

ARCH CAPITAL GROUP LTD.

Form 10-Q

November 08, 2013

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

FORM 10-Q

(Mark One)

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

For the period ended September 30, 2013

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, Bermuda  
(Address of principal executive offices)

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

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

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

Large accelerated filer  x

Accelerated filer  o

Non-accelerated filer  o

Smaller reporting company  o

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

Yes  o No  x

The number of the registrant’s common shares (par value, \$0.0033 per share) outstanding as of October 31, 2013 was 133,543,538.

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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 September 30, 2013, and the related consolidated statements of income and comprehensive income for the three-month and nine-month periods ended September 30, 2013 and September 30, 2012, and the consolidated statements of changes in shareholders’ equity and cash flows for the nine-month periods ended September 30, 2013 and September 30, 2012. 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, 2012, and the related consolidated statements of income, comprehensive income, changes in shareholders’ equity, and cash flows for the year then ended (not presented herein), and in our report dated March 1, 2013, we expressed an unqualified opinion on those consolidated financial statements. In our opinion, the information set forth in the accompanying consolidated balance sheet as of December 31, 2012, is fairly stated in all material respects in relation to the consolidated balance sheet from which it has been derived.

/s/ PricewaterhouseCoopers LLP

New York, NY  
November 8, 2013

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## ARCH CAPITAL GROUP LTD. AND SUBSIDIARIES

## CONSOLIDATED BALANCE SHEETS

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

	(Unaudited)	
	September 30, 2013	December 31, 2012
Assets		
Investments:		
Fixed maturities available for sale, at fair value (amortized cost: \$9,671,665 and \$9,567,290)	\$9,688,345	\$9,839,988
Short-term investments available for sale, at fair value (amortized cost: \$992,644 and \$719,848)	993,375	722,121
Investment of funds received under securities lending, at fair value (amortized cost: \$39,793 and \$42,302)	42,135	42,531
Equity securities available for sale, at fair value (cost: \$418,319 and \$298,414)	452,195	312,749
Other investments available for sale, at fair value (cost: \$527,435 and \$519,955)	528,938	549,280
Investments accounted for using the fair value option	1,139,725	917,466
Investments accounted for using the equity method	226,644	307,105
Total investments	13,071,357	12,691,240
Cash	436,141	371,041
Accrued investment income	64,428	71,748
Investment in joint venture (cost: \$100,000)	106,982	107,284
Fixed maturities and short-term investments pledged under securities lending, at fair value	48,361	50,848
Premiums receivable	850,386	688,873
Reinsurance recoverable on unpaid and paid losses and loss adjustment expenses	1,795,888	1,870,037
Contractholder receivables	1,028,772	865,728
Prepaid reinsurance premiums	330,980	298,484
Deferred acquisition costs, net	338,671	262,822
Receivable for securities sold	288,080	19,248
Other assets	570,777	519,409
Total Assets	\$18,930,823	\$17,816,762
Liabilities		
Reserve for losses and loss adjustment expenses	\$8,819,419	\$8,933,292
Unearned premiums	1,983,408	1,647,978
Reinsurance balances payable	190,721	188,546
Contractholder payables	1,028,772	865,728
Senior notes	300,000	300,000
Revolving credit agreement borrowings	100,000	100,000
Securities lending payable	49,849	52,356
Payable for securities purchased	519,244	37,788
Other liabilities	496,125	522,196
Total Liabilities	13,487,538	12,647,884
Commitments and Contingencies		
Shareholders' Equity		

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Non-cumulative preferred shares	325,000	325,000
Common shares (\$0.0033 par, shares issued: 169,350,789 and 168,255,572)	565	561
Additional paid-in capital	283,449	227,778
Retained earnings	5,886,149	5,354,361
Accumulated other comprehensive income, net of deferred income tax	41,955	287,017
Common shares held in treasury, at cost (shares: 35,870,466 and 34,412,959)	(1,093,833 )	(1,025,839 )
Total Shareholders' Equity	5,443,285	5,168,878
Total Liabilities and Shareholders' Equity	\$ 18,930,823	\$ 17,816,762

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 September 30,		(Unaudited) Nine Months Ended September 30,	
	2013	2012	2013	2012
Revenues				
Net premiums written	\$839,135	\$755,249	\$2,602,446	\$2,439,093
Change in unearned premiums	(44,135)	) (6,558	) (295,860	) (283,434
Net premiums earned	795,000	748,691	2,306,586	2,155,659
Net investment income	66,083	73,221	200,124	221,126
Net realized gains (losses)	(6,022	) 60,391	64,970	139,379
Other-than-temporary impairment losses	(901	) (2,644	) (3,873	) (6,129
Less investment impairments recognized in other comprehensive income, before taxes	173	265	175	776
Net impairment losses recognized in earnings	(728	) (2,379	) (3,698	) (5,353
Fee income	526	1,077	1,966	2,426
Equity in net income of investment funds accounted for using the equity method	5,665	24,330	30,429	56,943
Other income (loss)	624	(532	) 2,702	(7,905
Total revenues	861,148	904,799	2,603,079	2,562,275
Expenses				
Losses and loss adjustment expenses	427,045	443,871	1,245,101	1,238,771
Acquisition expenses	147,313	128,065	406,582	375,316
Other operating expenses	118,070	113,429	365,661	337,602
Interest expense	5,937	7,378	17,687	22,338
Net foreign exchange losses	40,562	16,959	2,487	5,958
Total expenses	738,927	709,702	2,037,518	1,979,985
Income before income taxes	122,221	195,097	565,561	582,290
Income tax expense	7,396	5,441	17,320	8,110
Net income	114,825	189,656	548,241	574,180
Preferred dividends	5,484	5,484	16,453	19,594
Loss on repurchase of preferred shares	—	—	—	10,612
Net income available to common shareholders	\$109,341	\$184,172	\$531,788	\$543,974
Net income per common share				
Basic	\$0.83	\$1.36	\$4.05	\$4.04
Diluted	\$0.80	\$1.33	\$3.92	\$3.93

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Weighted average common shares and common  
share equivalents outstanding

Basic	131,495,296	135,067,360	131,262,309	134,519,046
Diluted	136,034,413	138,696,934	135,680,829	138,235,995

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 September 30,		(Unaudited) Nine Months Ended September 30,	
	2013	2012	2013	2012
Comprehensive Income (Loss)				
Net income	\$ 114,825	\$ 189,656	\$ 548,241	\$ 574,180
Other comprehensive income, net of deferred income tax				
Unrealized appreciation (decline) in value of investments:				
Unrealized holding gains (losses) arising during period	41,226	164,733	(208,865	) 277,656
Portion of other-than-temporary impairment losses recognized in other comprehensive income, net of deferred income tax	(173	) (265	) (175	) (776
Reclassification of net realized gains, net of income taxes, included in net income	20,701	(47,411	) (31,916	) (118,714
Foreign currency translation adjustments, net of deferred income tax	29,523	13,978	(4,106	) 12,043
Other comprehensive income (loss)	91,277	131,035	(245,062	) 170,209
Comprehensive Income	\$ 206,102	\$ 320,691	\$ 303,179	\$ 744,389

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)	
	Nine Months Ended	
	September 30,	
	2013	2012
Non-Cumulative Preferred Shares		
Balance at beginning of year	\$ 325,000	\$ 325,000
Shares issued - Series C	—	325,000
Shares repurchased - Series A and B	—	(325,000 )
Balance at end of period	325,000	325,000
Common Shares		
Balance at beginning of year	561	549
Common shares issued, net	4	7
Balance at end of period	565	556
Additional Paid-in Capital		
Balance at beginning of year	227,778	161,419
Common shares issued, net	5,583	4,561
Issue costs on Series C preferred shares	—	(9,398 )
Reversal of issue costs on repurchase of preferred shares	—	10,612
Exercise of stock options	7,438	7,619
Amortization of share-based compensation	40,305	34,659
Other	2,345	1,747
Balance at end of period	283,449	211,219
Retained Earnings		
Balance at beginning of year	5,354,361	4,796,655
Net income	548,241	574,180
Dividends declared on preferred shares	(16,453 )	(19,594 )
Loss on repurchase of preferred shares	—	(10,612 )
Balance at end of period	5,886,149	5,340,629
Accumulated Other Comprehensive Income		
Balance at beginning of year	287,017	153,923
Change in unrealized appreciation (decline) in value of investments, net of deferred income tax	(240,781 )	158,942
Portion of other-than-temporary impairment losses recognized in other comprehensive income, net of deferred income tax	(175 )	(776 )
Foreign currency translation adjustments, net of deferred income tax	(4,106 )	12,043
Balance at end of period	41,955	324,132
Common Shares Held in Treasury, at Cost		
Balance at beginning of year	(1,025,839 )	(845,472 )
Shares repurchased for treasury	(67,994 )	(7,270 )
Balance at end of period	(1,093,833 )	(852,742 )

Total Shareholders' Equity	\$5,443,285	\$5,348,794
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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)	
	Nine Months Ended	
	September 30,	
	2013	2012
Operating Activities		
Net income	\$548,241	\$574,180
Adjustments to reconcile net income to net cash provided by operating activities:		
Net realized losses	(66,957	) (142,703
Net impairment losses recognized in earnings	3,698	5,353
Equity in net income or loss of investment funds accounted for using the equity method and other income or loss	35,634	(37,318
Share-based compensation	40,305	34,659
Changes in:		
Reserve for losses and loss adjustment expenses, net of unpaid losses and loss adjustment expenses recoverable	(24,305	) 180,016
Unearned premiums, net of prepaid reinsurance premiums	295,860	283,433
Premiums receivable	(160,091	) (204,854
Deferred acquisition costs, net	(73,793	) (51,222
Reinsurance balances payable	2,573	19,171
Other liabilities	(15,893	) 21,664
Other items, net	41,776	49,572
Net Cash Provided By Operating Activities	627,048	731,951
Investing Activities		
Purchases of:		
Fixed maturity investments	(12,436,587	) (12,670,073
Equity securities	(438,255	) (215,921
Other investments	(992,935	) (700,308
Proceeds from the sales of:		
Fixed maturity investments	11,877,419	11,522,538
Equity securities	373,000	264,417
Other investments	813,596	329,093
Proceeds from redemptions and maturities of fixed maturity investments	595,503	867,080
Net purchases of short-term investments	(268,968	) 72,139
Change in investment of securities lending collateral	2,508	22,840
Purchase of business, net of cash acquired	—	28,948
Purchases of furniture, equipment and other assets	(10,953	) (13,894
Net Cash Used For Investing Activities	(485,672	) (493,141
Financing Activities		
Proceeds from issuance of Series C preferred shares, net	—	315,763
Repurchase of Series A and B preferred shares	—	(325,000
Purchases of common shares under share repurchase program	(57,796	) —
Proceeds from common shares issued, net	(425	) 1,604
Repayments of borrowings	—	(124,577
Change in securities lending collateral	(2,508	) (22,840

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Other	5,679	4,479
Preferred dividends paid	(16,453	) (22,897
Net Cash Used For Financing Activities	(71,503	) (173,468
Effects of exchange rate changes on foreign currency cash	(4,773	) 5,399
Increase in cash	65,100	70,741
Cash beginning of year	371,041	351,699
Cash end of period	\$436,141	\$422,440

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 wholly owned subsidiaries.

The interim consolidated financial statements have been prepared in conformity with accounting principles generally accepted in the United States of America (“GAAP”) and include the accounts of ACGL and its wholly owned subsidiaries (together with ACGL, the “Company”). 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, 2012, 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. Share Transactions

Share Repurchases

The board of directors of ACGL has authorized the investment in ACGL’s common shares through a share repurchase program. Repurchases under the program may be effected from time to time in open market or privately negotiated transactions through December 2014. Since the inception of the share repurchase program, ACGL has repurchased approximately 109.9 million common shares for an aggregate purchase price of \$2.79 billion. During the 2013 third quarter and nine months ended September 30, 2013, ACGL repurchased 26,300 and 1.3 million common shares, respectively, for an aggregate purchase price of \$1.3 million and \$57.8 million, respectively. No share repurchases were made in the comparable 2012 periods. At September 30, 2013, \$712.1 million of share repurchases were available under the program. The timing and amount of the repurchase transactions under this program will depend on a variety of factors, including market conditions and corporate and regulatory considerations.

Loss on Repurchase of Preferred Shares

The Company issued \$325.0 million of 6.75% Series C preferred shares in April 2012 and subsequently redeemed all of its \$200.0 million of 8.0% Series A preferred shares and \$125.0 million of 7.875% Series B preferred shares at a redemption price equal to \$25.00 per share in May 2012. In accordance with GAAP, upon issuance of the Series A and B preferred shares in 2006, costs of \$10.6 million were recognized as a reduction of additional paid-in capital in

shareholders' equity. Following the redemption of such shares, such issue costs were recorded as a "loss on repurchase of preferred shares" to remove the costs from additional paid-in capital in the second quarter of 2012, as revised and as disclosed in the Company's Annual Report on Form 10-K for the year ended December 31, 2012 (see Note 16 and Note 21).

3. Recent Accounting Pronouncements

Effective January 1, 2013, the Company adopted Financial Accounting Standards Board ("FASB") guidance requiring additional disclosures about reclassification adjustments from accumulated other comprehensive income. As this guidance is disclosure-related only, the adoption of this guidance did not impact the Company's results of operations, financial condition or liquidity. The additional disclosures are provided in Note 11, "Other Comprehensive Income."

Effective January 1, 2013, the Company adopted FASB guidance requiring additional disclosures about financial instruments and derivative instruments that are either: (1) offset for balance sheet presentation purposes or (2) subject to an enforceable master netting arrangement or similar arrangement, regardless of whether they are offset for balance sheet presentation purposes. The disclosure requirements of this guidance are limited to derivatives, repurchase agreements and reverse repurchase agreements, and securities borrowing/lending transactions. As this guidance is disclosure-related only and did not amend existing balance sheet offsetting guidance, adoption did not impact the Company's results of operations, financial condition or liquidity. The additional disclosures are provided in Note 7, "Investment Information," and Note 9, "Derivative Instruments."

#### 4. Commitments and Contingencies

##### Letter of Credit and Revolving Credit Facilities

As of September 30, 2013, the Company had a \$300 million unsecured revolving loan and letter of credit facility and a \$500 million secured letter of credit facility (the "Credit Agreement"). The Credit Agreement expires on August 18, 2014. In addition, the Company had access to secured letter of credit facilities of approximately \$113.8 million as of September 30, 2013, 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 September 30, 2013, the Company had \$408.4 million in outstanding letters of credit under the LOC Facilities, which were secured by investments with a fair value of \$480.4 million, and had \$100.0 million of borrowings outstanding under the Credit Agreement. The Company was in compliance with all covenants contained in the LOC Facilities at September 30, 2013.

##### 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 \$815.3 million at September 30, 2013.

##### Acquisition of CMG Mortgage Insurance Company and Mortgage Insurance Operating Platform of PMI

In February 2013, certain of the Company's U.S.-based subsidiaries (collectively "Arch U.S. MI") entered into a definitive agreement to acquire (1) CMG Mortgage Insurance Company ("CMG MI") from its current owners, PMI Mortgage Insurance Co. in rehabilitation ("PMI"), which has been under the receivership of the Arizona Department of Insurance since 2011, and CMFG Life Insurance Company, and (2) PMI's mortgage insurance operating platform and certain related assets from PMI. In connection with the closing of the transactions, PMI and an affiliate of the Company's U.S.-based subsidiaries will enter into a quota share reinsurance agreement pursuant to which such affiliate, as the reinsurer, will agree to provide 100% quota share indemnity reinsurance to PMI for all certificates of insurance that were issued by PMI between and including January 1, 2009 and December 31, 2011 that are not in default as of an agreed upon effective date. At closing, it is currently estimated that the Company's U.S.-based subsidiaries will pay aggregate consideration of approximately \$300 million under all transaction documents. Additional amounts may be paid based on the actual results of CMG MI's pre-closing portfolio over an agreed upon period. In addition, the Company will enter into a services agreement with PMI to provide for necessary services to administer the run-off of PMI's legacy business at the direction of PMI.

