |
|                                      | 2009          | 27,005         | AAA                    | 26,859               | 99.5                | % 0.2                                  | % |
|                                      | 2010          | 22,094         | AA+                    | 21,767               | 98.5                | % 0.2                                  | % |
|                                      | 2013          | 50,485         | AAA                    | 51,389               | 101.8               | % 0.4                                  | % |
|                                      | 2014          | 48,897         | AA                     | 48,918               | 100.0               | % 0.3                                  | % |
|                                      | 2015          | 1,659          | NR                     | 1,662                | 100.2               | % —                                    | % |
| Total non-agency MBS                 |               | \$ 273,310     | BB+                    | \$ 283,537           | 103.7               | % 2.0                                  | % |
| Non-agency CMBS:                     | 2002-2008     | 74,414         | A+                     | 75,290               | 101.2               | % 0.5                                  | % |
|                                      | 2009          | 366            | BBB-                   | 368                  | 100.5               | % —                                    | % |
|                                      | 2010          | 42,380         | AAA                    | 44,246               | 104.4               | % 0.3                                  | % |
|                                      | 2011          | 62,346         | AAA                    | 62,939               | 101.0               | % 0.4                                  | % |
|                                      | 2012          | 67,577         | AAA                    | 69,551               | 102.9               | % 0.5                                  | % |
|                                      | 2013          | 214,565        | AA+                    | 222,261              | 103.6               | % 1.5                                  | % |
|                                      | 2014          | 379,244        | AAA                    | 387,521              | 102.2               | % 2.7                                  | % |
|                                      | 2015          | 118,208        | AA+                    | 118,892              | 100.6               | % 0.8                                  | % |
| Total non-agency CMBS                |               | \$ 959,100     | AA+                    | \$ 981,068           | 102.3               | % 6.8                                  | % |
| Additional Statistics:               |               |                |                        | Non-Agency MBS       |                     | Non-Agency CMBS (1)                    |   |
| Weighted average loan age (months)   |               |                |                        | 82                   |                     | 28                                     |   |
| Weighted average life (months) (2)   |               |                |                        | 50                   |                     | 54                                     |   |
| Weighted average loan-to-value % (3) |               |                |                        | 64.9                 | %                   | 58.5                                   | % |
| Total delinquencies (4)              |               |                |                        | 12.5                 | %                   | 0.6                                    | % |

|                              |     |   |      |   |
|------------------------------|-----|---|------|---|
| Current credit support % (5) | 8.2 | % | 37.8 | % |
|------------------------------|-----|---|------|---|

- 
- (1) Loans defeased with government/agency obligations were not material to the collateral underlying our CMBS holdings.
  - (2) The weighted average life for MBS is based on the interest rates in effect at March 31, 2015. The weighted average life for CMBS reflects the average life of the collateral underlying our CMBS holdings.
  - (3) The range of loan-to-values is 26% to 106% on MBS and 8% to 201% on CMBS.
  - (4) Total delinquencies includes 60 days and over.
  - (5) Current credit support % represents the % for a collateralized mortgage obligation (“CMO”) or CMBS class/tranche from other subordinate classes in the same CMO or CMBS deal.

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The following table provides information on our asset backed securities (“ABS”) at March 31, 2015:

|               | Amortized<br>Cost | Average<br>Credit<br>Quality | Weighted<br>Average<br>Credit<br>Support | Estimated Fair Value |                           |   |
|---------------|-------------------|------------------------------|--|----------------------|---------------------------|---|
|               |                   |                              |  | Total                | % of<br>Amortized<br>Cost | % of Investable<br>Assets<br>Managed by<br>Arch |
| Sector:       |                   |                              |  |                      |                           |   |
| Credit cards  | \$676,323         | AAA                          | 15                                       | % \$681,630          | 100.8                     | % 4.7   |
| Autos         | 393,521           | AAA                          | 25                                       | % 396,785            | 100.8                     | % 2.7   |
| Loans         | 256,985           | AA                           | 42                                       | % 257,070            | 100.0                     | % 1.8   |
| Equipment     | 177,969           | AA                           | 8  | % 178,046            | 100.0                     | % 1.2   |
| Other (1)     | 142,616           | A+                           | 10                                       | % 144,400            | 101.3                     | % 1.0   |
| Total ABS (2) | \$1,647,414       | AA+                          |  | \$1,657,931          | 100.6                     | % 11.5  |

(1) Including rate reduction bonds, commodities, home equity, U.K. securitized and other.

(2) The effective duration of the total ABS was 1.9 years at March 31, 2015.

At March 31, 2015, our fixed income portfolio included \$21.6 million par value in sub-prime securities with a fair value of \$12.7 million and average credit quality ratings from S&P/Moody’s of “CCC-/Caa3.” At December 31, 2014, our fixed income portfolio included \$16.9 million par value in sub-prime securities with a fair value of \$8.5 million and average credit quality ratings from S&P/Moody’s of “CCC/Caa3.” Such amounts were primarily in the home equity sector of our ABS, with the balance in other ABS, MBS and CMBS sectors. We define sub-prime mortgage-backed securities as investments in which the underlying loans primarily exhibit one or more of the following characteristics: low FICO scores, above-prime interest rates, high loan-to-value ratios or high debt-to-income ratios. In addition, the portfolio of collateral backing our securities lending program contained \$5.7 million fair value of sub-prime securities with average credit quality ratings from S&P/Moody’s of “CCC-/Ca” at March 31, 2015, compared to \$5.8 million and “CCC/Ca” at December 31, 2014.

The following table provides information on the fair value of our Eurozone investments at March 31, 2015:

|                   | Sovereign (2) | Financial<br>Corporates | Other<br>Corporates | Bank<br>Loans (3) | Equities and<br>Other | Total     |
|-------------------|---------------|-------------------------|---------------------|-------------------|-----------------------|-----------|
| Country (1)       |               |                         |                     |                   |                       |           |
| Netherlands       | \$77,445      | \$1,499                 | \$60,030            | \$11,663          | \$140                 | \$150,777 |
| Germany           | 67,892        | —                       | 10,835              | 26,142            | 191                   | 105,060   |
| Supranational (4) | 52,284        | —                       | —                   | —                 | —                     | 52,284    |
| Belgium           | 42,525        | —                       | —                   | —                 | —                     | 42,525    |
| Luxembourg        | —             | —                       | 30,769              | 7,646             | 1,783                 | 40,198    |
| Spain             | 21,050        | —                       | 804                 | —                 | —                     | 21,854    |
| France            | 1,992         | 2,274                   | 7,413               | 2,776             | 3,295                 | 17,750    |
| Ireland           | —             | —                       | 3,186               | 1,637             | 4,901                 | 9,724     |
| Italy             | —             | —                       | 558                 | 464               | —                     | 1,022     |
| Slovenia          | 840           | —                       | —                   | —                 | —                     | 840       |
| Total             | \$264,028     | \$3,773                 | \$113,595           | \$50,328          | \$10,310              | \$442,034 |

The country allocations set forth in the table are based on various assumptions made by us in assessing the country in which the underlying credit risk resides, including a review of the jurisdiction of organization, business operations and other factors. Based on such analysis, we do not believe that we have any other Eurozone investments at March 31, 2015.

(2) Sovereign includes securities issued and/or guaranteed by Eurozone governments.

(3) Included in “investments accounted for using the fair value option.”

(4) Includes World Bank, European Investment Bank, International Finance Corp. and European Bank for Reconstruction and Development.

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At March 31, 2015, our equity portfolio included \$687.7 million of equity securities, compared to \$658.2 million at December 31, 2014. Our equity portfolio primarily consists of publicly traded common stocks in the natural resources, energy and consumer staples sectors. The following table provides information on the severity of the unrealized loss position as a percentage of cost for all equity securities classified as available for sale which were in an unrealized loss position:

| Severity of Unrealized Loss | March 31, 2015       |                         |                                    | December 31, 2014    |                         |                                    |
|-----------------------------|----------------------|-------------------------|------------------------------------|----------------------|-------------------------|------------------------------------|
|                             | Estimated Fair Value | Gross Unrealized Losses | % of Total Gross Unrealized Losses | Estimated Fair Value | Gross Unrealized Losses | % of Total Gross Unrealized Losses |
| 0-10%                       | \$180,329            | \$(5,923)               | ) 47.5                             | \$127,467            | \$(4,973)               | ) 37.2                             |
| 10-20%                      | 42,216               | (5,370)                 | ) 43.1                             | 47,880               | (6,546)                 | ) 49.0                             |
| 20-30%                      | 4,158                | (1,170)                 | ) 9.4                              | 5,328                | (1,695)                 | ) 12.7                             |
| Greater than 30%            | 8                    | (4)                     | ) —                                | 327                  | (150)                   | ) 1.1                              |
| Total                       | \$226,711            | \$(12,467)              | ) 100.0                            | \$181,002            | \$(13,364)              | ) 100.0                            |

On a quarterly basis, we evaluate the unrealized losses of our equity securities by issuer and forecast a reasonable period of time by which the fair value of the securities would increase and we would recover the cost basis. All of the unrealized losses on equity securities were on holdings which have been in a continual unrealized loss position for less than 12 months at March 31, 2015. We believe that a reasonable period of time exists to allow for recovery of the cost basis of our equity securities that are in an unrealized loss position at March 31, 2015.