On June 20, 2013, the Arizona receivership court provided the required approval of the acquisition. The transaction is also subject to approvals of the applicable regulators and approvals by the Federal National Mortgage Association and the Federal Home Loan Mortgage Corporation of Arch U.S. MI as an eligible insurance carrier in the U.S. mortgage insurance marketplace, as well as the satisfaction of customary closing conditions. In connection with obtaining such



consents of regulatory authorities and government-sponsored entities, it is anticipated that Arch U.S. MI or its affiliates will be required to make certain financial commitments to CMG MI, the form and amount of which will be determined based upon discussions with such authorities and entities. Arch U.S. MI's obligation to the sellers to accept financial requirements imposed by regulatory authorities and government-sponsored entities will be determined on the basis of, among other things, the appropriateness of such requirements in light of Arch U.S. MI's business plan and the consistency of such requirements with those imposed on other active participants in the U.S. mortgage insurance industry, as described in the purchase agreements. If these approvals are obtained, it is expected the transaction will close during the 2013 fourth quarter or early 2014.

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## ARCH CAPITAL GROUP LTD. AND SUBSIDIARIES

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)

## 5. Earnings Per Common Share

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

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2013	2012	2013	2012
Numerator:				
Net income	\$ 114,825	\$ 189,656	\$ 548,241	\$ 574,180
Preferred dividends	(5,484	) (5,484	) (16,453	) (19,594
Loss on repurchase of preferred shares	—	—	—	(10,612
Net income available to common shareholders	\$ 109,341	\$ 184,172	\$ 531,788	\$ 543,974
Denominator:				
Weighted average common shares outstanding — basic	131,495,296	135,067,360	131,262,309	134,519,046
Effect of dilutive common share equivalents:				
Nonvested restricted shares	1,124,644	723,538	1,094,327	847,959
Stock options (1)	3,414,473	2,906,036	3,324,193	2,868,990
Weighted average common shares and common share equivalents outstanding — diluted	136,034,413	138,696,934	135,680,829	138,235,995
Earnings per common share:				
Basic	\$ 0.83	\$ 1.36	\$ 4.05	\$ 4.04
Diluted	\$ 0.80	\$ 1.33	\$ 3.92	\$ 3.93

Certain stock options were not included in the computation of diluted earnings per share where the exercise price of the stock options exceeded the average market price and would have been anti-dilutive or where, when applying the treasury stock method to in-the-money options, the sum of the proceeds, including unrecognized compensation, exceeded the average market price and would have been anti-dilutive. For the 2013 third quarter and 2012 third quarter, the number of stock options excluded were 387,249 and 621,556, respectively. For the nine months ended September 30, 2013 and 2012, the number of stock options excluded were 1,735,995 and 860,088, respectively.

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## ARCH CAPITAL GROUP LTD. AND SUBSIDIARIES

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)

## 6. Segment Information

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 September 30, 2013			Three Months Ended September 30, 2012		
	Insurance	Reinsurance	Total	Insurance	Reinsurance	Total
Gross premiums written (1)	\$682,839	\$355,091	\$1,036,987	\$658,599	\$279,751	\$936,764
Net premiums written	501,971	337,164	839,135	483,356	271,893	755,249
Net premiums earned	\$479,129	\$315,871	\$795,000	\$456,341	\$292,350	\$748,691
Fee income	545	(19 )	526	645	432	1,077
Losses and loss adjustment expenses	(305,921 )	(121,124 )	(427,045 )	(307,155 )	(136,716 )	(443,871 )
Acquisition expenses, net	(82,799 )	(64,514 )	(147,313 )	(73,663 )	(54,402 )	(128,065 )
Other operating expenses	(75,734 )	(34,442 )	(110,176 )	(75,379 )	(29,001 )	(104,380 )
Underwriting income	\$15,220	\$95,772	110,992	\$789	\$72,663	73,452
Net investment income			66,083			73,221
Net realized gains (losses)			(6,022 )			60,391
Net impairment losses recognized in earnings			(728 )			(2,379 )
Equity in net income of investment funds accounted for using the equity method			5,665			24,330
Other income (loss)			624			(532 )
Other expenses			(7,894 )			(9,049 )
Interest expense			(5,937 )			(7,378 )
Net foreign exchange losses			(40,562 )			(16,959 )
Income before income taxes			122,221			195,097
Income tax expense			(7,396 )			(5,441 )
Net income			114,825			189,656
Preferred dividends			(5,484 )			(5,484 )
Net income available to common shareholders			\$109,341			\$184,172

## Underwriting Ratios

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Loss ratio	63.8	% 38.3	% 53.7	% 67.3	% 46.8	% 59.3	%
Acquisition expense ratio (2)	17.2	% 20.4	% 18.5	% 16.0	% 18.6	% 17.0	%
Other operating expense ratio	15.8	% 10.9	% 13.8	% 16.5	% 9.9	% 13.9	%
Combined ratio	96.8	% 69.6	% 86.0	% 99.8	% 75.3	% 90.2	%

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

(2) The acquisition expense ratio is adjusted to include policy-related fee income.

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## ARCH CAPITAL GROUP LTD. AND SUBSIDIARIES

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)

	Nine Months Ended September 30, 2013			Nine Months Ended September 30, 2012		
	Insurance	Reinsurance	Total	Insurance	Reinsurance	Total
Gross premiums written (1)	\$2,075,560	\$1,168,938	\$3,241,424	\$2,022,802	\$1,036,708	\$3,055,233
Net premiums written	1,508,089	1,094,357	2,602,446	1,438,620	1,000,473	2,439,093
Net premiums earned	\$1,382,750	\$923,836	\$2,306,586	\$1,344,675	\$810,984	\$2,155,659
Fee income	1,599	367	1,966	1,803	623	2,426
Losses and loss adjustment expenses	(880,580 )	(364,521 )	(1,245,101 )	(900,735 )	(338,036 )	(1,238,771 )
Acquisition expenses, net	(227,806 )	(178,776 )	(406,582 )	(223,591 )	(151,725 )	(375,316 )
Other operating expenses	(232,216 )	(101,234 )	(333,450 )	(225,366 )	(84,264 )	(309,630 )
Underwriting income (loss)	\$43,747	\$279,672	323,419	\$(3,214 )	\$237,582	234,368
Net investment income			200,124			221,126
Net realized gains			64,970			139,379
Net impairment losses recognized in earnings			(3,698 )			(5,353 )
Equity in net income of investment funds accounted for using the equity method			30,429			56,943
Other income (loss)			2,702			(7,905 )
Other expenses			(32,211 )			(27,972 )
Interest expense			(17,687 )			(22,338 )
Net foreign exchange losses			(2,487 )			(5,958 )
Income before income taxes			565,561			582,290
Income tax expense			(17,320 )			(8,110 )
Net income			548,241			574,180
Preferred dividends			(16,453 )			(19,594 )
Loss on repurchase of preferred shares			—			(10,612 )
Net income available to common shareholders			\$531,788			\$543,974

## Underwriting Ratios

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Loss ratio	63.7	% 39.5	% 54.0	% 67.0	% 41.7	% 57.5	%
Acquisition expense ratio (2)	16.4	% 19.4	% 17.5	% 16.5	% 18.7	% 17.3	%
Other operating expense ratio	16.8	% 11.0	% 14.5	% 16.8	% 10.4	% 14.4	%
Combined ratio	96.9	% 69.9	% 86.0	% 100.3	% 70.8	% 89.2	%

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

(2) The acquisition expense ratio is adjusted to include policy-related fee income.

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## ARCH CAPITAL GROUP LTD. AND SUBSIDIARIES

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)

## 7. Investment Information

## Available For Sale Investments

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

	Fair Value	Gross Unrealized Gains	Gross Unrealized Losses	Cost or Amortized Cost	OTTI Unrealized Losses (2)
September 30, 2013					
Fixed maturities and fixed maturities pledged under securities lending agreements (1):					
Corporate bonds	\$2,428,219	\$37,646	\$(46,263)	) \$2,436,836	\$(21)
Mortgage backed securities	1,499,403	17,831	(36,567)	) 1,518,139	(9,335)
Municipal bonds	1,531,324	36,907	(9,079)	) 1,503,496	(17)
Commercial mortgage backed securities	783,718	13,690	(11,322)	) 781,350	(199)
U.S. government and government agencies	1,121,898	11,336	(4,299)	) 1,114,861	(19)
Non-U.S. government securities	1,172,057	16,401	(15,789)	) 1,171,445	—
Asset backed securities	1,199,241	19,442	(12,221)	) 1,192,020	(3,494)
Total	9,735,860	153,253	(135,540)	) 9,718,147	(13,085)
Equity securities	452,195	41,295	(7,419)	) 418,319	—
Other investments	528,938	26,860	(25,357)	) 527,435	—
Short-term investments	994,221	1,172	(449)	) 993,498	—
Total	\$11,711,214	\$222,580	\$(168,765)	) \$11,657,399	\$(13,085)
December 31, 2012					
Fixed maturities and fixed maturities pledged under securities lending agreements (1):					
Corporate bonds	\$2,857,513	\$105,798	\$(6,710)	) \$2,758,425	\$(62)
Mortgage backed securities	1,532,736	24,809	(7,484)	) 1,515,411	(9,329)
Municipal bonds	1,463,586	62,322	(1,421)	) 1,402,685	(17)
Commercial mortgage backed securities	824,165	37,514	(4,468)	) 791,119	(270)
U.S. government and government agencies	1,131,688	20,178	(1,095)	) 1,112,605	(19)
Non-U.S. government securities	998,901	33,701	(8,860)	) 974,060	—
Asset backed securities	1,073,999	25,528	(5,838)	) 1,054,309	(3,346)
Total	9,882,588	309,850	(35,876)	) 9,608,614	(13,043)
Equity securities	312,749	26,625	(12,290)	) 298,414	—
Other investments	549,280	32,582	(3,257)	) 519,955	—

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Short-term investments	730,369	3,521	(1,248	)	728,096	—
Total	\$11,474,986	\$372,578	\$(52,671	)	\$11,155,079	\$(13,043 )

(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 September 30, 2013, the net unrealized gain related to securities for which a non-credit OTTI was recognized in AOCI was \$5.1 million, compared to a net unrealized gain of \$2.0 million at December 31, 2012.



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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	
	Fair Value	Gross Unrealized Losses	Fair Value	Gross Unrealized Losses	Fair Value	Gross Unrealized Losses
September 30, 2013						
Fixed maturities and fixed maturities pledged under securities lending agreements (1):						
Corporate bonds	\$1,351,619	\$(44,843)	\$18,507	\$(1,420)	\$1,370,126	\$(46,263)
Mortgage backed securities	750,898	(32,059)	51,227	(4,508)	802,125	(36,567)
Municipal bonds	444,603	(8,886)	3,817	(193)	448,420	(9,079)
Commercial mortgage backed securities	381,215	(11,157)	1,660	(165)	382,875	(11,322)
U.S. government and government agencies	266,379	(4,299)	—	—	266,379	(4,299)
Non-U.S. government securities	615,731	(13,890)	10,138	(1,899)	625,869	(15,789)
Asset backed securities	588,492	(9,962)	38,279	(2,259)	626,771	(12,221)
Total	4,398,937	(125,096)	123,628	(10,444)	4,522,565	(135,540)
Equity securities	151,580	(7,419)	—	—	151,580	(7,419)
Other investments	183,501	(20,934)	46,988	(4,423)	230,489	(25,357)
Short-term investments	9,500	(449)	—	—	9,500	(449)
Total	\$4,743,518	\$(153,898)	\$170,616	\$(14,867)	\$4,914,134	\$(168,765)
December 31, 2012						
Fixed maturities and fixed maturities pledged under securities lending agreements (1):						
Corporate bonds	\$490,784	\$(3,692)	\$52,334	\$(3,018)	\$543,118	\$(6,710)
Mortgage backed securities	537,883	(4,290)	60,574	(3,194)	598,457	(7,484)
Municipal bonds	147,766	(1,120)	7,052	(301)	154,818	(1,421)
Commercial mortgage backed securities	36,649	(2,261)	8,878	(2,207)	45,527	(4,468)
U.S. government and government agencies	146,526	(1,095)	—	—	146,526	(1,095)
Non-U.S. government securities	244,827	(1,070)	135,564	(7,790)	380,391	(8,860)
Asset backed securities	234,584	(1,508)	57,371	(4,330)	291,955	(5,838)
Total	1,839,019	(15,036)	321,773	(20,840)	2,160,792	(35,876)
Equity securities	130,385	(10,200)	16,469	(2,090)	146,854	(12,290)

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Other investments	23,849	(2,474	)	35,083	(783	)	58,932	(3,257	)
Short-term investments	57,415	(1,248	)	—	—		57,415	(1,248	)
Total	\$2,050,668	\$(28,958	)	\$373,325	\$(23,713	)	\$2,423,993	\$(52,671	)

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(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.”

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## ARCH CAPITAL GROUP LTD. AND SUBSIDIARIES

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)

At September 30, 2013, on a lot level basis, approximately 1,840 security lots out of a total of approximately 4,560 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 \$3.0 million. At December 31, 2012, on a lot level basis, approximately 910 security lots out of a total of approximately 4,580 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 \$2.5 million.

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	September 30, 2013		December 31, 2012	
	Fair Value	Amortized Cost	Fair Value	Amortized Cost
Due in one year or less	\$247,663	\$243,987	\$446,402	\$436,376
Due after one year through five years	3,743,302	3,703,446	3,876,062	3,769,426
Due after five years through 10 years	2,009,579	2,023,258	1,949,297	1,869,698
Due after 10 years	252,954	255,947	179,927	172,275
	6,253,498	6,226,638	6,451,688	6,247,775
Mortgage backed securities	1,499,403	1,518,139	1,532,736	1,515,411
Commercial mortgage backed securities	783,718	781,350	824,165	791,119
Asset backed securities	1,199,241	1,192,020	1,073,999	1,054,309
Total	\$9,735,860	\$9,718,147	\$9,882,588	\$9,608,614

## 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 \$48.4 million and \$47.3 million, respectively, at September 30, 2013, compared to \$50.8 million and \$49.6 million, respectively, at December 31, 2012. The fair value of the portfolio of collateral backing the Company's securities lending program was \$42.1 million at September 30, 2013, compared to \$42.5 million at December 31, 2012. Such amounts included approximately \$6.4 million of sub-prime securities at September 30, 2013, compared to \$5.4 million at December 31, 2012. 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.

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## ARCH CAPITAL GROUP LTD. AND SUBSIDIARIES

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)

## Other Investments

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

	September 30, 2013	December 31, 2012
Available for sale:		
Asian and emerging markets	\$ 357,069	\$ 316,860
Investment grade fixed income	164,768	220,410
Other	7,101	12,010
Total available for sale	528,938	549,280
Fair value option:		
Term loan investments (par value: \$487,083 and \$307,016)	496,477	308,596
Asian and emerging markets	19,705	24,035
Investment grade fixed income	75,328	67,624
Non-investment grade fixed income	9,408	11,093
Other (1)	171,655	116,623
Total fair value option	772,573	527,971
Total	\$ 1,301,511	\$ 1,077,251

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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 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.