The following table summarizes our other investments:

|  | March 31, 2015 | December 31, 2014 |
|--|----------------|-------------------|
| Available for sale:  |                |                   |
| Asian and emerging markets                                 | \$270,087      | \$236,586         |
| Investment grade fixed income                              | 59,590         | 59,638            |
| Total available for sale                                   | 329,677        | 296,224           |
| Fair value option:   |                |                   |
| Term loan investments (par value: \$387,402 and \$415,462) | 388,062        | 410,995           |
| Mezzanine debt funds                                       | 121,570        | 121,341           |
| Credit related funds                                       | 138,576        | 114,436           |
| Investment grade fixed income                              | 63,162         | 69,108            |
| Asian and emerging markets                                 | 26,846         | 25,800            |
| Other (1)  | 162,908        | 147,573           |
| Total fair value option                                    | 901,124        | 889,253           |
| Total  | \$1,230,801    | \$1,185,477       |

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

Certain of our other investments are in investment funds for which we have 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 our 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 our investment is eligible to be redeemed, the time to redeem such investment can take weeks or months following the notification.

Certain of our investment managers may use leverage to achieve a higher rate of return on their assets under management, primarily those included in "other investments available for sale, at fair value," "investments accounted for using the fair value option" and "investments accounted for using the equity method" on our balance sheet. While leverage presents opportunities for increasing the total return of such investments, it may increase losses as well. Accordingly, any event that adversely affects the value of the underlying holdings would be magnified to the extent leverage is used and our potential losses would be magnified. In addition, the structures used to generate leverage may lead to such investments being required to meet covenants based on market valuations and asset coverage. Market valuation declines could force the sale of investments into a depressed

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market, which may result in significant additional losses. Alternatively, the levered investments may attempt to delever by raising additional equity or potentially changing the terms of the established financing arrangements. We may choose to participate in the additional funding of such investments.

Our investment strategy allows for the use of derivative instruments. We utilize various derivative instruments such as futures contracts to enhance investment performance, replicate investment positions or manage market exposures and duration risk that would be allowed under our investment guidelines if implemented in other ways. See note 8, "Derivative Instruments," of the notes accompanying our consolidated financial statements for additional disclosures concerning derivatives.

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. See note 7, "Fair Value," of the notes accompanying our consolidated financial statements for a summary of our financial assets and liabilities measured at fair value at March 31, 2015 and December 31, 2014 segregated by level in the fair value hierarchy.

## Investable Assets in the 'Other' Segment

Investable assets in the 'other' segment are managed by Watford Re. The board of directors of Watford Re establishes their investment policies and guidelines. Watford Re's investments are accounted for using the fair value option with changes in the carrying value of such investments recorded in net realized gains or losses. The following table summarizes investable assets in the 'other' segment:

|  | March 31,<br>2015 | December 31,<br>2014 |
|--|-------------------|----------------------|
| Cash   | \$68,698          | \$11,455             |
| Investments accounted for using the fair value option:                         |                   |                      |
| Term loan investments (par value: \$667,862 and \$678,875)                     | 656,700           | 662,654              |
| Fixed maturities   | 408,778           | 254,971              |
| Short-term investments   | 125,788           | 251,601              |
| Total investments accounted for using the fair value option                    | 1,191,266         | 1,169,226            |
| Securities transactions entered into but not settled at the balance sheet date | 7,624             | (17,441 )            |
| Total investable assets included in 'other' segment                            | \$1,267,588       | \$1,163,240          |

## Premiums Receivable and Reinsurance Recoverables

At March 31, 2015, 83.3% of premiums receivable of \$1.12 billion represented amounts not yet due, while amounts in excess of 90 days overdue were 3.0% of the total. At December 31, 2014, 80.9% of premiums receivable of \$948.7 million represented amounts not yet due, while amounts in excess of 90 days overdue were 5.4% of the total. Approximately 3.8% of the \$44.5 million of paid losses and loss adjustment expenses recoverable at March 31, 2015 were more than 90 days overdue, while 1.0% of the \$34.5 million of paid losses and loss adjustment expenses recoverable at December 31, 2014 were more than 90 days overdue. Our reserves for doubtful accounts were approximately \$14.2 million at March 31, 2015, compared to \$13.4 million at December 31, 2014.

At March 31, 2015, approximately 82.1% of reinsurance recoverables on paid and unpaid losses (not including prepaid reinsurance premiums) of \$1.79 billion were due from carriers which had an A.M. Best rating of "A-" or better and the largest reinsurance recoverables from any one carrier was approximately 3.5% of our total shareholders' equity. At December 31, 2014, approximately 83.0% of reinsurance recoverables on paid and unpaid losses (not including prepaid reinsurance premiums) of \$1.81 billion were due from carriers which had an A.M. Best rating of "A-"

or better and the largest reinsurance recoverables from any one carrier was approximately 3.7% of our total shareholders' equity.



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The effects of reinsurance on written and earned premiums and losses and loss adjustment expenses with unaffiliated reinsurers were as follows:

|                                     | Three Months Ended<br>March 31, |             |
|-------------------------------------|---------------------------------|-------------|
|                                     | 2015                            | 2014        |
| Premiums Written                    |                                 |             |
| Direct                              | \$794,433                       | \$745,989   |
| Assumed                             | 547,589                         | 549,147     |
| Ceded                               | (275,027 )                      | (230,146 )  |
| Net                                 | \$1,066,995                     | \$1,064,990 |
| Premiums Earned                     |                                 |             |
| Direct                              | \$734,216                       | \$681,888   |
| Assumed                             | 397,251                         | 382,298     |
| Ceded                               | (221,204 )                      | (204,406 )  |
| Net                                 | \$910,263                       | \$859,780   |
| Losses and Loss Adjustment Expenses |                                 |             |
| Direct                              | \$430,842                       | \$385,715   |
| Assumed                             | 159,545                         | 144,021     |
| Ceded                               | (96,670 )                       | (93,496 )   |
| Net                                 | \$493,717                       | \$436,240   |

## Reserves for Losses and Loss Adjustment Expenses

We establish reserves for losses and loss adjustment expenses (“Loss Reserves”) which represent estimates involving actuarial and statistical projections, at a given point in time, of our expectations of the ultimate settlement and administration costs of losses incurred. Estimating Loss Reserves is inherently difficult, which is exacerbated by the fact that we have relatively limited historical experience upon which to base such estimates. We utilize actuarial models as well as available historical insurance industry loss ratio experience and loss development patterns to assist in the establishment of Loss Reserves. Actual losses and loss adjustment expenses paid will deviate, perhaps substantially, from the reserve estimates reflected in our financial statements.

At March 31, 2015 and December 31, 2014, our Loss Reserves, net of unpaid losses and loss adjustment expenses recoverable, by type and by operating segment were as follows:

|                          | March 31,<br>2015 | December 31,<br>2014 |
|--------------------------|-------------------|----------------------|
| Insurance:               |                   |                      |
| Case reserves            | \$1,430,171       | \$1,459,040          |
| IBNR reserves            | 3,067,179         | 3,066,962            |
| Total net reserves       | 4,497,350         | 4,526,002            |
| Reinsurance:             |                   |                      |
| Case reserves            | 791,428           | 794,838              |
| Additional case reserves | 21,882            | 97,413               |
| IBNR reserves            | 1,650,825         | 1,658,468            |
| Total net reserves       | 2,464,135         | 2,550,719            |
| Mortgage:                |                   |                      |
| Case reserves            | 95,865            | 96,092               |
| IBNR reserves            | 22,470            | 21,709               |

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|                          |             |             |
|--------------------------|-------------|-------------|
| Total net reserves       | 118,335     | 117,801     |
| Other:                   |             |             |
| Case reserves            | 21,237      | 12,010      |
| IBNR reserves            | 83,799      | 51,613      |
| Total net reserves       | 105,036     | 63,623      |
| Total:                   |             |             |
| Case reserves            | 2,338,701   | 2,361,980   |
| Additional case reserves | 21,882      | 97,413      |
| IBNR reserves            | 4,824,273   | 4,798,752   |
| Total net reserves       | \$7,184,856 | \$7,258,145 |

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At March 31, 2015 and December 31, 2014, the insurance segment's Loss Reserves by major line of business, net of unpaid losses and loss adjustment expenses recoverable, were as follows:

|                                       | March 31,<br>2015 | December 31,<br>2014 |
|---------------------------------------|-------------------|----------------------|
| Professional lines (1)                | \$1,425,045       | \$1,453,770          |
| Construction and national accounts    | 827,176           | 806,007              |
| Excess and surplus casualty (2)       | 684,562           | 683,305              |
| Programs                              | 684,143           | 669,601              |
| Property, energy, marine and aviation | 360,665           | 407,730              |
| Travel, accident and health           | 57,268            | 60,888               |
| Lenders products                      | 41,002            | 40,579               |
| Other (3)                             | 417,489           | 404,122              |
| Total net reserves                    | \$4,497,350       | \$4,526,002          |

(1) Includes professional liability, executive assurance and healthcare business.