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## ARCH CAPITAL GROUP LTD. AND SUBSIDIARIES

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)

## Fair Value Option

The Company elected to carry certain fixed maturity securities, equity securities and other investments (primarily term loans) at fair value under the fair value option afforded by accounting guidance regarding the fair value option for financial assets and liabilities. Changes in fair value of investments accounted for using the fair value option are included in net realized gains or losses while interest income, dividends received and distributions from fund investments which are not a return of capital are reflected in net investment income, where practicable. The primary reasons for electing the fair value option were to reflect economic events in earnings on a timely basis and to address practicality and cost-benefit considerations.

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

	September 30, 2013	December 31, 2012
Fixed maturities	\$ 367,152	\$ 363,541
Other investments	772,573	527,971
Equity securities	—	25,954
Investments accounted for using the fair value option	1,139,725	917,466
Securities sold but not yet purchased (1)	—	(6,924 )
Net assets accounted for using the fair value option	\$ 1,139,725	\$ 910,542

(1) Represents the Company's obligation to deliver equity securities that it did not own at the time of sale. Such amounts are included in "other liabilities" on the Company's consolidated balance sheets.

## Net Investment Income

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

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2013	2012	2013	2012
Fixed maturities	\$62,447	\$68,202	\$186,457	\$211,942
Term loan investments (1)	5,296	4,876	15,539	10,732
Equity securities	2,241	2,009	6,828	6,098
Short-term investments	417	485	1,173	1,617
Other (2)	3,753	3,795	14,786	9,968
Gross investment income	74,154	79,367	224,783	240,357
Investment expenses	(8,071 )	(6,146 )	(24,659 )	(19,231 )
Net investment income	\$66,083	\$73,221	\$200,124	\$221,126

(1) Included in "investments accounted for using the fair value option" on the Company's consolidated balance sheets.

(2) Amounts include dividends on investment funds and other items.

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## ARCH CAPITAL GROUP LTD. AND SUBSIDIARIES

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)

## Net Realized Gains (Losses)

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

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2013	2012	2013	2012
Available for sale securities:				
Gross gains on investment sales	\$47,433	\$70,510	\$183,306	\$186,458
Gross losses on investment sales	(69,256 )	(20,672 )	(149,095 )	(59,365 )
Change in fair value of assets and liabilities accounted for using the fair value option:				
Fixed maturities	5,599	5,322	3,955	8,729
Equity securities	—	1,466	704	1,264
Other investments	8,221	3,810	8,670	5,819
TALF investments	—	(21 )	—	(71 )
TALF borrowings	—	(209 )	—	686
Derivative instruments (1)	1,574	297	16,842	(4,095 )
Other	407	(112 )	588	(46 )
Net realized gains (losses)	\$(6,022 )	\$60,391	\$64,970	\$139,379

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

## 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 September 30,		Nine Months Ended September 30,	
	2013	2012	2013	2012
Fixed maturities:				
Mortgage backed securities	\$(280 )	\$(1,511 )	\$(295 )	\$(2,403 )
Corporate bonds	(88 )	(150 )	(88 )	(1,512 )
Non-U.S. government securities	—	—	—	(261 )
Commercial mortgage backed securities	—	(211 )	—	(211 )
Asset backed securities	(20 )	—	(40 )	(106 )
U.S. government and government agencies	—	—	—	(10 )
Total	(388 )	(1,872 )	(423 )	(4,503 )
Investment of funds received under securities lending agreements	—	—	—	(87 )
Equity securities	(340 )	(507 )	(3,275 )	(763 )
Net impairment losses recognized in earnings	\$(728 )	\$(2,379 )	\$(3,698 )	\$(5,353 )

A description of the methodology and significant inputs used to measure the amount of net impairment losses recognized in earnings in the 2013 periods is as follows:

Equity securities — the Company utilized information received from asset managers on common stocks, including the business prospects, recent events, industry and market data and other factors. For certain equities which were in an unrealized loss position and where the Company determined that it did not have the intent or ability to hold such securities for a reasonable period of time by which the fair value of the securities would increase and the Company would recover its cost, the cost basis of such securities was adjusted down accordingly;

Mortgage backed and asset 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

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## ARCH CAPITAL GROUP LTD. AND SUBSIDIARIES

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)

expected recovery value for each security. The analysis includes expected cash flow projections under base case and stress case scenarios which modify the expected default expectations, loss severities and prepayment assumptions. The significant inputs in the models include the expected default rates, delinquency rates and foreclosure costs. The expected recovery values were reduced on a small number of securities, primarily as a result of increases in expected default expectations and foreclosure costs. The amortized cost basis of the securities were adjusted down, if required, to the expected recovery value calculated in the OTTI review process;

Corporate bonds — the Company reviewed the business prospects, credit ratings, estimated loss given default factors, foreign currency impacts 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.

The Company believes that the \$13.1 million of OTTI included in accumulated other comprehensive income at September 30, 2013 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 September 30, 2013, 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		Nine Months Ended	
	September 30,		September 30,	
	2013	2012	2013	2012
Balance at start of period	\$61,449	\$62,526	\$62,001	\$66,545
Credit loss impairments recognized on securities not previously impaired	369	747	402	2,652
Credit loss impairments recognized on securities previously impaired	19	1,632	21	2,701
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	—	(1,709)	(587)	(8,702)
Balance at end of period	\$61,837	\$63,196	\$61,837	\$63,196

## 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 4, "Commitments and Contingencies—Letter of Credit and Revolving Credit Facilities," for further details. The following table details the value of the Company's restricted assets:

	September 30,	December 31,
	2013	2012
Assets used for collateral or guarantees:		



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Affiliated transactions	\$ 4,146,190	\$ 4,062,097
Third party agreements	784,567	771,631
Deposits with U.S. regulatory authorities	303,634	290,441
Deposits with non-U.S. regulatory authorities	6,765	247,321
Trust funds	75,531	96,342
Total restricted assets	\$ 5,316,687	\$ 5,467,832

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ARCH CAPITAL GROUP LTD. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)

8. Fair Value

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

The levels in the hierarchy are defined as follows:

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

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

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

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

The Company determines the existence of an active market based on its judgment as to whether transactions for the financial instrument occur in such market with sufficient frequency and volume to provide reliable pricing information. The independent pricing sources obtain market quotations and actual transaction prices for securities that have quoted prices in active markets. The Company uses quoted values and other data provided by nationally recognized independent pricing sources as inputs into its process for determining fair values of its fixed maturity investments. To validate the techniques or models used by pricing sources, the Company's review process includes, but is not limited to: (i) quantitative analysis (e.g., comparing the quarterly return for each managed portfolio to its target benchmark, with significant differences identified and investigated); (ii) a review of the average number of prices obtained in the pricing process and the range of resulting fair values; (iii) initial and ongoing evaluation of methodologies used by outside parties to calculate fair value including a review of deep dive reports on selected securities which indicate the use of observable inputs in the pricing process; (iv) comparing the fair value estimates to its knowledge of the current market; (v) a comparison of the pricing services' fair values to other pricing services' fair values for the same investments; and (vi) back-testing, which includes randomly selecting purchased or sold securities and comparing the executed prices to the fair value estimates from the pricing service. For a majority of investments, the Company obtained multiple quotes. A price source hierarchy was maintained in order to determine which price source would be used (i.e., a price obtained from a pricing service with more seniority in the hierarchy will be used over a less senior one in all cases). The hierarchy prioritizes pricing services based on availability and reliability and assigns the highest priority to index providers. Based on the above review, the Company will challenge any prices for a security or portfolio which are considered not to be representative of fair value. The Company did not adjust any of the prices obtained from the pricing services at September 30, 2013.

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 \$12.85 billion of financial assets and liabilities measured at fair value at September 30, 2013, approximately \$874.1 million, or 6.8%, were priced using non-binding broker-dealer quotes. Of the \$12.40 billion of financial

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ARCH CAPITAL GROUP LTD. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)

assets and liabilities measured at fair value at December 31, 2012, approximately \$927.9 million, or 7.5%, were priced using non-binding broker-dealer quotes.

The Company reviews its securities measured at fair value and discusses the proper classification of such investments with investment advisors and others. A discussion of the general classification of the Company's financial instruments follows:

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

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

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

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

The Company reviews the classification of its investments each quarter. No transfers were made in the periods presented.

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.

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## ARCH CAPITAL GROUP LTD. AND SUBSIDIARIES

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)

The following table presents the Company's financial assets and liabilities measured at fair value by level at September 30, 2013:

	Fair Value	Fair Value Measurement Using:		
		Quoted Prices in Significant Active Markets for Identical Assets (Level 1)	Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
Assets measured at fair value:				
Available for sale securities:				
Fixed maturities and fixed maturities pledged under securities lending agreements (1):				
Corporate bonds	\$2,428,219	\$—	\$2,426,130	\$2,089
Mortgage backed securities	1,499,403	—	1,499,403	—
Municipal bonds	1,531,324	—	1,531,324	—
Commercial mortgage backed securities	783,718	—	783,718	—
U.S. government and government agencies	1,121,898	1,121,898	—	—
Non-U.S. government securities	1,172,057	—	1,172,057	—
Asset backed securities	1,199,241	—	1,199,241	—
Total	9,735,860	1,121,898	8,611,873	2,089
Equity securities	452,195	452,020	175	—
Other investments	528,938	—	324,284	204,654
Short-term investments	994,221	978,604	15,617	—
Fair value option:				
Investments accounted for using the fair value option:				
Corporate bonds	314,109	—	314,109	—
Non-U.S. government bonds	53,043	—	53,043	—
Other investments	772,573	—	413,729	358,844
Equity securities	—	—	—	—
Total	1,139,725	—	780,881	358,844
Total assets measured at fair value	\$12,850,939	\$2,552,522	\$9,732,830	\$565,587
Liabilities measured at fair value:				
Fair value option:				
Securities sold but not yet purchased (2)	\$—	\$—	\$—	\$—
Total liabilities measured at fair value	\$—	\$—	\$—	\$—

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.

(2) Represents the Company's obligation to deliver securities that it did not own at the time of sale. Such amounts are included in "other liabilities" on the Company's consolidated balance sheets.



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## ARCH CAPITAL GROUP LTD. AND SUBSIDIARIES

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)

The following table presents the Company's financial assets and liabilities measured at fair value by level at December 31, 2012:

	Fair Value	Fair Value Measurement Using:		
		Quoted Prices in Significant Active Markets for Identical Assets (Level 1)	Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
Assets measured at fair value:				
Available for sale securities:				
Fixed maturities and fixed maturities pledged under securities lending agreements (1):				
Corporate bonds	\$2,857,513	\$—	\$2,759,109	\$98,404
Mortgage backed securities	1,532,736	—	1,532,736	—
Municipal bonds	1,463,586	—	1,463,586	—
Commercial mortgage backed securities	824,165	—	824,165	—
U.S. government and government agencies	1,131,688	1,131,688	—	—
Non-U.S. government securities	998,901	—	998,901	—
Asset backed securities	1,073,999	—	1,073,999	—
Total	9,882,588	1,131,688	8,652,496	98,404
Equity securities	312,749	312,666	83	—
Other investments	549,280	—	365,078	184,202
Short-term investments	730,369	678,441	51,928	—
Fair value option:				
Investments accounted for using the fair value option:				
Corporate bonds	275,132	—	275,132	—
Non-U.S. government bonds	88,409	—	88,409	—
Other investments	527,971	—	332,621	195,350
Equity securities	25,954	25,954	—	—
Total	917,466	25,954	696,162	195,350
Total assets measured at fair value	\$12,392,452	\$2,148,749	\$9,765,747	\$477,956
Liabilities measured at fair value:				
Fair value option:				
Securities sold but not yet purchased (2)	\$6,924	\$6,924	\$—	\$—
Total liabilities measured at fair value	\$6,924	\$6,924	\$—	\$—

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.

(2) Represents the Company's obligation to deliver securities that it did not own at the time of sale. Such amounts are included in "other liabilities" on the Company's consolidated balance sheets.





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## ARCH CAPITAL GROUP LTD. AND SUBSIDIARIES

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)

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

s	Fair Value Measurements Using: Significant Unobservable Inputs (Level 3)			
	Available-For-Sale		Fair Value Option	Total
	Corporate Bonds	Other Investments	Other Investments	
<b>Three Months Ended September 30, 2013</b>				
Balance at beginning of period	\$2,360	\$189,893	\$290,189	\$482,442
Total gains or (losses) (realized/unrealized)				
Included in earnings (1)	—	—	8,731	8,731
Included in other comprehensive income	—	(5,239 )	—	(5,239 )
Purchases, issuances, sales and settlements				
Purchases	—	20,000	63,348	83,348
Issuances	—	—	—	—
Sales	—	—	—	—
Settlements	(271 )	—	(3,424 )	(3,695 )
Transfers in and/or out of Level 3	—	—	—	—
Balance at end of period	\$2,089	\$204,654	\$358,844	\$565,587
<b>Three Months Ended September 30, 2012</b>				
Balance at beginning of period	\$92,036	\$6,386	\$—	\$98,422
Total gains or (losses) (realized/unrealized)				
Included in earnings (1)	1,402	1,627	—	3,029
Included in other comprehensive income	1,229	(1,590 )	—	(361 )
Purchases, issuances, sales and settlements				
Purchases	—	—	—	—
Issuances	—	—	—	—
Sales	—	—	—	—
Settlements	(38 )	(1,627 )	—	(1,665 )
Transfers in and/or out of Level 3	—	—	—	—
Balance at end of period	\$94,629	\$4,796	\$—	\$99,425

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

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## ARCH CAPITAL GROUP LTD. AND SUBSIDIARIES

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)

s	Fair Value Measurements Using: Significant Unobservable Inputs (Level 3)			
	Available-For-Sale		Fair Value Option	Total
	Corporate Bonds	Other Investments	Other Investments	
Nine Months Ended September 30, 2013				
Balance at beginning of period	\$98,404	\$184,202	\$195,350	\$477,956
Total gains or (losses) (realized/unrealized)				
Included in earnings (1)	4,679	4,762	7,029	16,470
Included in other comprehensive income	(3,051	) 632	—	(2,419 )
Purchases, issuances, sales and settlements				
Purchases	—	25,000	223,918	248,918
Issuances	—	—	—	—
Sales	(96,655	) —	—	(96,655 )
Settlements	(1,288	) (9,942	) (67,453	) (78,683 )
Transfers in and/or out of Level 3	—	—	—	—
Balance at end of period	\$2,089	\$204,654	\$358,844	\$565,587
Nine Months Ended September 30, 2012				
Balance at beginning of period	\$92,091	\$5,124	\$—	\$97,215
Total gains or (losses) (realized/unrealized)				
Included in earnings (1)	3,185	1,708	—	4,893
Included in other comprehensive income	(530	) (328	) —	(858 )
Purchases, issuances, sales and settlements				
Purchases	—	—	—	—
Issuances	—	—	—	—
Sales	—	—	—	—
Settlements	(117	) (1,708	) —	(1,825 )
Transfers in and/or out of Level 3	—	—	—	—
Balance at end of period	\$94,629	\$4,796	\$—	\$99,425

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

The amount of total gains for the 2013 third quarter included in earnings attributable to the change in unrealized gains or losses relating to assets still held at September 30, 2013 was \$8.7 million, while the amount of total gains for the nine months ended September 30, 2013 included in earnings attributable to the change in unrealized gains or losses relating to assets still held at September 30, 2013 was \$13.2 million. The amount of total gains for the 2012 third quarter included in earnings attributable to the change in unrealized gains or losses relating to assets still held at September 30, 2012 was \$3.0 million, while the amount of total gains for the nine months ended September 30, 2012 was \$4.9 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 September 30, 2013, due to their respective short maturities. As these financial instruments are not actively traded, their respective fair values are classified within Level 2.

At September 30, 2013, the Company's senior notes were carried at their cost of \$300.0 million and had a fair value of \$379.4 million. The fair value of the Company's senior notes was 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)

## 9. Derivative Instruments

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

In addition, the Company purchases to-be-announced mortgage backed securities ("TBAs") as part of its investment strategy. TBAs represent commitments to purchase a future issuance of agency mortgage backed securities. For the period between purchase of a TBA and issuance of the underlying security, the Company's position is accounted for as a derivative. The Company purchases TBAs in both long and short positions to enhance investment performance and as part of its overall investment strategy. The Company did not hold any derivatives which were designated as hedging instruments at September 30, 2013 or December 31, 2012.

The following table summarizes information on the fair values and notional values of the Company's derivative instruments. The fair value of TBAs is included in "fixed maturities available for sale, at fair value" while the fair value of all other derivatives is included in "other investments available for sale, at fair value" in the consolidated balance sheets.

	Asset Derivatives Fair Value	Liability Derivatives Fair Value	Net Derivatives Fair Value	Notional Value
September 30, 2013				
Futures contracts	\$82	\$(207)	\$(125)	\$412,884
Foreign currency forward contracts	6,183	(4,912)	1,271	566,070
TBAs	381,739	(192,563)	189,176	551,990
Other	1,384	(1,203)	181	409,996
Total	\$389,388	\$(198,885)	\$190,503	
December 31, 2012				
Futures contracts	\$52	\$(52)	\$—	\$340,400
Foreign currency forward contracts	2,809	(2,678)	131	396,468
TBAs	23,599	(4,346)	19,253	26,000
Other	448	(676)	(228)	50,341
Total	\$26,908	\$(7,752)	\$19,156	

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 September 30, 2013, asset derivatives and liability derivatives of \$251.2 million and \$81.4 million, respectively, were subject to a master netting agreement, compared to \$26.9 million and \$7.8 million, respectively, at December 31, 2012. 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		Nine Months Ended	
	September 30,		September 30,	
Derivatives not designated as hedging instruments	2013	2012	2013	2012
Futures contracts	\$(2,804 )	\$(245 )	\$6,990	\$(4,588 )
Foreign currency forward contracts	1,344	737	8,224	(206 )
TBAs	2,511	1,140	(699 )	2,882
Other	523	(1,335 )	2,327	(2,183 )
Total	\$1,574	\$297	\$16,842	\$(4,095 )

## 10. Income Taxes

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

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

The Company's income tax provision on income before income taxes resulted in an expense of 3.1% for the nine months ended September 30, 2013, compared to an expense of 1.4% for the 2012 period. The Company's effective tax rate, which is based upon the expected annual effective tax rate, may fluctuate from period to period based on the relative mix of income or loss reported by jurisdiction and the varying tax rates in each jurisdiction. The Company had a net deferred tax asset of \$143.8 million at September 30, 2013, compared to \$98.6 million at December 31, 2012. In addition, the Company paid \$7.6 million in income taxes for the nine months ended September 30, 2013, while the

Company paid \$4.1 million for the 2012 period.

The United States also imposes an excise tax on insurance and reinsurance premiums paid to non-U.S. insurers or reinsurers with respect to risks located in the United States. The Company incurs federal excise taxes on certain of its reinsurance transactions, including amounts ceded through intercompany transactions. The Company incurred \$6.8 million of federal excise taxes for the nine months ended September 30, 2013, compared to \$6.2 million for the 2012 period. Such amounts are reflected as acquisition expenses in the Company's consolidated statements of income.

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## ARCH CAPITAL GROUP LTD. AND SUBSIDIARIES

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)

## 11. Other Comprehensive Income (Loss)

The following table presents the changes in each component of accumulated other comprehensive income ("AOCI"), net of tax:

	Unrealized Gains on Available-For-Sale Securities	Foreign Currency Translation Adjustments	Total
Three Months Ended September 30, 2013			
Beginning balance	\$ (12,753 )	\$(36,569 )	\$(49,322 )
Other comprehensive income before reclassifications	41,053	29,523	70,576
Amounts reclassified from accumulated other comprehensive income	20,701	—	20,701
Net current period other comprehensive income	61,754	29,523	91,277
Ending balance	\$ 49,001	\$(7,046 )	\$41,955
Nine Months Ended September 30, 2013			
Beginning balance	\$ 289,957	\$(2,940 )	\$287,017
Other comprehensive income before reclassifications	(209,040 )	(4,106 )	(213,146 )
Amounts reclassified from accumulated other comprehensive income	(31,916 )	—	(31,916 )
Net current period other comprehensive income (loss)	(240,956 )	(4,106 )	\$(245,062 )
Ending balance	\$ 49,001	\$(7,046 )	\$41,955

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

Details About AOCI Components	Consolidated Statement of Income Line Item That Includes Reclassification	Amounts Reclassed from AOCI	
		Three Months Ended September 30, 2013	Nine Months Ended September 30, 2013
Unrealized Gains on Available-For-Sale Securities			
	Net realized gains (losses)	\$(21,825 )	\$37,176
	Net impairment losses included in earnings	(901 )	(3,873 )
	Total before tax	(22,726 )	33,303
	Income tax benefit (expense)	2,025	(1,387 )
	Net of tax	\$(20,701 )	\$31,916



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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)

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

	Before Tax Amount	Tax Expense (Benefit)	Net of Tax Amount
<b>Three Months Ended September 30, 2013</b>			
Unrealized appreciation (decline) in value of investments:			
Unrealized holding gains (losses) arising during period	\$41,122	\$(104)	\$41,226
Portion of other-than-temporary impairment losses recognized in other comprehensive income (loss)	(173)	—	(173)
Less reclassification of net realized gains included in net income	(22,726)	(2,025)	(20,701)
Foreign currency translation adjustments	29,523	—	29,523
Other comprehensive income (loss)	\$93,198	\$1,921	\$91,277
<b>Three Months Ended September 30, 2012</b>			
Unrealized appreciation (decline) in value of investments:			
Unrealized holding gains (losses) arising during period	\$170,287	\$5,554	\$164,733
Portion of other-than-temporary impairment losses recognized in other comprehensive income (loss)	(265)	—	(265)
Less reclassification of net realized gains included in net income	48,898	1,487	47,411
Foreign currency translation adjustments	16,420	2,442	13,978
Other comprehensive income (loss)	\$137,544	\$6,509	\$131,035
<b>Nine Months Ended September 30, 2013</b>			
Unrealized appreciation (decline) in value of investments:			
Unrealized holding gains (losses) arising during period	\$(229,921)	\$(21,056)	\$(208,865)
Portion of other-than-temporary impairment losses recognized in other comprehensive income (loss)	(175)	—	(175)
Less reclassification of net realized gains included in net income	33,303	1,387	31,916
Foreign currency translation adjustments	(4,104)	2	(4,106)
Other comprehensive income (loss)	\$(267,503)	\$(22,441)	\$(245,062)
<b>Nine Months Ended September 30, 2012</b>			
Unrealized appreciation (decline) in value of investments:			
Unrealized holding gains (losses) arising during period	\$272,487	\$(5,169)	\$277,656
Portion of other-than-temporary impairment losses recognized in other comprehensive income (loss)	(776)	—	(776)
Less reclassification of net realized gains included in net income	125,041	6,327	118,714
Foreign currency translation adjustments	13,590	1,547	12,043
Other comprehensive income (loss)	\$160,260	\$(9,949)	\$170,209

## 12. 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 September 30, 2013, 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.



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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, 2012 ("2012 Form 10-K"). In addition, readers should review "Risk Factors" set forth in Item 1A of Part I of our 2012 Form 10-K. Tabular amounts are in U.S. Dollars in thousands, except share amounts, unless otherwise noted.

Arch Capital Group Ltd. ("ACGL" and, together with its subsidiaries, "we" or "us") is a Bermuda public limited liability company with approximately \$5.84 billion in capital at September 30, 2013 and, through operations in Bermuda, the United States, Europe and Canada, writes insurance and reinsurance on a worldwide basis. While we are positioned to provide a full range of property and casualty insurance and reinsurance lines, we focus on writing specialty lines of insurance and reinsurance. It is our belief that our underwriting platform, our experienced management team and our strong capital base that is unencumbered by significant pre-2002 risks have enabled us to establish a strong presence in the insurance and reinsurance markets.

Current Outlook

The broad market environment continued to show improvement in the 2013 third quarter, although rate increases moderated somewhat relative to earlier in 2013. In our U.S. insurance business, weighted rate increases provided 1.7% of expected margin improvement (i.e., rates in excess of loss cost trends) in the 2013 third quarter. We expanded our insurance underwriting platform in the excess and surplus lines market in March 2013 by starting a binding authority insurance facility that caters to smaller accounts through the wholesale distribution channel. This group immediately began contributing to our premiums and continues to gain traction across Arch's distribution platform. On an absolute basis, we believe that most longer-tail casualty business still requires rate improvement to meet our return objectives but some segments are approaching rate adequacy. In our reinsurance business, we see pressure on terms and conditions in property catastrophe business, where alternative capacity is putting pressure on rates. In addition, cedents have pressed for additional ceding commissions (generally one to two points) and are moving to excess of loss instead of pro rata coverage. Our underwriting teams continue to execute a disciplined strategy by emphasizing small and medium-sized accounts over large accounts and focusing more on short-tail business.

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 significant portion of our overall book in catastrophe-exposed business which has the potential to increase the volatility of our operating results.

The current economic conditions could continue to 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, the impact of the continuing 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 possible additional 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 of securities in our investment portfolio.

#### 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. We reserve the right to change this threshold at any time. Based on in-force exposure estimated as of October 1, 2013, our modeled peak zone catastrophe exposure was a windstorm affecting the

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Northeastern U.S., with a net probable maximum pre-tax loss of \$868 million, followed by windstorms affecting the Gulf of Mexico and Florida Tri-County with net probable maximum pre-tax losses of \$736 million and \$615 million, respectively. Based on in-force exposure estimated as of July 1, 2013, our modeled peak zone exposure was a windstorm affecting the Northeastern U.S., with a net probable maximum pre-tax loss of \$858 million, followed by windstorms affecting the Gulf of Mexico and Florida Tri-County with net probable maximum pre-tax losses of \$746 million and \$606 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 October 1, 2013, our modeled peak zone earthquake exposure (New Madrid earthquake) represented less than 45% 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 our total shareholders' equity from one or more catastrophic events due to several factors, including the inherent uncertainties in estimating the frequency and severity of such events and the margin of error in making such determinations resulting from potential inaccuracies 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 2012 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 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 \$38.34 at September 30, 2013, compared to \$36.80 at June 30, 2013 and \$36.79 at September 30, 2012. The 4.2% increase in the 2013 third quarter and trailing twelve months was primarily driven by strong underwriting results.

### Operating Return on Average Common Equity

Operating return on average common equity ("Operating ROAE") represents annualized after-tax operating income available to common shareholders divided by the average of beginning and ending common shareholders' equity during the period. After-tax operating income available to common shareholders, a "non-GAAP measure" as defined in the SEC rules, represents net income available to 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, net foreign exchange gains or losses and loss on repurchase of preferred shares, 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 11.9% for the 2013 third quarter, compared to 9.9% for the 2012 third quarter, and 11.9% for the nine months ended September 30, 2013, compared to 10.8% for the 2012 period. The higher level of Operating ROAE for the 2013 periods primarily resulted from better underwriting results in our reinsurance and insurance segments.

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## 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 our investment portfolio. Total return is calculated on a pre-tax basis and before investment expenses and includes 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 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 is a weighted average of the benchmarks assigned to each of our investment managers and vary based on the nature of the portfolios under management.

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. 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 September 30, 2013, the benchmark return index had an average credit quality of “Aa2” by Moody’s Investors Service (“Moody’s”), an estimated duration of 3.56 years and included weightings to the following indices:

	Weighting	
The Bank of America Merrill Lynch 1-10 Year U.S. Treasury & Agency Index	30.875	%
The Bank of America Merrill Lynch 1-10 Year AA U.S. Corporate & Yankees Index	20.875	%
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	%
MSCI World Free Index	5.000	%
The Bank of America Merrill Lynch 0-3 Month U.S. Treasury Bill Index	4.750	%
The Bank of America Merrill Lynch U.S. High Yield Constrained Index	2.375	%
Barclays Capital U.S. High-Yield Corporate Loan Index	2.375	%
The Bank of America Merrill Lynch 1-10 Year U.K. Gilt Index	2.375	%
The Bank of America Merrill Lynch 1-10 Year Euro Government Index	2.375	%
Total	100.000	%

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

	Arch Portfolio		Benchmark Return	
Pre-tax total return (before investment expenses):				
2013 third quarter	1.43	%	1.36	%
2012 third quarter	2.45	%	1.86	%
Nine Months Ended September 30, 2013	0.31	%	0.38	%
Nine Months Ended September 30, 2012	5.04	%	4.34	%

Total return for the 2013 periods reflected positive returns of our equity and alternatives portfolios, partially offset by the impact of both higher interest rates and wider credit spreads compared to the 2012 periods. Excluding foreign exchange, total return was 0.84% for the 2013 third quarter, compared to 2.17% for the 2012 third quarter, and 0.27% for the nine months ended September 30, 2013, compared to 4.89% for the 2012 period.



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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 common shareholders, which is defined as net income available to 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, net foreign exchange gains or losses and loss on repurchase of preferred shares, net of income taxes. The presentation of after-tax operating income available to common shareholders is a “non-GAAP financial measure” as defined in Regulation G. The reconciliation of such measure to net income available to 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, net foreign exchange gains or losses and loss on repurchase of preferred shares 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. The loss on repurchase of preferred shares related to the redemption of the Series A and B preferred shares in April 2012 and had no impact on total shareholders' equity or cash flows. 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, net foreign exchange gains or losses and loss on repurchase of preferred shares from the calculation of after-tax operating income available to common shareholders.

We believe that showing net income available to 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 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 common shareholders to net income available to common shareholders:

	Three Months Ended		Nine Months Ended	
	September 30,		September 30,	
	2013	2012	2013	2012
After-tax operating income available to common shareholders	\$ 149,205	\$ 120,247	\$ 442,974	\$ 375,307
Net realized gains (losses), net of tax	(3,442 )	58,904	65,260	133,052
Net impairment losses recognized in earnings, net of tax	(728 )	(2,379 )	(3,698 )	(5,353 )
Equity in net income of investment funds accounted for using the equity method, net of tax	5,665	24,330	30,429	56,943
Net foreign exchange losses, net of tax	(41,359 )	(16,930 )	(3,177 )	(5,363 )
Loss on repurchase of preferred shares, net of tax	—	—	—	(10,612 )
Net income available to common shareholders	\$ 109,341	\$ 184,172	\$ 531,788	\$ 543,974

## Segment Information

We classify our businesses into two underwriting segments — insurance and reinsurance — and corporate and other (non-underwriting). Management measures segment performance based on underwriting income or loss. We do not manage our assets by segment and, accordingly, investment income is not allocated to each underwriting segment. In addition, other revenue and expense items are not evaluated by segment.

## Insurance Segment

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

	Three Months Ended September 30,			Nine Months Ended September 30,		
	2013	2012	% Change	2013	2012	% Change
Gross premiums written	\$ 682,839	\$ 658,599	3.7	\$ 2,075,560	\$ 2,022,802	2.6
Net premiums written	501,971	483,356	3.9	1,508,089	1,438,620	4.8
Net premiums earned	\$ 479,129	\$ 456,341	5.0	\$ 1,382,750	\$ 1,344,675	2.8
Fee income	545	645		1,599	1,803	
Losses and loss adjustment expenses	(305,921 )	(307,155 )		(880,580 )	(900,735 )	
Acquisition expenses, net	(82,799 )	(73,663 )		(227,806 )	(223,591 )	
Other operating expenses	(75,734 )	(75,379 )		(232,216 )	(225,366 )	
Underwriting income (loss)	\$ 15,220	\$ 789	n/m	\$ 43,747	\$ (3,214 )	n/m

## Underwriting Ratios

	% Point Change			% Point Change		
Loss ratio	63.8	% 67.3	% (3.5 )	63.7	% 67.0	% (3.3 )
Acquisition expense ratio (1)	17.2	% 16.0	% 1.2	16.4	% 16.5	% (0.1 )
Other operating expense ratio	15.8	% 16.5	% (0.7 )	16.8	% 16.8	% —
Combined ratio	96.8	% 99.8	% (3.0 )	96.9	% 100.3	% (3.4 )

(1) The acquisition expense ratio is adjusted to include certain fee income.