(2) Includes casualty and contract binding business.

(3) Includes alternative markets, excess workers' compensation and surety business.

At March 31, 2015 and December 31, 2014, the reinsurance segment's Loss Reserves by major line of business, net of unpaid losses and loss adjustment expenses recoverable, were as follows:

|   | March 31,<br>2015 | December 31,<br>2014 |
|---|-------------------|----------------------|
| Casualty (1)                                | \$1,393,761       | \$1,432,203          |
| Other specialty (2)                         | 427,123           | 448,418              |
| Property excluding property catastrophe (3) | 341,610           | 346,610              |
| Marine and aviation                         | 138,343           | 139,318              |
| Property catastrophe                        | 109,887           | 128,436              |
| Other (4)                                   | 53,411            | 55,734               |
| Total net reserves                          | \$2,464,135       | \$2,550,719          |

(1) Includes executive assurance, professional liability, workers' compensation, excess motor, healthcare and other.

(2) Includes non-excess motor, surety, accident and health, workers' compensation catastrophe, agriculture, trade credit and other.

(3) Includes facultative business.

(4) Includes life, casualty clash and other.

#### Mortgage Operations Supplemental Information

For the 2015 periods, the mortgage segment's insurance in force ("IIF"), which represents the aggregate dollar amount of each insured mortgage loan's original principal balance, and risk in force ("RIF"), which represents the aggregate dollar amount of each insured mortgage loan's current principal balance multiplied by the insurance coverage percentage specified in the policy for insurance policies issued, were as follows:

| (U.S. Dollars in millions) | March 31, 2015 |               | December 31, 2014 |               | September 30, 2014 |               | June 30, 2014 |               |
|----------------------------|----------------|---------------|-------------------|---------------|--------------------|---------------|---------------|---------------|
|                            | Amount         | % of<br>Total | Amount            | % of<br>Total | Amount             | % of<br>Total | Amount        | % of<br>Total |
| Insurance In Force (IIF):  |                |               |                   |               |                    |               |               |               |
| U.S. mortgage insurance    | \$22,984       | 41            | \$22,402          | 47            | \$22,055           | 46            | \$21,168      | 45            |
| Mortgage reinsurance       | 20,262         | 36            | 20,772            | 44            | 21,097             | 44            | 21,405        | 45            |
| Other (1)                  | 12,944         | 23            | 4,400             | 9             | 4,464              | 10            | 4,586         | 10            |

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|                                    |          |     |          |     |          |     |          |     |
|------------------------------------|----------|-----|----------|-----|----------|-----|----------|-----|
| Total                              | \$56,190 | 100 | \$47,574 | 100 | \$47,616 | 100 | \$47,159 | 100 |
| Risk In Force (RIF) (2):           |          |     |          |     |          |     |          |     |
| U.S. mortgage insurance            | \$5,733  | 54  | \$5,600  | 56  | \$5,506  | 55  | \$5,273  | 53  |
| Mortgage reinsurance               | 4,209    | 40  | 4,393    | 43  | 4,483    | 44  | 4,601    | 46  |
| Other (1)                          | 619      | 6   | 136      | 1   | 136      | 1   | 139      | 1   |
| Total                              | \$10,561 | 100 | \$10,129 | 100 | \$10,125 | 100 | \$10,013 | 100 |
| Ending number of policies in force |          |     |          |     |          |     |          |     |
|                                    | 133,079  |     | 131,111  |     | 129,665  |     | 126,347  |     |

(1) Includes risk-sharing products offered to government sponsored enterprises and mortgage lenders and international insurance business.

For international business and risk-sharing products, the calculation is based on the maximum claim amount which (2) we are exposed to on each insured mortgage loan. For certain of our mortgage reinsurance treaties, such amount incorporates loss ratio caps.

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The following table provides supplemental disclosures for our mortgage segment's U.S. mortgage insurance operations related to RIF:

| (U.S. Dollars in millions)          | March 31, 2015 |            | December 31, 2014 |            | September 30, 2014 |            | June 30, 2014 |            |
|-------------------------------------|----------------|------------|-------------------|------------|--------------------|------------|---------------|------------|
|                                     | Amount         | % of Total | Amount            | % of Total | Amount             | % of Total | Amount        | % of Total |
| Total RIF by credit quality (FICO): |                |            |                   |            |                    |            |               |            |
| >=740                               | \$3,009        | 53         | \$2,917           | 52         | \$2,864            | 52         | \$2,687       | 51         |
| 680-739                             | 1,895          | 33         | 1,846             | 33         | 1,803              | 32         | 1,724         | 33         |
| 620-679                             | 698            | 12         | 700               | 13         | 694                | 13         | 709           | 13         |
| <620                                | 131            | 2          | 137               | 2          | 145                | 3          | 153           | 3          |
| Total                               | \$5,733        | 100        | \$5,600           | 100        | \$5,506            | 100        | \$5,273       | 100        |
| Weighted average FICO score         | 734            |            | 733               |            | 733                |            | 731           |            |
| Total RIF by Loan-To-Value (LTV):   |                |            |                   |            |                    |            |               |            |
| 95.01% and above                    | \$1,102        | 19         | \$1,123           | 20         | \$1,139            | 21         | \$1,161       | 22         |
| 90.01% to 95.00%                    | 2,742          | 48         | 2,652             | 47         | 2,558              | 46         | 2,389         | 45         |
| 85.01% to 90.00%                    | 1,590          | 28         | 1,552             | 28         | 1,544              | 28         | 1,474         | 28         |
| 85.00% and below                    | 299            | 5          | 273               | 5          | 265                | 5          | 249           | 5          |
| Total                               | \$5,733        | 100        | \$5,600           | 100        | \$5,506            | 100        | \$5,273       | 100        |
| Weighted average LTV                | 93.3           | %          | 93.4              | %          | 93.4               | %          | 93.4          | %          |
| Total RIF by State:                 |                |            |                   |            |                    |            |               |            |
| Wisconsin                           | \$536          | 9          | \$538             | 10         | \$532              | 10         | \$517         | 10         |
| California                          | 492            | 9          | 480               | 9          | 474                | 9          | 454           | 9          |
| Texas                               | 307            | 5          | 302               | 5          | 293                | 5          | 283           | 5          |
| Minnesota                           | 278            | 5          | 274               | 5          | 271                | 5          | 258           | 5          |
| Florida                             | 280            | 5          | 273               | 5          | 271                | 5          | 264           | 5          |
| Washington                          | 234            | 4          | 232               | 4          | 231                | 4          | 228           | 4          |
| Massachusetts                       | 213            | 4          | 210               | 4          | 209                | 4          | 204           | 4          |
| Alaska                              | 209            | 4          | 209               | 4          | 207                | 4          | 202           | 4          |
| Virginia                            | 206            | 3          | 200               | 3          | 196                | 3          | 186           | 4          |
| New York                            | 189            | 3          | 188               | 3          | 188                | 3          | 184           | 3          |
| Others                              | 2,789          | 49         | 2,694             | 48         | 2,634              | 48         | 2,493         | 47         |
| Total                               | \$5,733        | 100        | \$5,600           | 100        | \$5,506            | 100        | \$5,273       | 100        |
| Weighted average coverage (1)       | 24.9           | %          | 25.0              | %          | 25.0               | %          | 24.9          | %          |
| Analysts' persistency (2)           | 79.6           | %          | 80.9              | %          | 81.2               | %          | 80.5          | %          |
| Risk-to-capital ratio (3)           | 9.3:1          |            | 9.5:1             |            | 9.3:1              |            | 8.9:1         |            |

(1) Represents the end of period RIF divided by end of period IIF.

(2) Represents the percentage of IIF at the beginning of a 12-month period that remained in force at the end of the period.

(3) Represents total current (non-delinquent) RIF, net of reinsurance, divided by total statutory capital. Ratio calculated for Arch MI U.S. only (estimate for March 31, 2015).

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The following table provides supplemental disclosures for our mortgage segment's U.S. mortgage insurance operations related to insured loans and loss metrics:

| (U.S. Dollars in thousands, except loan count) | Three Months Ended |                      |                       |                  |
|--|--------------------|----------------------|-----------------------|------------------|
|  | March 31,<br>2015  | December 31,<br>2014 | September 30,<br>2014 | June 30,<br>2014 |
| Rollforward of insured loans in default:       |                    |                      |                       |                  |
| Beginning delinquent number of loans           | 3,474              | 3,625                | 3,641                 | 3,858            |
| Plus: new notices                              | 1,190              | 1,402                | 1,553                 | 1,377            |
| Less: cures                                    | (1,376)            | (1,202)              | (1,168)               | (1,202)          |
| Less: paid claims                              | (288)              | (351)                | (397)                 | (383)            |
| Less: delinquent rescissions and denials       | 6                  | —                    | (4)                   | (9)              |
| Ending delinquent number of loans              | 3,006              | 3,474                | 3,625                 | 3,641            |
| Ending percentage of loans in default          | 2.3                | % 2.6                | % 2.8                 | % 2.9            |
| Losses:  |                    |                      |                       |                  |
| Number of claims paid                          | 288                | 351                  | 397                   | 383              |
| Total paid claims                              | \$12,180           | \$15,358             | \$17,093              | \$16,190         |
| Average per claim                              | \$42.3             | \$43.8               | \$43.1                | \$42.3           |
| Severity (1)                                   | 97.1               | % 99.2               | % 93.7                | % 93.0           |
| Average reserve per default                    | \$33.1             | \$27.5               | \$27.1                | \$28.1           |

(1) Represents total paid claims divided by RIF of loans for which claims were paid.

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## Shareholders' Equity and Book Value per Common Share

Total shareholders' equity available to Arch was \$6.29 billion at March 31, 2015, compared to \$6.13 billion at December 31, 2014. The increase in 2015 was primarily attributable to net income, reflecting contributions from both underwriting and investing activities, partially offset by share purchase activity.

The following table presents the calculation of book value per common share:

| (U.S. dollars in thousands, except share data)        | March 31,<br>2015 | December 31,<br>2014 |
|---|-------------------|----------------------|
| Calculation of book value per common share:           |                   |                      |
| Total shareholders' equity available to Arch          | \$6,288,702       | \$6,130,053          |
| Less preferred shareholders' equity                   | 325,000           | 325,000              |
| Common shareholders' equity available to Arch         | \$5,963,702       | \$5,805,053          |
| Common shares outstanding, net of treasury shares (1) | 124,760,841       | 127,367,934          |
| Book value per common share                           | \$47.80           | \$45.58              |

(1) Excludes the effects of 7,736,178 and 7,804,033 stock options and 440,848 and 447,073 restricted stock units outstanding at March 31, 2015 and December 31, 2014, respectively.

## Liquidity and Capital Resources

ACGL is a holding company whose assets primarily consist of the shares in its subsidiaries. Generally, ACGL depends on its available cash resources, liquid investments and dividends or other distributions from its subsidiaries to make payments, including the payment of debt service obligations and operating expenses it may incur and any dividends or liquidation amounts with respect to the non-cumulative preferred shares and common shares. ACGL's readily available cash, short-term investments and marketable securities, excluding amounts held by our regulated insurance and reinsurance subsidiaries, totaled \$8.0 million at March 31, 2015, compared to \$3.3 million at December 31, 2014. During 2015, ACGL received dividends of \$186.0 million from Arch Reinsurance Ltd. ("Arch Re Bermuda"), our Bermuda-based reinsurer and insurer.

The ability of our regulated insurance and reinsurance subsidiaries to pay dividends or make distributions or other payments to us is dependent on their ability to meet applicable regulatory standards. Under Bermuda law, Arch Re Bermuda is required to maintain an enhanced capital requirement which must equal or exceed its minimum solvency margin (i.e., the amount by which the value of its general business assets must exceed its general business liabilities) equal to the greatest of (1) \$100.0 million, (2) 50% of net premiums written (being gross premiums written less any premiums ceded by Arch Re Bermuda, but Arch Re Bermuda may not deduct more than 25% of gross premiums when computing net premiums written) and (3) 15% of net aggregated losses and loss expense provisions and other insurance reserves. Arch Re Bermuda is prohibited from declaring or paying any dividends during any financial year if it is not in compliance with its enhanced capital requirement, minimum solvency margin or minimum liquidity ratio. In addition, Arch Re Bermuda is prohibited from declaring or paying in any financial year dividends of more than 25% of its total statutory capital and surplus (as shown on its previous financial year's statutory balance sheet) unless it files, at least seven days before payment of such dividends, with the Bermuda Monetary Authority ("BMA") an affidavit stating that it will continue to meet the required margins. In addition, Arch Re Bermuda is prohibited, without prior approval of the BMA, from reducing by 15% or more its total statutory capital, as set out in its previous year's statutory financial statements. As a Class 4 insurer, Arch Re Bermuda is required to maintain available statutory capital and surplus pertaining to its general business at a level equal to or in excess of its enhanced capital requirement ("ECR") which is established by reference to either the BSCR model ("BSCR") or an approved internal capital model. At December 31, 2014, as determined under Bermuda law, Arch Re Bermuda had statutory capital of \$2.40 billion (\$2.36

billion at December 31, 2013) and statutory capital and surplus of \$5.42 billion (\$5.42 billion at December 31, 2013), which amounts were in compliance with Arch Re Bermuda's ECR at such date. Such amounts include ownership interests in U.S. insurance and reinsurance subsidiaries. Accordingly, Arch Re Bermuda can pay approximately \$1.17 billion to ACGL during the remainder of 2015 without providing an affidavit to the BMA, as discussed above. Under BMA guidelines, the value of the assets of our insurance group (i.e., the group of companies that conducts exclusively, or mainly, insurance business) must exceed the amount of the group's liabilities by the aggregate minimum margin of solvency of each qualifying member of the group (the "Group MSM"). A member is a qualifying member of the insurance group if it is subject to solvency requirements in the jurisdiction in which it is registered. We were in compliance with the Group MSM at December 31, 2014.

Our U.S. insurance and reinsurance subsidiaries are subject to insurance laws and regulations in the jurisdictions in which they operate. The ability of our regulated insurance subsidiaries to pay dividends or make distributions is dependent on their ability to meet applicable regulatory standards. These regulations include restrictions that limit the amount of dividends or other



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distributions, such as loans or cash advances, available to shareholders without prior approval of the insurance regulatory authorities. Dividends or distributions, if any, made by Arch Re U.S. would result in an increase in available capital at Arch Capital Group (U.S.) Inc. (“Arch-U.S.”), a wholly-owned subsidiary of ACGL. Arch Re U.S. can declare a maximum of approximately \$110 million of dividends during the remainder of 2015 subject to the approval of the Commissioner of the Delaware Department of Insurance (“Commissioner”). In addition, with respect to dividends in excess of the \$110 million (extraordinary dividend), no payment can be made until (1) 30 days after the Commissioner has received notice of the declaration thereof and has not within such period disapproved such payment; or (2) the Commissioner shall have approved the payment within the 30-day period. Delaware insurance laws also require that the statutory surplus of Arch Re U.S. following any dividend or distribution be reasonable in relation to its outstanding liabilities and adequate to its financial needs.

Arch MI U.S. is currently approved by the GSEs as an eligible mortgage insurer. In addition to existing eligibility requirements applicable to all eligible mortgage insurers, the GSEs imposed conditions in connection with their approvals of Arch MI U.S. as a qualified mortgage insurer. These conditions require, among other things, that Arch MI U.S.: (i) maintain minimum capital funding of \$400 million which may consist of statutory capital (policyholders’ surplus plus contingency reserves), dedicated reinsurance trust assets for any primary business reinsured and a value for purchased technology assets; (ii) maintain minimum statutory capital (defined as policyholders’ surplus plus contingency reserves) of no less than \$260 million; (iii) maintain a risk-to-capital ratio of no greater than 18 to 1; and (iv) refrain from paying dividends to affiliates for three years commencing February 2014. On December 31, 2015, these requirements will be superceded by the GSEs’ revised private mortgage insurer eligibility requirements discussed below.

In addition to meeting applicable regulatory standards, the ability of our insurance and reinsurance subsidiaries to pay dividends to intermediate parent companies owned by Arch Re Bermuda is also constrained by our dependence on the financial strength ratings of our insurance and reinsurance subsidiaries from independent rating agencies. The ratings from these agencies depend to a large extent on the capitalization levels of our insurance and reinsurance subsidiaries. We believe that ACGL has sufficient cash resources and available dividend capacity to service its indebtedness and other current outstanding obligations.

Our insurance and reinsurance subsidiaries are required to maintain assets on deposit, which primarily consist of fixed maturities, with various regulatory authorities to support their operations. The assets on deposit are available to settle insurance and reinsurance liabilities to third parties. Our 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. At March 31, 2015 and December 31, 2014, such amounts approximated \$5.54 billion and \$5.52 billion, respectively.