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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 September 30,				Nine Months Ended September 30,			
	2013		2012		2013		2012	
	Amount	%	Amount	%	Amount	%	Amount	%
Programs	\$116,399	23	\$98,052	20	\$339,895	23	\$272,666	19
Property, energy, marine and aviation	77,201	15	92,266	19	242,487	16	258,475	18
Professional liability	57,367	11	68,923	14	179,289	12	204,682	14
Executive assurance	56,410	11	63,059	13	160,483	11	191,642	13
Construction	29,927	6	23,481	5	127,557	8	106,918	7
Casualty	29,311	6	23,662	5	79,343	5	81,273	6
National accounts	18,618	4	22,483	5	77,376	5	62,882	4
Lenders products	16,848	3	20,257	4	61,361	4	63,149	4
Surety	17,324	3	14,958	3	50,081	3	39,815	3
Travel and accident	14,068	3	22,017	5	47,283	3	65,147	5
Healthcare	10,227	2	8,722	2	30,247	2	27,316	2
Other (1)	58,271	13	25,476	5	112,687	8	64,655	5
Total	\$501,971	100	\$483,356	100	\$1,508,089	100	\$1,438,620	100

(1) Includes alternative markets, contract binding, accident and health and excess workers' compensation business.

2013 third quarter versus 2012. Net premiums written were 3.9% higher than in the 2012 third quarter with increases in programs, contract binding (launched in March 2013), excess workers' compensation, construction and accident and health lines, partially offset by a reduction in property lines, professional liability, executive assurance and travel premiums. The increase in program business resulted from a mix of new business, underlying exposure growth within existing programs and rate increases. Growth in excess workers' compensation and accident and health primarily resulted from new business while the higher level of construction business resulted from expanded product lines, new business and rate increases. The decrease in property lines reflected reductions in offshore and onshore energy, property and marine business in response to current market conditions while the lower level of professional liability and executive assurance business resulted from a continued strategic reduction in exposure to international business. The decline in travel premiums was due in part to a change in distribution strategy at the end of 2012.

Nine Months Ended September 30, 2013 versus 2012. Net premiums written were 4.8% higher than in the 2012 period with increases in programs, contract binding, construction and accident and health lines, partially offset by reduction in executive assurance, professional liability, travel and property premiums. The increase in program business resulted from a mix of new business, underlying exposure growth within existing programs and rate increases. The increase in construction business resulted from expanded product lines, new business and rate increases while growth in accident and health primarily resulted from new business. The lower level of executive assurance and professional liability business resulted from a continued strategic reduction in exposure to international business, while the decline in travel premiums was due in part to a change in distribution strategy at the end of 2012. The decrease in property lines reflected reductions in offshore and onshore energy, property and marine business in response to current market conditions.

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## Net Premiums Earned.

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

	Three Months Ended September 30,				Nine Months Ended September 30,			
	2013		2012		2013		2012	
	Amount	%	Amount	%	Amount	%	Amount	%
Programs	\$103,603	22	\$83,978	18	\$293,247	21	\$238,565	18
Property, energy, marine and aviation	77,437	16	77,862	17	227,420	16	233,946	17
Professional liability	58,948	12	66,299	15	177,002	13	197,572	15
Executive assurance	54,628	11	61,599	13	168,322	12	181,221	13
Construction	37,378	8	32,409	7	109,868	8	95,909	7
Casualty	26,146	5	27,175	6	76,430	6	84,342	6
National accounts	27,957	6	21,919	5	73,542	5	59,470	4
Lenders products	20,220	4	20,271	4	62,032	4	73,835	5
Surety	15,023	3	12,643	3	42,512	3	34,001	3
Travel and accident	12,953	3	21,826	5	43,751	3	59,200	4
Healthcare	10,445	2	9,565	2	28,894	2	27,540	2
Other (1)	34,391	8	20,795	5	79,730	7	59,074	6
Total	\$479,129	100	\$456,341	100	\$1,382,750	100	\$1,344,675	100

(1) Includes alternative markets, contract binding, accident and health and excess workers' compensation business.

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 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		September 30,		Nine Months Ended		September 30,	
	2013	2012	2013	2012	2013	2012	2013	2012
Current year	67.5	% 69.6	% 66.5	% 69.1	%	%	%	%
Prior period reserve development	(3.7	)% (2.3	)% (2.8	)% (2.1	)%	)%	)%	)%
Loss ratio	63.8	% 67.3	% 63.7	% 67.0	%	%	%	%

## Current Year Loss Ratio.

The insurance segment's current year loss ratio was 2.1 points lower in the 2013 third quarter compared to the 2012 third quarter and 2.6 points lower for the nine months ended September 30, 2013 than in the 2012 period. The 2013 third quarter loss ratio reflected 2.6 points of current year catastrophic activity, compared to 3.1 points for the 2012 third quarter. The loss ratio for the nine months ended September 30, 2013 reflected 1.4 points of catastrophic activity, compared to 1.4 points for the 2012 period. The loss ratios for the 2013 periods reflected continued margin expansion and changes in the mix of business earned.

## Prior Period Reserve Development.

2013 third quarter: The insurance segment's net favorable development of \$17.5 million, or 3.7 points, consisted of \$24.9 million of net favorable development in short-tailed lines and \$7.4 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 2007 to 2012 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 2012 named catastrophic events was favorable by \$6.9 million in the quarter. Net adverse development in medium-tailed and long-tailed lines reflected increases of \$16.3 million in program reserves, primarily due to a small number of programs, \$4.5 million in casualty reserves, primarily from the 2006 and 2008 accident years, and \$5.2 million in construction reserves, spread between the 2007 to 2010 accident years. Such amounts were partially offset by reductions of \$7.4 million in healthcare reserves, \$4.7 million in executive assurance reserves and \$4.6 million in excess workers' compensation reserves, all spread across various accident years.

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2012 third quarter: The insurance segment's net favorable development of \$10.3 million, or 2.3 points, consisted of net favorable development of \$9.9 million in short-tailed lines and \$0.4 million 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 2007 to 2010 accident years, primarily due to varying levels of reported claims activity. Favorable development in medium-tailed and long-tailed lines reflected a reduction of \$15.6 million in professional liability reserves, primarily from the 2006 to 2010 accident years, partially offset by increases of \$6.3 million in casualty reserves, primarily from the 2003 to 2005 accident years, \$5.3 million in executive assurance reserves in the 2007 to 2011 accident years, and \$2.7 million in programs, spread across a number of years.

Nine Months Ended September 30, 2013: The insurance segment's net favorable development of \$38.5 million, or 2.8 points, consisted of \$52.7 million of net favorable development in short-tailed lines, partially offset by \$14.2 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 2008 to 2011 accident years, primarily due to varying levels of reported claims activity. Development on the 2005 to 2012 named catastrophic events was favorable by \$15.5 million in the period. Net adverse development in medium-tailed and long-tailed lines included increases of \$19.1 million in program reserves, primarily due to a small number of programs, \$14.9 million in casualty reserves, primarily related to claims from the two most recent accident years on certain Canadian accounts which have been non-renewed, and \$10.5 million in construction reserves, spread between the 2007 to 2010 accident years, partially offset by reductions of \$14.9 million in healthcare reserves, \$4.6 million in national accounts, \$4.5 million in marine, and \$4.2 million in excess workers' compensation, all spread across various accident years.

Nine Months Ended September 30, 2012: The insurance segment's net favorable development of \$28.0 million, or 2.1 points, consisted of net favorable development of \$47.3 million in short-tailed lines, partially offset by \$19.3 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 2007 to 2011 accident years, primarily due to varying levels of reported claims activity. Adverse development in medium-tailed and long-tailed lines included increases of \$21.1 million in executive assurance reserves, primarily from the 2007 to 2011 accident years, \$17.5 million in casualty reserves, primarily from the 2004 to 2008 accident years, and \$8.5 million in construction reserves, primarily from the 2007 to 2009 accident years. Such amounts were partially offset by favorable development of \$19.3 million in professional liability reserves, primarily from the 2009 accident year, and \$9.9 million in healthcare reserves across most accident years.

## Underwriting Expenses.

2013 third quarter versus 2012: The insurance segment's underwriting expense ratio was 33.0% in the 2013 third quarter, compared to 32.5% in the 2012 third quarter. The acquisition expense ratio was 17.2% in the 2013 third quarter, compared to 16.0% in the 2012 third quarter. The comparison of the 2013 third quarter and 2012 third quarter acquisition expense ratios is influenced by, among other things, the mix and type of business written and earned and the level of ceding commissions. In addition, the acquisition expense ratio was impacted by changes in development of prior year ceded loss reserves which increased the 2013 third quarter commission expense ratio by 0.9 points, compared to a 0.6 point reduction in the 2012 third quarter. The other operating expense ratio was 15.8% for the 2013 third quarter, compared to 16.5% for the 2012 third quarter. The 2013 third quarter operating expense ratio benefited from the higher level of net premiums earned as aggregate expenses were in line with the 2012 third quarter.

Nine Months Ended September 30, 2013 versus 2012: The insurance segment's underwriting expense ratio was 33.2% for the 2013 period, compared to 33.3% for the 2012 period. The acquisition expense ratio was 16.4% for the 2013 period, compared to 16.5% for the 2012 period. The acquisition expense ratio for the 2013 period included 0.4 points of commission expense related to development in prior year loss reserves, compared to 0.1 point in the 2012 period.



The other operating expense ratio was 16.8% for the 2013 period, compared to 16.8% for the 2012 period.

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## Reinsurance Segment

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

	Three Months Ended September 30,			Nine Months Ended September 30,		
	2013	2012	% Change	2013	2012	% Change
Gross premiums written	\$355,091	\$279,751	26.9	\$1,168,938	\$1,036,708	12.8
Net premiums written	337,164	271,893	24.0	1,094,357	1,000,473	9.4
Net premiums earned	\$315,871	\$292,350	8.0	\$923,836	\$810,984	13.9
Fee income	(19 )	432		367	623	
Losses and loss adjustment expenses	(121,124 )	(136,716 )		(364,521 )	(338,036 )	
Acquisition expenses, net	(64,514 )	(54,402 )		(178,776 )	(151,725 )	
Other operating expenses	(34,442 )	(29,001 )		(101,234 )	(84,264 )	
Underwriting income	\$95,772	\$72,663	31.8	\$279,672	\$237,582	17.7
Underwriting Ratios			% Point Change			% Point Change
Loss ratio	38.3	% 46.8	% (8.5 )	39.5	% 41.7	% (2.2 )
Acquisition expense ratio	20.4	% 18.6	% 1.8	19.4	% 18.7	% 0.7
Other operating expense ratio	10.9	% 9.9	% 1.0	11.0	% 10.4	% 0.6
Combined ratio	69.6	% 75.3	% (5.7 )	69.9	% 70.8	% (0.9 )

## Premiums Written.

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

	Three Months Ended September 30,				Nine Months Ended September 30,			
	2013		2012		2013		2012	
	Amount	%	Amount	%	Amount	%	Amount	%
Other specialty (1)	\$125,666	37	\$71,854	26	\$318,483	29	\$240,727	24
Property excluding property catastrophe (2)	78,085	23	68,627	25	230,083	21	209,854	21
Property catastrophe	33,810	10	50,196	18	210,826	19	265,994	27
Casualty (3)	58,893	17	36,831	14	207,640	19	163,343	16
Marine and aviation	13,283	4	19,152	7	50,744	5	63,611	6
Other (4)	27,427	9	25,233	10	76,581	7	56,944	6
Total	\$337,164	100	\$271,893	100	\$1,094,357	100	\$1,000,473	100
Pro rata	\$233,334	69	\$170,556	63	\$536,290	49	\$439,435	44
Excess of loss	103,830	31	101,337	37	558,067	51	561,038	56
Total	\$337,164	100	\$271,893	100	\$1,094,357	100	\$1,000,473	100

(1)Includes U.K. motor, trade credit, surety, workers' compensation catastrophe, accident and health and other.

(2)Includes facultative business.

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

(4)Includes mortgage, life, casualty clash and other.

2013 third quarter versus 2012. Net premiums written were 24.0% higher than in the 2012 third quarter, reflecting increases in other specialty, and new business written in casualty multi-line and property facultative lines, partially offset by reductions in property catastrophe. Growth in other specialty premiums primarily resulted from the impact of a multi-line quota share reinsurance agreement entered into during the 2013 third quarter, covering certain brokerage commercial automobile liability, commercial multi-peril property, commercial multi-peril liability and other liability business. Such agreement resulted in \$55.2 million of premiums written, including a \$39.7 million unearned premium transfer from policies in-force at June 30, 2013, and is not expected to recur in 2014. In addition, other specialty premiums reflected growth in trade credit and crop hail business, partially offset by a continued reduction in U.K. motor business. The reduction in property catastrophe business reflected market conditions, selected non-renewals and a higher usage of retrocessional coverage.

Nine Months Ended September 30, 2013 versus 2012. Net premiums written were 9.4% higher than in the 2012 period, reflecting increases in other specialty, casualty and mortgage business, partially offset by reductions in property catastrophe business. The growth in other specialty business primarily resulted from the other specialty reinsurance transaction noted above

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along with renewals of the credit and surety business acquired from Ariel Reinsurance Company Ltd. ("Ariel") in April 2012, partially offset by a lower level of U.K. motor business. The increase in casualty business primarily resulted from new multi-line and professional liability contracts written in the period. The reduction in property catastrophe business was due to rate reductions as well as to a targeted reduction in the utilization of limits in reaction to changing market conditions and an increase in the usage of retrocessional protection.

## Net Premiums Earned.

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

	Three Months Ended September 30,				Nine Months Ended September 30,			
	2013		2012		2013		2012	
	Amount	%	Amount	%	Amount	%	Amount	%
Other specialty (1)	\$103,565	33	\$88,570	30	\$272,666	30	\$214,622	26
Property excluding property catastrophe (2)	69,975	22	63,572	22	201,857	22	183,924	23
Property catastrophe	48,595	15	69,059	24	176,160	19	199,914	25
Casualty (3)	59,324	19	47,429	16	169,251	18	140,240	17
Marine and aviation	18,566	6	16,853	6	59,062	6	57,502	7
Other (4)	15,846	5	6,867	2	44,840	5	14,782	2
Total	\$315,871	100	\$292,350	100	\$923,836	100	\$810,984	100
Pro rata	\$172,703	55	\$140,111	48	\$468,509	51	\$364,977	45
Excess of loss	143,168	45	152,239	52	455,327	49	446,007	55
Total	\$315,871	100	\$292,350	100	\$923,836	100	\$810,984	100

(1)Includes U.K. motor, trade credit, surety, workers' compensation catastrophe, accident and health and other.

(2)Includes facultative business.

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

(4)Includes mortgage, life, casualty clash and other.

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 reflect changes in net premiums written over the previous five quarters, including the mix and type of business written. Net premiums earned in the 2013 periods included \$15.2 million related to the other specialty reinsurance transaction noted above.