Our non-U.S. operations account for a significant percentage of our net premiums written. In general, the business written by our non-U.S. operations, which is heavily weighted towards reinsurance business, has been more profitable than the business written in our U.S. operations, which is weighted more towards insurance business. In general, our reinsurance segment has operated at a higher margin than our insurance segment, which is due to prevailing market conditions and the mix and type of business written. Historically, the most profitable line of business has been catastrophe-exposed property reinsurance, which is written primarily in our non-U.S. operations. Additionally, a significant component of our pre-tax income is generated through our investment performance. We hold a substantial amount of our investable assets in our non-U.S. operations and, accordingly, a large portion of our investment income is produced in our non-U.S. operations. In addition, ACGL, through its subsidiaries, provides financial support to certain of its insurance subsidiaries and affiliates, through certain reinsurance arrangements beneficial to the ratings of such subsidiaries. Our U.S.-based insurance and reinsurance groups enter into separate reinsurance arrangements with Arch Re Bermuda covering individual lines of business. For the 2014 calendar year, the U.S. groups ceded business to Arch Re Bermuda at an aggregate net cession rate (i.e., net of third party reinsurance) of approximately 53%, compared to 55% for 2013. All of the above factors have resulted in the non-U.S. group providing a higher

contribution to our overall pre-tax income in the current period than the percentage of net premiums written would indicate.

Except as described in the above paragraph, or where express reinsurance, guarantee or other financial support contractual arrangements are in place, each of ACGL's subsidiaries or affiliates is solely responsible for its own liabilities and commitments (and no other ACGL subsidiary or affiliate is so responsible). Any reinsurance arrangements, guarantees or other financial support contractual arrangements that are in place are solely for the benefit of the ACGL subsidiary or affiliate involved and third parties (creditors or insureds of such entity) are not express beneficiaries of such arrangements.

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The following table summarizes our consolidated cash flows from operating, investing and financing activities:

|   | Three Months Ended<br>March 31, |             |
|---|---------------------------------|-------------|
|   | 2015                            | 2014        |
| Total cash provided by (used for):                        |                                 |             |
| Operating activities                                      | \$85,461                        | \$198,169   |
| Investing activities                                      | 44,619                          | (41,226 )   |
| Financing activities                                      | (138,302 )                      | 978,364     |
| Effects of exchange rate changes on foreign currency cash | (6,468 )                        | 241         |
| Increase (decrease) in cash                               | \$(14,690 )                     | \$1,135,548 |

Cash provided by operating activities for the 2015 first quarter was lower than in the 2014 first quarter. The decrease in operating cash flows reflected an increase in outflows related to claim payments, including amounts which are reimbursable from insureds, reinsurers and others, and a lower level of premiums collected, primarily reflecting a higher level of outflows to reinsurers. In the 2015 first quarter, net outflows to Watford Re on affiliated transactions increased compared to the 2014 first quarter. Excluding Watford Re's operating cash flows, our cash flow from operating activities was \$15.6 million, compared to \$197.4 million.

Cash provided by investing activities for the 2015 first quarter was higher than in the 2014 first quarter. Activity for the 2015 first quarter reflected an increase in securities lending transactions while the 2014 first quarter reflected our acquisition of Arch MI U.S.

Cash used for financing activities for the 2015 first quarter was lower than the cash provided by financing activities in the 2014 first quarter. There were \$162.9 million of repurchases under our share repurchase program for the 2015 first quarter, while the 2014 first quarter reflected the capital raising of Watford Re.

Our insurance and reinsurance operations provide liquidity in that premiums are received in advance, sometimes substantially in advance, of the time losses are paid. The period of time from the occurrence of a claim through the settlement of the liability may extend many years into the future. Sources of liquidity include cash flows from operations, financing arrangements or routine sales of investments.

As part of Arch's investment strategy, we seek to establish a level of cash and highly liquid short-term and intermediate-term securities which, combined with expected cash flow, is believed by us to be adequate to meet our foreseeable payment obligations. However, due to the nature of our operations, cash flows are affected by claim payments that may comprise large payments on a limited number of claims and which can fluctuate from year to year. We believe that our liquid investments and cash flow will provide us with sufficient liquidity in order to meet our claim payment obligations. However, the timing and amounts of actual claim payments related to recorded Loss Reserves vary based on many factors, including large individual losses, changes in the legal environment, as well as general market conditions. The ultimate amount of the claim payments could differ materially from our estimated amounts. Certain lines of business written by us, such as excess casualty, have loss experience characterized as low frequency and high severity. The foregoing may result in significant variability in loss payment patterns. The impact of this variability can be exacerbated by the fact that the timing of the receipt of reinsurance recoverables owed to us may be slower than anticipated by us. Therefore, the irregular timing of claim payments can create significant variations in cash flows from operations between periods and may require us to utilize other sources of liquidity to make these payments, which may include the sale of investments or utilization of existing or new credit facilities or capital market transactions. If the source of liquidity is the sale of investments, we may be forced to sell such investments at a loss, which may be material.

Our investments in certain securities, including certain fixed income and structured securities, investments in funds accounted for using the equity method, other investments and our investments in Gulf Reinsurance Limited (joint venture) and Watford Re may be illiquid due to contractual provisions or investment market conditions. If we require significant amounts of cash on short notice in excess of anticipated cash requirements, then we may have difficulty selling these investments in a timely manner or may be forced to sell or terminate them at unfavorable values.

At March 31, 2015, total investable assets of \$15.72 billion included \$14.46 billion managed by Arch and \$1.27 billion included in the 'other' segment (i.e., attributable to Watford Re). The primary goals of our asset liability management process are to satisfy the insurance liabilities, manage the interest rate risk embedded in those insurance liabilities and maintain sufficient liquidity to cover fluctuations in projected liability cash flows, including debt service obligations. Generally, the expected principal and interest payments produced by our fixed income portfolio adequately fund the estimated runoff of our

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insurance reserves. Although this is not an exact cash flow match in each period, the substantial degree by which the fair value of the fixed income portfolio exceeds the expected present value of the net insurance liabilities, as well as the positive cash flow from newly sold policies and the large amount of high quality liquid bonds, provide assurance of our ability to fund the payment of claims and to service our outstanding debt without having to sell securities at distressed prices or access credit facilities. Our unfunded investment commitments totaled approximately \$1.22 billion at March 31, 2015.

Changes in general economic conditions, including new or continued sovereign debt concerns in Eurozone countries or downgrades of U.S. securities by credit rating agencies, could have a material adverse effect on financial markets and economic conditions in the U.S. and throughout the world. In turn, this could have a material adverse effect on our business, financial condition and results of operations and, in particular, this could have a material adverse effect on the value and liquidity of securities in our investment portfolio. Our investment portfolio as of March 31, 2015 included \$264.0 million of securities issued and/or guaranteed by Eurozone governments at fair value, \$1.52 billion of obligations of the U.S. government and government agencies at fair value and \$1.63 billion of municipal bonds at fair value. Please refer to Item 1A “Risk Factors” of our 2014 Form 10-K for a discussion of other risks relating to our business and investment portfolio.

We expect that our liquidity needs, including our anticipated insurance obligations and operating and capital expenditure needs, for the next twelve months, at a minimum, will be met by funds generated from underwriting activities and investment income, as well as by our balance of cash, short-term investments, proceeds on the sale or maturity of our investments, and our credit facilities.

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

On April 17, 2015, Fannie Mae and Freddie Mac (the GSEs) issued revised requirements for private mortgage insurers, including Arch MI U.S. These revised Private Mortgage Insurer Eligibility Requirements (“PMIERS”) are effective December 31, 2015. Proposed PMIERS had been released for public comment by the Federal Housing Finance Agency in July 2014. The revised PMIERS establish new standards that mortgage insurers must meet in order to insure loans sold to or guaranteed by the GSEs. The PMIERS’ financial requirements are based in part on a risk-based, required assets model and employ a grid approach based upon a number of factors, including vintage (origination year), original loan-to-value and original credit score of performing loans and the delinquency status of non-performing loans. No later than March 1, 2016, mortgage insurers must certify to the GSEs that they meet all of the requirements of the PMIERS or identify specific requirements that they do not meet. If a mortgage insurer is unable to meet the financial requirements of the PMIERS, it must submit by March 31, 2016 a transition plan to the GSEs for their review and approval. Mortgage insurers that have not met the financial requirements of the PMIERS by June 30, 2017 will be subject to remediation actions by the GSEs. The available assets required to satisfy the revised financial requirements of the PMIERS at any point in time will be affected by many factors, including macro-economic conditions, the size and composition of Arch MI U.S.’s mortgage insurance portfolio at the applicable point in time, and the amount of ceded risk that may be deducted by Arch MI U.S. in its calculation of “minimum required assets.” Based upon our interpretation of the revised PMIERS and Arch MI U.S.’s mortgage insurance portfolio

and balance sheet as of March 31, 2015, we believe that Arch MI U.S. currently satisfies the PMIERS' financial requirements.

In December 2013, Arch-U.S., a wholly-owned subsidiary of ACGL, completed a public offering of \$500.0 million principal amount of 5.144% senior notes issued at par and due November 1, 2043 ("Arch-U.S. Senior Notes"), fully and unconditionally guaranteed by ACGL (the "Guarantee"). The Arch-U.S. Senior Notes and the Guarantee are unsecured and unsubordinated obligations of Arch-U.S. and ACGL, respectively, and rank equally and ratably with the other unsecured and unsubordinated indebtedness of Arch-U.S. and ACGL, respectively. A portion of the proceeds from the offering were used to fund the acquisition of the mortgage operations noted below. In addition, the proceeds are available for other corporate purposes.

On January 30, 2014, we completed our acquisition of CMG Mortgage Insurance Company and its affiliated mortgage insurance companies (the "CMG Entities"). The Stock Purchase Agreement contains provisions for 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

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one time extension period of one to three years at the sellers' discretion). The maximum amount of contingent consideration payments is \$136.9 million over the earn-out period. To the extent that the adjusted book value of the CMG Entities drops below the cumulative amount paid by us, no additional payments would be due.

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

The board of directors of ACGL has authorized the investment in ACGL's common shares through a share repurchase program. Since the inception of the share repurchase program through March 31, 2015, ACGL has repurchased 120.9 million common shares for an aggregate purchase price of \$3.40 billion. At March 31, 2015, approximately \$724.2 million of share repurchases were available under the program. Repurchases under this authorization may be effected from time to time in open market or privately negotiated transactions through December 31, 2016. 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. We will continue to monitor our share price and, depending upon results of operations, market conditions and the development of the economy, as well as other factors, we will consider share repurchases on an opportunistic basis.

To the extent that our existing capital is insufficient to fund our future operating requirements or maintain such ratings, we may need to raise additional funds through financings or limit our growth. We can provide no assurance that, if needed, we would be able to obtain additional funds through financing on satisfactory terms or at all. Adverse developments in the financial markets, such as disruptions, uncertainty or volatility in the capital and credit markets, may result in realized and unrealized capital losses that could have a material adverse effect on our results of operations, financial position and our businesses, and may also limit our access to capital required to operate our business.

If we are not able to obtain adequate capital, our business, results of operations and financial condition could be adversely affected, which could include, among other things, the following possible outcomes: (1) potential downgrades in the financial strength ratings assigned by ratings agencies to our operating subsidiaries, which could place those operating subsidiaries at a competitive disadvantage compared to higher-rated competitors; (2) reductions in the amount of business that our operating subsidiaries are able to write in order to meet capital adequacy-based tests enforced by statutory agencies; and (3) any resultant ratings downgrades could, among other things, affect our ability to write business and increase the cost of bank credit and letters of credit. In addition, under certain of the reinsurance agreements assumed by our reinsurance operations, upon the occurrence of a ratings downgrade or other specified triggering event with respect to our reinsurance operations, such as a reduction in surplus by specified amounts during specified periods, our ceding company clients may be provided with certain rights, including, among other things, the right to terminate the subject reinsurance agreement and/or to require that our reinsurance operations post additional collateral.

In addition to common share capital, we depend on external sources of finance to support our underwriting activities, which can be in the form (or any combination) of debt securities, preference shares, common equity and bank credit facilities providing loans and/or letters of credit. As noted above, equity or debt financing, if available at all, may be on terms that are unfavorable to us. In the case of equity financings, dilution to our shareholders could result, and, in any case, such securities may have rights, preferences and privileges that are senior to those of our outstanding securities.

In June 2014, we entered into a five-year agreement for a \$300 million unsecured revolving loan and letter of credit facility and a \$500 million secured letter of credit facility. Under the terms of the agreement, Arch Reinsurance Company, our U.S.-based reinsurer, and Arch Re Bermuda are limited to issuing \$100 million of unsecured letters of credit as part of the unsecured revolving loan. In addition, we have access to secured letter of credit facilities of approximately \$180.0 million, which are available on a limited basis and for limited purposes. Refer to note 9, “Commitments and Contingencies—Letter of Credit and Revolving Credit Facilities,” of the notes accompanying our consolidated financial statements for a discussion of our available facilities, applicable covenants on such facilities and available capacity.

In March 2015, ACGL and Arch Capital Group (U.S.) Inc. filed a universal shelf registration statement with the SEC. This registration statement allows for the possible future offer and sale by us of various types of securities, including unsecured debt securities, preference shares, common shares, warrants, share purchase contracts and units and depositary shares. The shelf registration statement enables us to efficiently access the public debt and/or equity capital markets in order to meet our future capital needs. The shelf registration statement also allows selling shareholders to resell common shares that they own in one or more offerings from time to time. We will not receive any proceeds from any shares offered by the selling shareholders. This report is not an offer to sell or the solicitation of an offer to buy nor shall there be any sale of these securities in any state in



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which such offer, solicitation or sale would be unlawful prior to registration or qualification under the securities laws of any such state.

At March 31, 2015, total capital available to Arch of \$7.19 billion consisted of \$800.0 million of senior notes, representing 11.1% of the total, \$100.0 million of revolving credit agreement borrowings due in June 2019, representing 1.4% of the total, \$325.0 million of preferred shares, representing 4.5% of the total, and common shareholders' equity of \$5.96 billion, representing 83.0% of the total. At December 31, 2014, total capital available to Arch of \$7.03 billion consisted of \$800.0 million of senior notes, representing 11.4% of the total, \$100.0 million of revolving credit agreement borrowings due in August 2014, representing 1.4% of the total, \$325.0 million of preferred shares, representing 4.6% of the total, and common shareholders' equity of \$5.81 billion, representing 82.6% of the total. The increase in capital during 2015 reflected strong underwriting and investment returns, partially offset by share repurchase activity.

## Off-Balance Sheet Arrangements

Off-balance sheet arrangements are discussed in Management's Discussion and Analysis of Financial Condition and Results of Operations contained in our 2014 Form 10-K.

## Market Sensitive Instruments and Risk Management

In accordance with the SEC's Financial Reporting Release No. 48, we performed a sensitivity analysis to determine the effects that market risk exposures could have on the future earnings, fair values or cash flows of our financial instruments as of March 31, 2015. Market risk represents the risk of changes in the fair value of a financial instrument and is comprised of several components, including liquidity, basis and price risks. An analysis of material changes in market risk exposures at March 31, 2015 that affect the quantitative and qualitative disclosures presented in our 2014 Form 10-K (see section captioned "Management's Discussion and Analysis of Financial Condition and Results of Operations—Market Sensitive Instruments and Risk Management") were as follows:

## Investment Market Risk

**Fixed Income Securities.** We invest in interest rate sensitive securities, primarily debt securities. We consider the effect of interest rate movements on the fair value of our fixed maturities, fixed maturities pledged under securities lending agreements, short-term investments and certain of our other investments which invest in fixed income securities and the corresponding change in unrealized appreciation. As interest rates rise, the fair value of our interest rate sensitive securities falls, and the converse is also true. Based on historical observations, there is a low probability that all interest rate yield curves would shift in the same direction at the same time. Accordingly, the actual effect of interest rate movements may differ materially from the amounts set forth in the following tables.

The following table summarizes the effect that an immediate, parallel shift in the interest rate yield curve would have had on our fixed income securities (including amounts attributable to the 'other' segment):

| (U.S. dollars in millions) | Interest Rate Shift in Basis Points |            |            |            |            |
|----------------------------|-------------------------------------|------------|------------|------------|------------|
|                            | -100                                | -50        | —          | +50        | +100       |
| March 31, 2015             |                                     |            |            |            |            |
| Total fair value           | \$15,039.6                          | \$14,802.5 | \$14,564.6 | \$14,326.6 | \$14,095.4 |
| Change from base           | 3.26                                | % 1.63     | %          | (1.63)     | )% (3.22)  |
| Change in unrealized value | \$475.0                             | \$237.9    |            | \$(238.0)  | \$(469.2)  |
| December 31, 2014          |                                     |            |            |            |            |
| Total fair value           | \$14,753.8                          | \$14,523.4 | \$14,292.1 | \$14,067.5 | \$13,850.4 |

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|                            |         |   |         |   |          |    |          |    |
|----------------------------|---------|---|---------|---|----------|----|----------|----|
| Change from base           | 3.23    | % | 1.62    | % | (1.57    | )% | (3.09    | )% |
| Change in unrealized value | \$461.7 |   | \$231.3 |   | \$(224.6 | )  | \$(441.7 | )  |

In addition, we consider the effect of credit spread movements on the fair value of our fixed maturities, fixed maturities pledged under securities lending agreements, short-term investments and certain of our other investments and investment funds accounted for using the equity method which invest in fixed income securities and the corresponding change in unrealized appreciation. As credit spreads widen, the fair value of our fixed income securities falls, and the converse is also true.