## Losses and Loss Adjustment Expenses.

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

	Three Months Ended		Nine Months Ended	
	September 30,		September 30,	
	2013	2012	2013	2012
Current year	54.6	% 60.6	% 56.2	% 58.9
Prior period reserve development	(16.3	)% (13.8	)% (16.7	)% (17.2
Loss ratio	38.3	% 46.8	% 39.5	% 41.7

## Current Year Loss Ratio.

The reinsurance segment's current year loss ratio was 6.0 points lower in the 2013 third quarter compared to the 2012 third quarter and 2.7 points lower for the nine months ended September 30, 2013 than in the 2012 period. The 2013 third quarter loss ratio reflected 2.2 points related to current year catastrophic activity, compared to 4.6 points of catastrophic activity in the 2012 third quarter. The loss ratio for the nine months ended September 30, 2013 reflected 5.2 points of catastrophic activity, compared to 4.8 points for the 2012 period. The current year loss ratio for the 2013 periods also reflect changes in the mix of business earned including a higher contribution from mortgage business when compared to the 2012 periods.

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Prior Period Reserve Development.

2013 third quarter: The reinsurance segment's net favorable development of \$51.4 million, or 16.3 points, consisted of \$29.0 million from short-tailed lines, \$21.5 million from long-tailed lines and \$0.9 million from medium-tailed lines. Favorable development in short-tailed lines included \$23.5 million from property catastrophe and property other than property catastrophe reserves, primarily from the 2010 to 2012 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 amount was favorable development from the 2005 to 2012 named catastrophic events of \$8.4 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, primarily from the 2002 to 2008 underwriting years based on varying levels of reported and paid claims activity.

2012 third quarter: The reinsurance segment's net favorable development of \$40.2 million, or 13.8 points, consisted of \$23.8 million from short-tailed lines and \$16.4 million of net favorable development from medium-tailed and long-tailed lines. Favorable development in short-tailed lines included \$16.5 million from property catastrophe and property other than property catastrophe reserves, primarily from the 2008 to 2011 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. Net favorable development of \$16.4 million in medium-tailed and long-tailed lines included reductions in casualty reserves of \$11.5 million, primarily from the 2003 to 2006 underwriting years, and \$4.5 million in marine and aviation reserves, spread across various underwriting years.

Nine Months Ended September 30, 2013: The reinsurance segment's net favorable development of \$154.3 million, or 16.7 points, consisted of \$87.0 million of net favorable development in short-tailed lines, \$57.8 million from long-tailed lines and \$9.5 million from medium-tailed lines. Favorable development in short-tailed lines included \$92.5 million from property catastrophe and property other than property catastrophe reserves, primarily from the 2008 to 2012 underwriting years. Contained within this amount was favorable development from the 2005 to 2012 named catastrophic events of \$27.6 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. Such amounts were partially offset by an increase in estimates for U.S. crop hail losses of \$8.6 million. Favorable development in long-tailed lines reflected reductions in casualty reserves, primarily from the 2002 to 2008 underwriting years based on varying levels of reported and paid claims activity, while favorable development in medium-tailed lines was across most underwriting years.

Nine Months Ended September 30, 2012: The reinsurance segment's net favorable development of \$139.6 million, or 17.2 points, consisted of \$83.9 million from short-tailed lines and \$55.7 million of net favorable development from medium-tailed and long-tailed lines. Favorable development in short-tailed lines included \$63.7 million from property catastrophe and property other than property catastrophe reserves, primarily from the 2008 to 2011 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. Net favorable development of \$55.7 million in medium-tailed and long-tailed lines included reductions in casualty reserves of \$42.1 million, primarily from the 2003 to 2006 underwriting years, and \$13.0 million in marine and aviation reserves, spread across various underwriting years.

Underwriting Expenses.

2013 third quarter versus 2012: The underwriting expense ratio for the reinsurance segment was 31.3% in the 2013 third quarter, compared to 28.5% in the 2012 third quarter. The acquisition expense ratio for the 2013 third quarter was 20.4%, compared to 18.6% for the 2012 third quarter. The comparison of the 2013 third quarter and 2012 third quarter 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 2013 third quarter was 10.9%, compared to 9.9% in the 2012 third quarter. The 2013 third quarter operating expense ratio reflected an increase in aggregate expenses due, in part, to selected expansion of the reinsurance segment's operating platform, partially offset by the benefit of a higher level of net premiums earned.

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Nine Months Ended September 30, 2013 versus 2012: The reinsurance segment's underwriting expense ratio was 30.4% for the 2013 period, compared to 29.1% for the 2012 period. The acquisition expense ratio was 19.4% for the 2013 period, compared to 18.7% for the 2012 period. The other operating expense ratio was 11.0% for the 2013 period, compared to 10.4% for the 2012 period. The operating expense ratio for the 2013 period reflected a higher level of aggregate expenses than in the 2012 period due, in part, to selected expansion of the reinsurance segment's operating platform and increased share based compensation costs, partially offset by the benefit of a higher level of net premiums earned.

## Other Income or Expense Items

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

	Three Months Ended		Nine Months Ended	
	September 30,		September 30,	
	2013	2012	2013	2012
Fixed maturities	\$62,447	\$68,202	\$186,457	\$211,942
Term loan investments (1)	5,296	4,876	15,539	10,732
Equity securities	2,241	2,009	6,828	6,098
Short-term investments	417	485	1,173	1,617
Other (2)	3,753	3,795	14,786	9,968
Gross investment income	74,154	79,367	224,783	240,357
Investment expenses (3)	(8,071)	(6,146)	(24,659)	(19,231)
Net investment income	\$66,083	73,221	\$200,124	221,126

(1) Included in "investments accounted for using the fair value option" on the consolidated balance sheets.

(2) Amounts include dividends on investment funds and other items.

Investment expenses were approximately 0.25% of average invested assets for the 2013 third quarter, compared to (3)0.21% for the 2012 third quarter, and 0.27% for the nine months ended September 30, 2013, compared to 0.22% for the 2012 period.

The pre-tax investment income yield, calculated based on amortized cost and on an annualized basis, was 2.08% for the 2013 third quarter, compared to 2.20% for the 2013 first quarter and 2.45% for the 2012 third quarter. The pre-tax investment income yield was 2.16% for the nine months ended September 30, 2013, compared to 2.51% for the 2012 period. The lower yields in the 2013 periods compared to the 2012 periods reflect the effects of lower reinvestment yields, higher investment expenses and the impact of inflation adjustments on U.S. Treasury Inflation-Protected Securities. In addition, the decline in the 2013 periods also reflects our investment strategy which puts a priority on total return. Yields on future investment income 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 Aeolus LP and Gulf Reinsurance Limited (joint venture) using the equity method on a three month lag basis based on the availability of their financial statements. We recorded income of \$0.6 million on such investments in the 2013 third quarter, compared to a loss of \$0.5 million in the 2012 third quarter, and income of \$2.7 million for the nine months ended September 30, 2013, compared to a loss of \$7.9 million for the 2012 period. The amounts recorded for the 2013 periods primarily related to Gulf Reinsurance Limited, while the amount recorded in the nine months ended September 30, 2012 was primarily related to Aeolus LP, which is in runoff. The carrying value of our investment in Aeolus LP at September 30, 2013 was \$2.3 million.



Equity in Net Income of Investment Funds Accounted for Using the Equity Method. We recorded \$5.7 million of equity in net income related to investment funds accounted for using the equity method in the 2013 third quarter, compared to \$24.3 million for the 2012 third quarter, and \$30.4 million for the nine months ended September 30, 2013, compared to \$56.9 million for the 2012 period. 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 month lag with some investments reported on a 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 \$226.6 million at September 30, 2013, compared to \$307.1 million at December 31, 2012. The lower level of investment funds accounted for using the equity method

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at September 30, 2013 and related income for the 2013 periods primarily resulted from the redemption of one investment during the period.

**Net Realized Gains or Losses.** We recorded net realized losses of \$6.0 million for the 2013 third quarter, compared to net realized gains of \$60.4 million for the 2012 third quarter, and net realized gains of \$65.0 million for the nine months ended September 30, 2013, compared to net realized gains of \$139.4 million for the 2012 period. 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. In addition, net realized gains or losses include changes in the fair value of assets and liabilities accounted for using the fair value option. See note 7, "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 \$0.7 million of credit related impairments in earnings for the 2013 third quarter, compared to \$2.4 million for the 2012 third quarter, and \$3.7 million for the nine months ended September 30, 2013, compared to \$5.4 million for the 2012 period. The OTTI recorded for the nine months ended September 30, 2013 were primarily on equity securities following a review of available positive and negative evidence. See note 7, "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 \$7.9 million for the 2013 third quarter, compared to \$9.0 million for the 2012 third quarter, and \$32.2 million for the nine months ended September 30, 2013, compared to \$28.0 million for the 2012 period. 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. Other expenses for the nine months ended September 30, 2013 reflected a higher level of compensation and acquisition-related costs than in the 2012 period.

**Net Foreign Exchange Gains or Losses.** Net foreign exchange losses for the 2013 third quarter were \$40.6 million (net unrealized losses of \$39.4 million and net realized losses of \$1.1 million), compared to net foreign exchange losses for the 2012 third quarter of \$17.0 million (net unrealized losses of \$17.1 million and net realized gains of \$0.2 million). Net foreign exchange losses for the nine months ended September 30, 2013 were \$2.5 million (net unrealized gains of \$8.1 million and net realized losses of \$10.6 million), compared to net foreign exchange losses for the 2012 period of \$6.0 million (net unrealized losses of \$4.9 million and net realized losses of \$1.0 million). Net unrealized foreign exchange gains or losses result from the effects of revaluing the Company's 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. The Company has not matched a portion of its projected liabilities in foreign currencies with investments in the same currencies and may not match such amounts in future periods, which could increase the Company's exposure to foreign currency fluctuations and increase the volatility of the Company's shareholders' equity.

Loss on Repurchase of Preferred Shares. Following the issuance of \$325.0 million of 6.75% Series C preferred shares in April 2012, we redeemed all of our \$200.0 million of 8.0% Series A preferred shares and \$125.0 million of 7.875% Series B preferred shares at a redemption price equal to \$25.00 per share in May 2012. In accordance with GAAP, upon issuance of the Series A and B preferred shares in 2006, costs of \$10.6 million were recognized as a reduction of additional paid-in capital in shareholders' equity. Following the repurchase of such shares, the \$10.6 million of costs were recorded as a "loss on repurchase of preferred shares" to remove the costs from additional paid-in capital. Such adjustment had no impact on total shareholders' equity or cash flows.

## 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 2012 Form 10-K, updated where applicable in the notes accompanying our consolidated financial statements.

## FINANCIAL CONDITION, LIQUIDITY AND CAPITAL RESOURCES

## Financial Condition

## Investable Assets

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.

The following table summarizes our invested assets:

	September 30, 2013		December 31, 2012	
	Amount	% of Total	Amount	% of Total
Fixed maturities available for sale, at fair value	\$9,688,345	72.9	\$9,839,988	75.4
Fixed maturities, at fair value (1)	367,152	2.8	363,541	2.8
Fixed maturities pledged under securities lending agreements, at fair value (2)	47,515	0.4	42,600	0.3
Total fixed maturities	10,103,012	76.1	10,246,129	78.5
Short-term investments available for sale, at fair value	993,375	7.5	722,121	5.5
Short-term investments pledged under securities lending agreements, at fair value (2)	846	—	8,248	0.1
Cash	436,141	3.3	371,041	2.8
Equity securities available for sale, at fair value	452,195	3.4	312,749	2.4
Equity securities, at fair value (1)	—	—	25,954	0.2
Other investments available for sale, at fair value	528,938	4.0	549,280	4.2
Other investments, at fair value (1)	772,573	5.8	527,971	4.0
Investments accounted for using the equity method (3)	226,644	1.7	307,105	2.4
Total cash and investments	13,513,724	101.7	13,070,598	100.2
Securities sold but not yet purchased (4)	—	—	(6,924)	(0.1)
Securities transactions entered into but not settled at the balance sheet date	(231,164)	(1.7)	(18,540)	(0.1)
Total investable assets	\$13,282,560	100.0	\$13,045,134	100.0

(1) Represents securities 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 securities are

recorded in net realized gains or losses.

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

(4) Represents our obligation to deliver equity securities that we did not own at the time of sale. Such amounts are included in “other liabilities” on our balance sheet.

At September 30, 2013, 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 2.41%. At December 31, 2012, our fixed income portfolio had average credit quality ratings from S&P/Moody’s of “AA-/Aa2” and an average yield to maturity of 2.60%. Our investment portfolio had an average effective duration of 2.83 years at September 30, 2013, compared to 3.06 years at

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December 31, 2012. At September 30, 2013, approximately \$8.43 billion, or 63.4%, of our total investments and cash was internally managed, compared to \$8.35 billion, or 64.0%, at December 31, 2012.

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

	Fair Value	Gross Unrealized Gains	Gross Unrealized Losses	Cost or Amortized Cost
September 30, 2013				
Corporate bonds	\$2,742,328	\$37,646	\$(46,263)	\$2,750,945
Mortgage backed securities	1,499,403	17,831	(36,567)	1,518,139
Municipal bonds	1,531,324	36,907	(9,079)	1,503,496
Commercial mortgage backed securities	783,718	13,690	(11,322)	781,350
U.S. government and government agencies	1,121,898	11,336	(4,299)	1,114,861
Non-U.S. government securities	1,225,100	16,401	(15,789)	1,224,488
Asset backed securities	1,199,241	19,442	(12,221)	1,192,020
Total	\$10,103,012	\$153,253	\$(135,540)	\$10,085,299
December 31, 2012				
Corporate bonds	\$3,132,645	\$105,798	\$(6,710)	\$3,033,557
Mortgage backed securities	1,532,736	24,809	(7,484)	1,515,411
Municipal bonds	1,463,586	62,322	(1,421)	1,402,685
Commercial mortgage backed securities	824,165	37,514	(4,468)	791,119
U.S. government and government agencies	1,131,688	20,178	(1,095)	1,112,605
Non-U.S. government securities	1,087,310	33,701	(8,860)	1,062,469
Asset backed securities	1,073,999	25,528	(5,838)	1,054,309
Total	\$10,246,129	\$309,850	\$(35,876)	\$9,972,155

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

Rating (1)	September 30, 2013		December 31, 2012	
	Fair Value	% of Total	Fair Value	% of Total
U.S. government and government agencies (2)	\$2,418,555	23.9	\$2,523,212	24.6
AAA	3,137,464	31.1	3,413,431	33.3
AA	2,071,761	20.5	1,563,846	15.3
A	1,341,236	13.3	1,501,156	14.7
BBB	387,243	3.8	538,140	5.3
BB	162,520	1.6	174,527	1.7
B	189,379	1.9	220,772	2.2
Lower than B	245,777	2.4	175,866	1.7
Not rated	149,077	1.5	135,179	1.2
Total	\$10,103,012	100.0	\$10,246,129	100.0

(1) For individual fixed maturities, S&P ratings are used. In the absence of an S&P rating, 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.



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At September 30, 2013, below-investment grade securities comprised approximately 7.4% of our Fixed Maturities, compared to 6.9% at December 31, 2012. 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 September 30, 2013, corporate bonds represented 61% of the total below investment grade securities at fair value, mortgage backed securities represented 33% of the total and 6% were in other classes. At December 31, 2012, corporate bonds represented 32% of the total below investment grade securities at fair value, mortgage backed securities represented 49% of the total and 19% 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.

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	September 30, 2013			December 31, 2012		
	Fair Value	Gross Unrealized Losses	% of Total Gross Unrealized Losses	Fair Value	Gross Unrealized Losses	% of Total Gross Unrealized Losses
0-10%	\$4,399,920	\$(112,355 )	82.9	\$2,113,835	\$(28,439 )	79.3
10-20%	106,514	(17,635 )	13.0	43,871	(6,363 )	17.7
20-30%	10,823	(3,128 )	2.3	3,086	(1,074 )	3.0
30-40%	5,308	(2,422 )	1.8	—	—	—
Total	\$4,522,565	\$(135,540 )	100.0	\$2,160,792	\$(35,876 )	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	September 30, 2013			December 31, 2012		
	Fair Value	Gross Unrealized Losses	% of Total Gross Unrealized Losses	Fair Value	Gross Unrealized Losses	% of Total Gross Unrealized Losses
0-10%	\$190,067	\$(6,877 )	5.1	\$87,223	\$(2,513 )	7.0
10-20%	7,944	(1,152 )	0.8	9,107	(1,529 )	4.3
20-30%	3,245	(1,011 )	0.7	—	—	—
30-80%	674	(372 )	0.3	—	—	—
Total	\$201,930	\$(9,412 )	6.9	\$96,330	\$(4,042 )	11.3

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.





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The following table summarizes our top ten exposures to fixed income corporate issuers by fair value at September 30, 2013, excluding guaranteed amounts and covered bonds:

	Fair Value	Credit Rating (1)
General Electric Co.	\$62,884	AA+/Aa1
Apple Inc.	57,023	AA+/A1
Royal Dutch Shell PLC	53,768	AA/Aa1
Crown Castle Int'l Corp.	35,092	NR/A2
Caterpillar Inc.	35,040	A/A2
Merck & Co Inc.	33,668	AA/A2
Wal-Mart Stores Inc.	31,363	AA/Aa2
United Parcel Service Inc.	31,267	A+/Aa3
Bank of New York Mellon Corp.	31,133	A+/Aa3
Anheuser-Busch Inbev NV	30,186	A/A3
Total	\$401,424	

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(1) Ratings as assigned by S&P/Moody's.

At September 30, 2013, we held insurance enhanced municipal bonds, net of prerefunded bonds that are escrowed in U.S. government obligations, the fair value of which was \$185.0 million, or 1.4% of our total investable assets. These securities had average credit quality ratings from S&P/Moody's of "AA+/Aa2" with and without the insurance enhancement. This is due to the fact that, in cases where the claims paying ratings of the guarantors are below investment grade, those ratings have been withdrawn from the bonds by the relevant rating agencies, and the insured ratings have been equated to the underlying ratings. The ratings were obtained from the individual rating agencies and were assigned a numerical amount with 1 being the highest rating. The average ratings were calculated using the weighted average fair values of the individual bonds. The average ratings with and without the insurance enhancement are substantially the same at September 30, 2013. Guarantors of our insurance enhanced municipal bonds, net of prerefunded bonds that are escrowed in U.S. government obligations, included National Public Finance Guarantee (\$98.3 million), Assured Guaranty Ltd. (\$65.6 million) and the Texas Permanent School Fund (\$21.2 million). We do not have a significant exposure to insurance enhanced asset-backed or mortgage-backed securities. We do not have any significant investments in companies which guarantee securities at September 30, 2013.

Our portfolio includes investments, such as mortgage-backed securities, which are subject to prepayment risk. At September 30, 2013, our investments in residential mortgage-backed securities ("MBS") amounted to approximately \$1.50 billion, or 11.3% of total investable assets, compared to \$1.53 billion, or 11.7%, at December 31, 2012. 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 includes commercial mortgage backed securities ("CMBS"). At September 30, 2013, CMBS constituted approximately \$783.7 million, or 5.9% of total investable assets, compared to \$824.2 million, or 6.3%, at December 31, 2012. The commercial real estate market has experienced price deterioration, which could lead to increased delinquencies and defaults on commercial real estate mortgages.

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 subordinate 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.

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The following table provides information on our MBS and CMBS at September 30, 2013, excluding amounts guaranteed by the U.S. government:

	Issuance Year	Amortized Cost	Average Credit Quality	Fair Value Total	% of Amortized Cost	% of Investable Assets	
Non-agency MBS:	2003	\$1,738	AA-	\$1,842	106.0	% 0.0	%
	2004	6,029	BB	5,739	95.2	% 0.0	%
	2005	47,397	CCC+	49,306	104.0	% 0.4	%
	2006	70,772	CCC+	73,255	103.5	% 0.6	%
	2007	72,458	C+	76,823	106.0	% 0.6	%
	2008	5,368	CC+	5,621	104.7	% 0.0	%
	2009	1,608	AA-	1,646	102.4	% 0.0	%
	2010	12,986	AA-	12,996	100.1	% 0.1	%
	2012	45,748	AA+	45,549	99.6	% 0.3	%
	2013	111,904	AAA	106,279	95.0	% 0.8	%
Total non-agency MBS		\$376,008	BB+	\$379,056	100.8	% 2.9	%
Non-agency CMBS:	2004	677	AAA	627	92.6	% 0.0	%
	2005	29,844	AAA	29,636	99.3	% 0.2	%
	2006	18,148	AA+	18,116	99.8	% 0.1	%
	2007	26,310	A-	27,689	105.2	% 0.2	%
	2008	279	AA+	274	98.2	% 0.0	%
	2009	237	AAA	221	93.2	% 0.0	%
	2010	112,592	AAA	116,885	103.8	% 0.9	%
	2011	128,417	AAA	134,245	104.5	% 1.0	%
	2012	130,033	AA+	128,399	98.7	% 1.0	%
	2013	154,595	AAA	151,316	97.9	% 1.1	%
Total non-agency CMBS		\$601,132	AA+	\$607,408	101.0	% 4.6	%
Additional Statistics:				Non-Agency MBS		Non-Agency	
Weighted average loan age (months)				Re-REMICs	All Other	CMBS (1)	
Weighted average life (months) (2)				89	65	32	
Weighted average loan-to-value % (3)				19	53	48	
Total delinquencies (4)				69.6	% 67.1	% 59.9	%
Current credit support % (5)				21.0	% 15.3	% 1.2	%
				54.9	% 7.6	% 31.4	%

(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 September 30, 2013. 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 25% to 117% on MBS and 7% to 103% 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 September 30, 2013:

	Amortized Cost	Average Credit Quality	Weighted Average Credit Support	Fair Value			
				Total	% of Amortized Cost	% of Investable Assets	
Sector:							
Equipment	\$308,909	AA-	7	% \$303,771	98.3	% 2.3	%
Credit cards	325,870	AAA	18	% 328,941	100.9	% 2.5	%
Loans	209,007	AA+	48	% 209,550	100.3	% 1.6	%
Autos	145,854	AAA	29	% 144,986	99.4	% 1.1	%
Rate reduction bonds	71,525	AAA	5	% 73,209	102.4	% 0.6	%
Home equity	43,797	BBB	22	% 50,853	116.1	% 0.4	%
Commodities	23,000	AA+	6	% 23,310	101.3	% 0.2	%
U.K. securitized	16,743	AAA	19	% 17,192	102.7	% 0.1	%
Other	47,315	AA		47,429	100.2	% 0.4	%
Total ABS (1)	\$1,192,020	AA+		\$1,199,241	100.6	% 9.0	%

(1) The effective duration of the total ABS was 1.9 years at September 30, 2013.

At September 30, 2013, our fixed income portfolio included \$49.3 million par value in sub-prime securities with a fair value of \$27.2 million and average credit quality ratings from S&P/Moody’s of “B/Caa1.” At December 31, 2012, our fixed income portfolio included \$66.9 million par value in sub-prime securities with a fair value of \$42.1 million and average credit quality ratings from S&P/Moody’s of “A-/B2.” Such amounts were primarily in the home equity sector of our asset backed securities, 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 \$6.4 million fair value of sub-prime securities with average credit quality ratings from S&P/Moody’s of “CC/Caa3” at September 30, 2013, compared to \$5.4 million and “CCC-/Caa3” at December 31, 2012.

The following table provides information on the fair value of our Eurozone investments at September 30, 2013:

	Sovereign (2)	Financial Corporates	Other Corporates	Covered Bonds (3)	Bank Loans (4)	Equities and Other	Total
Country (1)							
Germany	\$83,090	\$—	\$4,295	\$10,075	\$4,864	\$7,973	\$110,297
Finland	101,733	—	—	—	—	—	101,733
Netherlands	1,884	463	81,026	—	5,533	6,750	95,656
Belgium	34,291	—	203	—	—	—	34,494
Supranational (5)	27,023	—	—	—	—	—	27,023
Luxembourg	—	—	17,702	—	6,240	372	24,314
France	—	4,973	7,261	—	4,494	4,538	21,266
Austria	10,464	3,450	440	—	—	—	14,354
Ireland	1,625	657	5,601	—	—	1,290	9,173
Spain	—	—	—	559	1,934	—	2,493
Italy	—	—	—	—	1,850	—	1,850

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Cyprus	\$—	\$—	\$339	\$—	\$—	\$—	\$339
Total	\$260,110	\$9,543	\$116,867	\$10,634	\$24,915	\$20,923	\$442,992

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 Eurozone investments from Estonia, Greece, Malta, Portugal, Slovakia or Slovenia at September 30, 2013.

- (1) Sovereign includes securities issued and/or guaranteed by Eurozone governments.
- (2) Securities issued by Eurozone banks where the security is backed by a separate group of loans.
- (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.
- (5)

At September 30, 2013, our equity portfolio included \$452.2 million of equity securities, compared to \$331.8 million at December 31, 2012, net of securities sold but not purchased. Our equity portfolio primarily consists of publicly traded common

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stocks in the consumer staples, real estate and natural resources 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	September 30, 2013			December 31, 2012		
	Fair Value	Gross Unrealized Losses	% of Total Gross Unrealized Losses	Fair Value	Gross Unrealized Losses	% of Total Gross Unrealized Losses
0-10%	\$137,640	\$(4,808)	) 64.8	\$114,670	\$(4,704)	) 38.3
10-20%	12,828	(2,131)	) 28.7	22,851	(3,612)	) 29.4
20-30%	622	(206)	) 2.8	6,205	(1,973)	) 16.1
30-40%	490	(274)	) 3.7	1,953	(981)	) 8.0
40-50%	—	—	—	1,027	(829)	) 6.7
50-80%	—	—	—	148	(191)	) 1.5
Total	\$151,580	\$(7,419)	) 100.0	\$146,854	\$(12,290)	) 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. Substantially 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 September 30, 2013. 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 September 30, 2013.

The following table summarizes our other investments:

	September 30, 2013	December 31, 2012
Available for sale:		
Asian and emerging markets	\$357,069	\$316,860
Investment grade fixed income	164,768	220,410
Other	7,101	12,010
Total available for sale	528,938	549,280
Fair value option:		
Term loan investments (par value: \$487,083 and \$307,016)	496,477	308,596
Asian and emerging markets	19,705	24,035
Investment grade fixed income	75,328	67,624
Non-investment grade fixed income	9,408	11,093
Other (1)	171,655	116,623
Total fair value option	\$772,573	\$527,971
Total	\$1,301,511	\$1,077,251

(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

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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 market, which may result in significant additional losses. Alternatively, the levered investments may attempt to deleverage 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 9, "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 8, "Fair Value," of the notes accompanying our consolidated financial statements for a summary of our financial assets and liabilities measured at fair value at September 30, 2013 and December 31, 2012 segregated by level in the fair value hierarchy.

#### Premiums Receivable and Reinsurance Recoverables

At September 30, 2013, 81.0% of premiums receivable of \$850.4 million represented amounts not yet due, while amounts in excess of 90 days overdue were 4.0% of the total. At December 31, 2012, 69.6% of premiums receivable of \$688.9 million represented amounts not yet due, while amounts in excess of 90 days overdue were 5.7% of the total. Approximately 28.1% of the \$49.3 million of paid losses and loss adjustment expenses recoverable at September 30, 2013 were more than 90 days overdue, while 18.9% of the \$41.0 million of paid losses and loss adjustment expenses recoverable at December 31, 2012 were more than 90 days overdue. Our reserves for doubtful accounts were approximately \$11.9 million at September 30, 2013, compared to \$12.0 million at December 31, 2012.

At September 30, 2013, approximately 86.6% of reinsurance recoverables on paid and unpaid losses (not including prepaid reinsurance premiums) of \$1.80 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 4.3% of our total shareholders' equity. At December 31, 2012, approximately 87.5% of reinsurance recoverables on paid and unpaid losses (not including prepaid reinsurance premiums) of \$1.87 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 4.7% of our total shareholders' equity.

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

	Three Months Ended		Nine Months Ended	
	September 30,		September 30,	
	2013	2012	2013	2012
Premiums Written				
Direct	\$681,772	\$677,516	\$2,113,548	\$2,082,991
Assumed	355,214	259,248	1,127,875	972,242
Ceded	(197,851 )	(181,515 )	(638,977 )	(616,140 )
Net	\$839,135	\$755,249	\$2,602,446	\$2,439,093
Premiums Earned				

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Direct	\$673,199	\$658,256	\$1,977,421	\$1,905,608
Assumed	328,720	294,089	935,059	844,625
Ceded	(206,919 )	(203,654 )	(605,894 )	(594,574 )
Net	\$795,000	\$748,691	\$2,306,586	\$2,155,659
Losses and Loss Adjustment Expenses				
Direct	\$409,623	\$383,436	\$1,177,156	\$1,123,268
Assumed	106,620	126,558	330,151	339,342
Ceded	(89,198 )	(66,123 )	(262,206 )	(223,839 )
Net	\$427,045	\$443,871	\$1,245,101	\$1,238,771

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## 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 are a relatively new company with relatively limited historical experience upon which to base such estimates. We utilize actuarial models as well as available historical insurance industry loss ratio experience and loss development patterns to assist in the establishment of Loss Reserves. Actual losses and loss adjustment expenses paid will deviate, perhaps substantially, from the reserve estimates reflected in our financial statements.

At September 30, 2013 and December 31, 2012, our Loss Reserves, net of unpaid losses and loss adjustment expenses recoverable, by type and by operating segment were as follows:

	September 30, 2013	December 31, 2012
Insurance:		
Case reserves	\$1,447,816	\$1,438,575
IBNR reserves	3,007,721	2,979,344
Total net reserves	\$4,455,537	\$4,417,919
Reinsurance:		
Case reserves	\$732,952	\$781,894
Additional case reserves	131,049	195,033
IBNR reserves	1,753,264	1,709,376
Total net reserves	\$2,617,265	\$2,686,303
Total:		
Case reserves	\$2,180,768	\$2,220,469
Additional case reserves	131,049	195,033
IBNR reserves	4,760,985	4,688,720
Total net reserves	\$7,072,802	\$7,104,222

At September 30, 2013 and December 31, 2012, the insurance segment’s Loss Reserves by major line of business, net of unpaid losses and loss adjustment expenses recoverable, were as follows:

	September 30, 2013	December 31, 2012
Executive assurance	\$790,847	\$772,768
Casualty	673,702	663,703
Programs	630,826	592,235
Professional liability	591,906	598,638
Property, energy, marine and aviation	529,511	613,176
Construction	445,540	430,170
National accounts	231,747	207,551
Healthcare	128,587	135,227
Surety	91,042	95,139
Travel and accident	34,542	36,568
Lenders products	32,685	28,606
Other (1)	274,602	244,138

Total net reserves	\$4,455,537	\$4,417,919
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(1)Includes alternative markets, contract binding, accident and health and excess workers' compensation business.

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At September 30, 2013 and December 31, 2012, the reinsurance segment's Loss Reserves by major line of business, net of unpaid losses and loss adjustment expenses recoverable, were as follows:

	September 30, 2013	December 31, 2012
Casualty	\$1,543,500	\$1,570,165
Other specialty	377,496	288,797
Property excluding property catastrophe	262,937	323,727
Property catastrophe	201,011	277,817
Marine and aviation	168,056	169,190
Other	64,265	56,607
Total net reserves	\$2,617,265	\$2,686,303

## Shareholders' Equity

Our shareholders' equity was \$5.44 billion at September 30, 2013, compared to \$5.17 billion at December 31, 2012. The increase in 2013 was primarily attributable to underwriting returns, partially offset by the impact of unrealized losses on our investment portfolio during 2013.