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The following table summarizes the effect that an immediate, parallel shift in credit spreads in a static interest rate environment would have had on our fixed income securities (including amounts attributable to the 'other' segment):

| (U.S. dollars in millions) | Credit Spread Shift in Basis Points |            |            |            |             |
|----------------------------|-------------------------------------|------------|------------|------------|-------------|
|                            | -100                                | -50        | —          | +50        | +100        |
| March 31, 2015             |                                     |            |            |            |             |
| Total fair value           | \$14,965.4                          | \$14,764.9 | \$14,564.6 | \$14,365.4 | \$14,166.5  |
| Change from base           | 2.75                                | % 1.38     | %          | (1.37)     | )% (2.73)   |
| Change in unrealized value | \$400.8                             | \$200.3    |            | \$(199.2)  | ) \$(398.1) |
| December 31, 2014          |                                     |            |            |            |             |
| Total fair value           | \$14,572.5                          | \$14,446.9 | \$14,292.1 | \$14,151.2 | \$14,012.8  |
| Change from base           | 1.96                                | % 1.08     | %          | (0.99)     | )% (1.95)   |
| Change in unrealized value | \$280.4                             | \$154.8    |            | \$(140.9)  | ) \$(279.3) |

Another method that attempts to measure portfolio risk is Value-at-Risk ("VaR"). VaR attempts to take into account a broad cross-section of risks facing a portfolio by utilizing relevant securities volatility data skewed towards the most recent months and quarters. VaR measures the amount of a portfolio at risk for outcomes 1.65 standard deviations from the mean based on normal market conditions over a one year time horizon and is expressed as a percentage of the portfolio's initial value. In other words, 95% of the time, should the risks taken into account in the VaR model perform per their historical tendencies, the portfolio's loss in any one year period is expected to be less than or equal to the calculated VaR, stated as a percentage of the measured portfolio's initial value. As of March 31, 2015, our portfolio's VaR was estimated to be 3.34%, compared to an estimated 2.86% at December 31, 2014.

**Certain Other Investments and Equity Securities.** Our investment portfolio includes certain other investments which do not invest in fixed income securities along with equity holdings. At March 31, 2015 and December 31, 2014, the fair value of such investments totaled \$688.6 million and \$658.2 million, respectively. These investments are exposed to price risk, which is the potential loss arising from decreases in fair value. An immediate hypothetical 10% decline in the value of each position would reduce the fair value of such investments by approximately \$68.9 million and \$65.8 million at March 31, 2015 and December 31, 2014, respectively, and would have decreased book value per common share by approximately \$0.55 and \$0.52, respectively. An immediate hypothetical 10% increase in the value of each position would increase the fair value of such investments by approximately \$68.9 million and \$65.8 million at March 31, 2015 and December 31, 2014, respectively, and would have increased book value per common share by approximately \$0.55 and \$0.52, respectively.

**Investment-Related Derivatives.** Derivative instruments may be used to enhance investment performance, replicate investment positions or manage market exposures and duration risk that would be allowed under our investment guidelines if implemented in other ways. The fair values of those derivatives are based on quoted market prices. See note 8, "Derivative Instruments," of the notes accompanying our consolidated financial statements for additional disclosures concerning derivatives. At March 31, 2015, the notional value of all derivative instruments (excluding to-be-announced mortgage backed securities which are included in the fixed income securities analysis above and foreign currency forward contracts which are included in the foreign currency exchange risk analysis below) was \$3.04 billion, compared to \$3.28 billion at December 31, 2014. If the underlying exposure of each investment-related derivative held at March 31, 2015 depreciated by 100 basis points, it would have resulted in a reduction in net income of approximately \$30.4 million, and a decrease in book value per common share of approximately \$0.24 per share, compared to \$32.8 million and \$0.26 per share, respectively, on investment-related derivatives held at December 31, 2014. If the underlying exposure of each investment-related derivative held at March 31, 2015 appreciated by 100 basis points, it would have resulted in an increase in net income of approximately \$30.4 million, and an increase in book value per common share of approximately \$0.24 per share, compared to \$32.8 million and \$0.26 per share, respectively, on investment-related derivatives held at December 31, 2014.

For further discussion on investment activity, please refer to “—Financial Condition, Liquidity and Capital Resources—Financial Condition—Investable Assets.”

#### Foreign Currency Exchange Risk

Foreign currency rate risk is the potential change in value, income and cash flow arising from adverse changes in foreign currency exchange rates. Through our subsidiaries and branches located in various foreign countries, we conduct our insurance and reinsurance operations in a variety of local currencies other than the U.S. Dollar. We generally hold investments in foreign currencies which are intended to mitigate our exposure to foreign currency fluctuations in our net insurance liabilities. We may also utilize foreign currency forward contracts and currency options as part of our investment strategy. See note 8, “Derivative Instruments,” of the notes accompanying our consolidated financial statements for additional information.

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The following table provides a summary of our net foreign currency exchange exposures, as well as foreign currency derivatives in place to manage these exposures:

| (U.S. dollars in thousands, except per share data)  | March 31,<br>2015 | December 31,<br>2014 |
|---|-------------------|----------------------|
| Net assets (liabilities), denominated in foreign currencies, excluding shareholders' equity and derivatives | \$ (44,909 )      | \$ 35,372            |
| Shareholders' equity denominated in foreign currencies (1)  | 321,727           | 336,565              |
| Net foreign currency forward contracts outstanding (2)  | (356,432 )        | (308,149 )           |
| Net exposures denominated in foreign currencies   | \$ (79,614 )      | \$ 63,788            |
| Pre-tax impact of a hypothetical 10% appreciation of the U.S. Dollar against foreign currencies:            |                   |                      |
| Shareholders' equity  | \$ 7,961          | \$ (6,379 )          |
| Book value per common share   | \$ 0.06           | \$ (0.05 )           |
| Pre-tax impact of a hypothetical 10% decline of the U.S. Dollar against foreign currencies:                 |                   |                      |
| Shareholders' equity  | \$ (7,961 )       | \$ 6,379             |
| Book value per common share   | \$ (0.06 )        | \$ 0.05              |

(1) Represents capital contributions held in the foreign currencies of our operating units.

(2) Notional value of the outstanding foreign currency forward contracts in U.S. Dollars.

As a result of the current financial and economic environment as well as the potential for additional investment returns, we may not match a portion of our projected liabilities in foreign currencies with investments in the same currencies, which would increase our exposure to foreign currency fluctuations and increase the volatility in our results of operations. Historical observations indicate a low probability that all foreign currency exchange rates would shift against the U.S. Dollar in the same direction and at the same time and, accordingly, the actual effect of foreign currency rate movements may differ materially from the amounts set forth above. For further discussion on foreign exchange activity, please refer to “—Results of Operations.”

#### Cautionary Note Regarding Forward-Looking Statements

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

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

- our ability to successfully implement our business strategy during “soft” as well as “hard” markets;

acceptance of our business strategy, security and financial condition by rating agencies and regulators, as well as by brokers and our insureds and reinsureds;

our ability to maintain or improve our ratings, which may be affected by our ability to raise additional equity or debt financings, by ratings agencies' existing or new policies and practices, as well as other factors described herein;

general economic and market conditions (including inflation, interest rates, foreign currency exchange rates, prevailing credit terms and the depth and duration of a recession) and conditions specific to the reinsurance and insurance markets (including the length and magnitude of the current "soft" market) in which we operate;

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

developments in the world's financial and capital markets and our access to such markets;

our ability to successfully enhance, integrate and maintain operating procedures (including information technology) to effectively support our current and new business;

the loss of key personnel;

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

accuracy of those estimates and judgments utilized in the preparation of our financial statements, including those related to revenue recognition, insurance and other reserves, reinsurance recoverables, investment valuations, intangible assets, bad debts, income taxes, contingencies and litigation, and any determination to use the deposit method of accounting, which for a relatively new insurance and reinsurance company, like our company, are even more difficult to make than those made in a mature company since relatively limited historical information has been reported to us through March 31, 2015;

greater than expected loss ratios on business written by us and adverse development on claim and/or claim expense liabilities related to business written by our insurance and reinsurance subsidiaries;

severity and/or frequency of losses;

claims for natural or man-made catastrophic events in our insurance or reinsurance business could cause large losses and substantial volatility in our results of operations;

acts of terrorism, political unrest and other hostilities or other unforecasted and unpredictable events;

availability to us of reinsurance to manage our gross and net exposures and the cost of such reinsurance;

the failure of reinsurers, managing general agents, third party administrators or others to meet their obligations to us;

the timing of loss payments being faster or the receipt of reinsurance recoverables being slower than anticipated by us;

our investment performance, including legislative or regulatory developments that may adversely affect the fair value of our investments;

changes in general economic conditions, including new or continued sovereign debt concerns in Eurozone countries or downgrades of U.S. securities by credit rating agencies, which could affect our business, financial condition and results of operations;

the volatility of our shareholders' equity from foreign currency fluctuations, which could increase due to us not matching portions of our projected liabilities in foreign currencies with investments in the same currencies;

losses relating to aviation business and business produced by a certain managing underwriting agency for which we may be liable to the purchaser of our prior reinsurance business or to others in connection with the May 5, 2000 asset sale described in our periodic reports filed with the SEC;

changes in accounting principles or policies or in our application of such accounting principles or policies;

changes in the political environment of certain countries in which we operate or underwrite business;

statutory or regulatory developments, including as to tax policy and matters and insurance and other regulatory matters such as the adoption of proposed legislation that would affect Bermuda-headquartered companies and/or Bermuda-based insurers or reinsurers and/or changes in regulations or tax laws applicable to us, our subsidiaries, brokers or customers; and

the other matters set forth under Item 1A "Risk Factors", Item 7 "Management's Discussion and Analysis of Financial Condition and Results of Operations" and other sections of our Annual Report on Form 10-K, as well as the other factors set forth in our other documents on file with the SEC, and management's response to any of the aforementioned factors.

All subsequent written and oral forward-looking statements attributable to us or persons acting on our behalf are expressly qualified in their entirety by these cautionary statements. The foregoing review of important factors should not be construed as exhaustive and should be read in conjunction with other cautionary statements that are included herein or elsewhere. We undertake no obligation to publicly update or revise any forward-looking statement, whether as a result of new information, future events or otherwise.

Other Financial Information

The consolidated financial statements as of March 31, 2015 and for the three month period ended March 31, 2015 and 2014 have been reviewed by PricewaterhouseCoopers LLP, an independent registered public accounting firm. Their report (dated May 8, 2015) is included on page 2. The report of PricewaterhouseCoopers LLP states that they did not audit and they do not express an opinion on that unaudited financial information. Accordingly, the degree of reliance

on their report on such information should be restricted in light of the limited nature of the review procedures applied. PricewaterhouseCoopers LLP is not subject to the liability provisions of Section 11 of the Securities Act of 1933 for their report on the unaudited financial



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information because that report is not a “report” or a “part” of the registration statement prepared or certified by PricewaterhouseCoopers LLP within the meaning of Sections 7 and 11 of the Securities Act of 1933.

### ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

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

### ITEM 4. CONTROLS AND PROCEDURES

#### Evaluation of Disclosure Controls and Procedures

In connection with the filing of this Form 10-Q, our management, including the Chief Executive Officer and Chief Financial Officer, conducted an evaluation of the effectiveness of disclosure controls and procedures pursuant to applicable Exchange Act Rules as of the end of the period covered by this report. Based on that evaluation, the Chief Executive Officer and Chief Financial Officer concluded that the disclosure controls and procedures were effective as of the end of and during the period covered by this report with respect to information being recorded, processed, summarized and reported within time periods specified in the SEC’s rules and forms and with respect to timely communication to them and other members of management responsible for preparing periodic reports of all material information required to be disclosed in this report as it relates to ACGL and its consolidated subsidiaries.

We continue to enhance our operating procedures and internal controls to effectively support our business and our regulatory and reporting requirements. Our management does not expect that our disclosure controls or our internal controls will prevent all errors and all fraud. A control system, no matter how well conceived and operated, can provide only reasonable, not absolute, assurance that the objectives of the control system are met. Further, the design of a control system must reflect the fact that there are resource constraints, and the benefits of controls must be considered relative to their costs. As a result of the inherent limitations in all control systems, no evaluation of controls can provide absolute assurance that all control issues and instances of fraud, if any, within the company have been detected. These inherent limitations include the realities that judgments in decision-making can be faulty, and that breakdowns can occur because of simple error or mistake. Additionally, controls can be circumvented by the individual acts of some persons or by collusion of two or more people. The design of any system of controls also is based in part upon certain assumptions about the likelihood of future events, and there can be no assurance that any design will succeed in achieving its stated goals under all potential future conditions; over time, controls may become inadequate because of changes in conditions, or the degree of compliance with the policies or procedures may deteriorate. As a result of the inherent limitations in a cost-effective control system, misstatement due to error or fraud may occur and not be detected. Accordingly, our disclosure controls and procedures are designed to provide reasonable, not absolute, assurance that the disclosure controls and procedures are met.

#### Changes in Internal Controls Over Financial Reporting

There have been no changes in internal control over financial reporting that occurred during the fiscal quarter ended March 31, 2015 that have materially affected, or are reasonably likely to materially affect, internal control over financial reporting.

## PART II. OTHER INFORMATION

### Item 1. Legal Proceedings

We, in common with the insurance industry in general, are subject to litigation and arbitration in the normal course of our business. As of March 31, 2015, we were not a party to any litigation or arbitration which is expected by management to have a material adverse effect on our results of operations and financial condition and liquidity.

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## Item 2. Unregistered Sales of Equity Securities and Use of Proceeds

The following table summarizes our purchases of our common shares for the 2015 first quarter:

| Period               | Issuer Purchases of Equity Securities |                              | Total Number of Shares Purchased as Part of Publicly Announced Plans or Programs | Approximate Dollar Value of Shares that May Yet be Purchased Under the Plan or Programs (2) |
|----------------------|---------------------------------------|------------------------------|--|---|
|                      | Total Number of Shares Purchased (1)  | Average Price Paid per Share |  |   |
| 1/1/2015 - 1/31/2015 | 884,993                               | \$58.79                      | 872,616  | \$835,835   |
| 2/1/2015 - 2/28/2015 | 351,801                               | 58.82                        | 333,717  | \$816,214   |
| 3/1/2015 - 3/31/2015 | 1,530,759                             | 60.32                        | 1,524,915  | \$724,242   |
| Total                | 2,767,553                             | \$59.64                      | 2,731,248  | \$724,242   |

(1) Includes repurchases by ACGL of shares, from time to time, from employees in order to facilitate the payment of withholding taxes on restricted shares granted and the exercise of stock appreciation rights. We purchased these shares at their fair value, as determined by reference to the closing price of our common shares on the day the restricted shares vested or the stock appreciation rights were exercised.

(2) Remaining amount available at March 31, 2015 under ACGL's share repurchase authorization, under which repurchases may be effected from time to time in open market or privately negotiated transactions through December 31, 2016.

## Item 5. Other Information

In accordance with Section 10a(i)(2) of the Securities Exchange Act of 1934, as amended, we are responsible for disclosing non-audit services to be provided by our independent auditor, PricewaterhouseCoopers LLP, which are approved by the Audit Committee of our board of directors. During the 2015 first quarter, the Audit Committee approved engagements of PricewaterhouseCoopers LLP for permitted non-audit services, which consisted of tax consulting services, tax compliance services and other accounting consulting services.

## Item 6. Exhibits

| Exhibit No. | Description   |
|-------------|---|
| 10.1        | Amended and Restated Employment Agreement, dated February 27, 2015, between Arch Capital Group Ltd. and John D. Vollaro   |
| 10.2        | Share Appreciation Right Agreement, dated November 6, 2014, between Arch Capital Group Ltd. and Marc Grandisson   |
| 10.3        | Restricted Share Agreement, dated November 6, 2014, between Arch Capital Group Ltd. and Marc Grandisson   |
| 15          | Accountants' Awareness Letter (regarding unaudited interim financial information)   |
| 31.1        | Certification of Chief Executive Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002  |
| 31.2        | Certification of Chief Financial Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002  |
| 32.1        | Certification of Chief Executive Officer pursuant to Section 906 of the Sarbanes-Oxley Act of 2002  |
| 32.2        | Certification of Chief Financial Officer pursuant to Section 906 of the Sarbanes-Oxley Act of 2002  |
| 101         | The following financial information from Arch Capital Group Ltd.'s Quarterly Report for the quarter ended March 31, 2015 formatted in XBRL: (i) Consolidated Balance Sheets at March 31, 2015 and |

December 31, 2014; (ii) Consolidated Statements of Income for the three month periods ended March 31, 2015 and 2014; (iii) Consolidated Statements of Comprehensive Income for the three month periods ended March 31, 2015 and 2014; (iv) Consolidated Statements of Changes in Shareholders' Equity for the three month periods ended March 31, 2015 and 2014; (v) Consolidated Statements of Cash Flows for the three month periods ended March 31, 2015 and 2014; and (vi) Notes to Consolidated Financial Statements.

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SIGNATURES

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

ARCH CAPITAL GROUP LTD.  
(REGISTRANT)

Date: May 8, 2015

/s/ Constantine Iordanou  
Constantine Iordanou  
President and Chief Executive Officer  
(Principal Executive Officer) and Chairman of the Board  
of Directors

Date: May 8, 2015

/s/ Mark D. Lyons  
Mark D. Lyons  
Executive Vice President, Chief Financial Officer and  
Treasurer (Principal Financial and Accounting Officer)

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