## Book Value per Common Share

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

(U.S. dollars in thousands, except share data)	September 30, 2013	December 31, 2012
Calculation of book value per common share:		
Total shareholders' equity	\$5,443,285	\$5,168,878
Less preferred shareholders' equity	325,000	325,000
Common shareholders' equity	\$5,118,285	\$4,843,878
Common shares outstanding (1)	133,480,323	133,842,613
Book value per common share	\$38.34	\$36.19

(1) Excludes the effects of 8,493,395 and 8,221,444 stock options and 459,009 and 480,406 restricted stock units outstanding at September 30, 2013 and December 31, 2012, 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 \$1.9 million at September 30, 2013, compared to \$14.7 million at December 31, 2012. For the nine months ended September 30, 2013, ACGL received dividends of \$94.0 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 prev

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ious 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, 2012, as determined under Bermuda law, Arch Re Bermuda had statutory capital of \$2.32 billion and statutory capital and surplus of \$5.01 billion, 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 \$1.16 billion to ACGL during the remainder of 2013 without providing an affidavit to the BMA, as discussed above. In addition, under BMA guidelines that became effective on January 1, 2013, 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, 2012.

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 September 30, 2013 and December 31, 2012, such amounts approximated \$5.32 billion and \$5.47 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. The most profitable line of business in the current environment continues to be 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 2012 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 46% (compared to 51% for 2011). 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:

	Nine Months Ended September 30,	
	2013	2012
Total cash provided by (used for):		
Operating activities	\$627,048	\$731,951
Investing activities	(485,672 )	(493,141 )
Financing activities	(71,503 )	(173,468 )
Effects of exchange rate changes on foreign currency cash	(4,773 )	5,399
Increase in cash	\$65,100	\$70,741

Cash provided by operating activities for the nine months ended September 30, 2013 was lower than in the 2012 period. The decrease in operating cash flows primarily resulted from higher paid losses for the nine months ended September 30, 2013, including outflows on named catastrophic events and the maturation of our reserves, partially offset by an increase in premium receipts. Cash flows for the nine months ended September 30, 2013 also included an income distribution from an investment fund accounted for using the equity method upon the redemption of such investment.

Cash used for investing activities for the nine months ended September 30, 2013 was lower than in the 2012 period. Activity for the nine months ended September 30, 2013 reflected a lower level of net purchases of fixed maturity investments, partially offset by a higher level of net purchases of equity securities and other investments than in the 2012 period.

Cash used for financing activities for the nine months ended September 30, 2013 was lower than in the 2012 period. The 2012 period reflected the repayment of \$124.6 million of TALF borrowings. Activity for the nine months ended September 30, 2013 reflected \$57.8 million of share repurchases under our share repurchase program while the 2012 period did not include any repurchase activity. In addition, the 2012 period reflected the issuance and repurchase of preferred shares.

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 our investment strategy, we seek to establish a level of cash and highly liquid short-term and intermediate-term securities which, combined with expected cash flow, is believed by us to be adequate to meet our foreseeable payment obligations. 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 investment in Gulf Reinsurance Limited (joint venture) 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.

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On a consolidated basis, our aggregate investable assets totaled \$13.28 billion at September 30, 2013, compared to \$13.05 billion at December 31, 2012. 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 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 \$815.3 million at September 30, 2013.

Various rating agencies have announced the possibility of future downgrades of the United States' credit rating, depending on spending levels, interest rates, fiscal pressures that result in a higher general government debt trajectory and other factors. In addition, the impact of the continuing 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 possible additional 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. Our investment portfolio as of September 30, 2013 included \$1.12 billion of obligations of the U.S. government and government agencies at fair value and \$1.53 billion of municipal bonds at fair value. Please refer to Item 1A "Risk Factors" of our 2012 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.

In February 2013, certain of our U.S.-based subsidiaries (collectively "Arch U.S. MI") entered into a definitive agreement to acquire (1) CMG Mortgage Insurance Company ("CMG MI") from its current owners, PMI Mortgage Insurance Co. in rehabilitation ("PMI"), which has been under the receivership of the Arizona Department of Insurance since 2011, and CMFG Life Insurance Company, and (2) PMI's mortgage insurance operating platform and certain related assets from PMI. In connection with the closing of the transactions, PMI and an affiliate of our U.S.-based subsidiaries will enter into a quota share reinsurance agreement pursuant to which such affiliate, as the reinsurer, will agree to provide 100% quota share indemnity reinsurance to PMI for all certificates of insurance that were issued by PMI between and including January 1, 2009 and December 31, 2011 that are not in default as of an agreed upon

effective date. At closing, it is currently estimated that our U.S.-based subsidiaries will pay aggregate consideration of approximately \$300 million under all transaction documents. Additional amounts may be paid based on the actual results of CMG MI's pre-closing portfolio over an agreed upon period. In addition, we will enter into a services agreement with PMI to provide for necessary services to administer the run-off of PMI's legacy business at the direction of PMI.

On June 20, 2013, the Arizona receivership court provided the required approval of the acquisition. The transaction is also subject to approvals of the applicable regulators and approvals by the Federal National Mortgage Association and the Federal Home Loan Mortgage Corporation of Arch U.S. MI as an eligible insurance carrier in the U.S. mortgage insurance marketplace, as well as the satisfaction of customary closing conditions. In connection with obtaining such consents of regulatory authorities and government-sponsored entities, it is anticipated that Arch U.S. MI or its affiliates will be required to make certain financial commitments to CMG MI, the form and amount of which will be determined based upon discussions with such authorities and entities. Arch U.S. MI's obligation to the sellers to accept financial requirements imposed by regulatory authorities and government-sponsored entities will be determined on the basis of, among other things, the appropriateness of such requirements

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in light of Arch U.S. MI's business plan and the consistency of such requirements with those imposed on other active participants in the U.S. mortgage insurance industry, as described in the purchase agreements. If these approvals are obtained, it is expected the transaction will close during the 2013 fourth quarter or early 2014.

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. Authorizations have consisted of a \$1.0 billion authorization in February 2007, a \$500.0 million authorization in May 2008, a \$1.0 billion authorization in November 2009 and a \$1.0 billion authorization in February 2011. Since the inception of the share repurchase program through September 30, 2013, ACGL has repurchased 109.9 million common shares for an aggregate purchase price of \$2.79 billion. At September 30, 2013, \$712.1 million of share repurchases were available under the program. Repurchases under the program may be effected from time to time in open market or privately negotiated transactions through December 2014. 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 August 2011, we entered into a three-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 \$113.8 million, which are available on a limited basis and for limited purposes. Refer to note 4, “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 2012, 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 depository 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

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

In April 2012, ACGL completed the underwritten public offering of \$325 million of its 6.75% Series C non-cumulative preferred shares. Except in specified circumstances relating to certain tax or corporate events, the Series C non-cumulative preferred shares are not redeemable prior to April 2, 2017. Dividends on the Series C preferred shares are non-cumulative. Consequently, in the event dividends are not declared on the Series C preferred shares for any dividend period, holders of preferred shares will not be entitled to receive a dividend for such period, and such undeclared dividend will not accrue and will not be payable. Holders of Series C preferred shares will be entitled to receive dividend payments only when, as and if declared by ACGL's board of directors or a duly authorized committee of ACGL's board of directors. Any such dividends will be payable from the date of original issue on a non-cumulative basis, quarterly in arrears on the last day of each period. To the extent declared, these dividends will accumulate, with respect to each dividend period, in an amount per share equal to 6.75% of the \$25.00 liquidation preference per annum.

At September 30, 2013, ACGL's capital of \$5.84 billion consisted of \$300.0 million of senior notes, representing 5.1% of the total, \$100.0 million of revolving credit agreement borrowings due in August 2014, representing 1.7% of the total, \$325.0 million of preferred shares, representing 5.6% of the total, and common shareholders' equity of \$5.12 billion, representing the balance. At December 31, 2012, ACGL's capital of \$5.57 billion consisted of \$300.0 million of senior notes, representing 5.4% of the total, \$100.0 million of revolving credit agreement borrowings due in August 2014, representing 1.8% of the total, \$325.0 million of preferred shares, representing 5.8% of the total, and common shareholders' equity of \$4.84 billion, representing the balance. The increase in capital during 2013 was primarily attributable to positive underwriting and investment returns.

### 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 2012 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 September 30, 2013. 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 September 30, 2013 that affect the quantitative and qualitative disclosures presented in our 2012 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.

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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:

(U.S. dollars in millions)	Interest Rate Shift in Basis Points						
	-100	-50	—	+50	+100		
September 30, 2013							
Total fair value	\$ 12,563.7	\$ 12,400.9	\$ 12,229.5	\$ 12,057.8	\$ 11,887.5		
Change from base	2.73	% 1.40	% —	(1.40	)% (2.80	)%	
Change in unrealized value	\$ 334.2	\$ 171.4	\$ —	\$(171.7	)	\$(342.0	)
December 31, 2012							
Total fair value	\$ 12,463.4	\$ 12,303.5	\$ 12,121.9	\$ 11,937.4	\$ 11,751.6		
Change from base	2.82	% 1.50	% —	(1.52	)% (3.05	)%	
Change in unrealized value	\$ 341.5	\$ 181.6	\$ —	\$(184.5	)	\$(370.3	)

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.

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:

(U.S. dollars in millions)	Credit Spread Shift in Basis Points						
	-100	-50	—	+50	+100		
September 30, 2013							
Total fair value	\$ 12,441.0	\$ 12,349.0	\$ 12,229.5	\$ 12,119.5	\$ 12,009.5		
Change from base	1.73	% 0.98	% —	(0.90	)% (1.80	)%	
Change in unrealized value	\$ 211.5	\$ 119.5	\$ —	\$(110.0	)	\$(220.0	)
December 31, 2012							
Total fair value	\$ 12,337.5	\$ 12,242.7	\$ 12,121.9	\$ 12,008.8	\$ 11,894.8		
Change from base	1.78	% 1.00	% —	(0.93	)% (1.87	)%	
Change in unrealized value	\$ 215.6	\$ 120.8	\$ —	\$(113.1	)	\$(227.1	)

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 September 30, 2013, our portfolio’s VaR was estimated to be 3.90%, compared to an estimated 2.75% at December 31, 2012.

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 September 30, 2013 and December 31, 2012, the fair value of such investments totaled \$617.4 million and \$563.7 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 \$61.7 million and \$56.4 million at September 30, 2013 and December 31, 2012, respectively, and would have decreased book value per common share by approximately \$0.46 and \$0.42, respectively. An immediate hypothetical 10% increase in the value of each position would increase the fair value of such investments by approximately \$61.7 million and \$56.4 million at September 30, 2013 and December 31, 2012, respectively, and would have increased book value per common share by approximately \$0.46 and \$0.42, 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 9, "Derivative Instruments," of the notes accompanying our consolidated financial statements for additional disclosures concerning

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derivatives. At September 30, 2013, the notional value of the net long position of 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 \$822.9 million, compared to \$390.7 million at December 31, 2012. A 100 basis point depreciation of the underlying exposure to these derivative instruments at September 30, 2013 and December 31, 2012 would have resulted in a reduction in net income of approximately \$8.2 million and \$3.9 million, respectively, and would have decreased book value per common share by \$0.06 and \$0.03, respectively. A 100 basis point appreciation of the underlying exposure to these derivative instruments at September 30, 2013 and December 31, 2012 would have resulted in an increase in net income of approximately \$8.2 million and \$3.9 million, respectively, and would have increased book value per common share by \$0.06 and \$0.03, respectively.

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 9, “Derivative Instruments,” of the notes accompanying our consolidated financial statements for additional information.

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)	September 30, 2013	December 31, 2012
Assets, net of insurance liabilities, denominated in foreign currencies, excluding shareholders' equity and derivatives	\$74,133	\$146,227
Shareholders' equity denominated in foreign currencies (1)	375,166	290,310
Net foreign currency forward contracts outstanding (2)	(65,962	) (76,517 )
Net exposures denominated in foreign currencies	\$383,337	\$360,020
Pre-tax impact of a hypothetical 10% appreciation of the U.S. Dollar against foreign currencies:		
Shareholders' equity	\$(38,334	) \$(36,002 )
Book value per common share	\$(0.29	) \$(0.27 )
Pre-tax impact of a hypothetical 10% decline of the U.S. Dollar against foreign currencies:		
Shareholders' equity	\$38,334	\$36,002
Book value per common share	\$0.29	\$0.27

(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.”

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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 its 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;
- 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 September 30, 2013;
- 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;

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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;

the impact of the continued weakness of the U.S., European countries or other key economies, projected budget deficits for the U.S., European countries and other governments and the consequences associated with possible additional downgrades of securities of the U.S., European countries and other governments by credit rating agencies, and the resulting effect on the value of securities in our investment portfolio as well as the uncertainty in the market generally;

losses relating to aviation business and business produced by a certain managing underwriting agency for which we may be liable to the purchaser of its 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 operates, underwrites business or invests;

statutory or regulatory developments, including as to tax policy 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 September 30, 2013 and for the three month and nine month periods ended September 30, 2013 and 2012 have been reviewed by PricewaterhouseCoopers LLP, an independent registered public accounting firm. Their report (dated November 8, 2013) 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 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

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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 September 30, 2013 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 September 30, 2013, 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 2013 third quarter:

Period	Issuer Purchases of Equity Securities			
	Total Number of Shares Purchased (1)	Average Price Paid per Share	Total Number of Shares Purchased as Part of Publicly Announced Plans or Programs (2)	Approximate Dollar Value of Shares that May Yet be Purchased Under the Plan or Programs
7/1/2013 - 7/31/2013	34,428	\$ 51.24	26,300	\$ 712,115
8/1/2013 - 8/31/2013	5,098	53.82	—	\$ 712,115
9/1/2013 - 9/30/2013	1,988	53.84	—	\$ 712,115
Total	41,514	\$ 51.68	26,300	\$ 712,115

(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) The board of directors of ACGL has authorized the investment in ACGL's common shares through a share repurchase program. Repurchases under the program may be effected from time to time in open market or privately negotiated transactions through December 2014. Since the inception of the share repurchase program, ACGL has repurchased 109.9 million common shares for an aggregate purchase price of \$2.79 billion. 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.

## 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 2013 third 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	Restricted Share Agreement with Arch Capital Group Ltd. substantially in the form signed by each of Constantine Iordanou, Marc Grandisson, W. Preston Hutchings, Mark D. Lyons and Louis T. Petrillo for May 9, 2013 grants
10.2	Share Appreciation Right Agreement with Arch Capital Group Ltd. substantially in the form signed by each of Constantine Iordanou, Mark D. Lyons, Marc Grandisson, W. Preston Hutchings, Mark D. Lyons, David McElroy and Louis T. Petrillo for May 9, 2013 grants
10.3	Restricted Share Unit Agreement, dated as of May 9, 2013, between Arch Capital Group Ltd. and David McElroy

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 September 30, 2013 formatted in XBRL: (i) Consolidated Balance Sheets at September 30, 2013 and December 31, 2012; (ii) Consolidated Statements of Income for the three and nine month periods ended September 30, 2013 and 2012; (iii) Consolidated Statements of Comprehensive Income for the three and nine month periods ended September 30, 2013 and 2012; (iv) Consolidated Statements of Changes in Shareholders' Equity for the nine month periods ended September 30, 2013 and 2012; (v) Consolidated Statements of Cash Flows for the nine month periods ended September 30, 2013 and 2012; and (vi) Notes to Consolidated Financial Statements.**

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\* Filed as an exhibit to our Report on Form 8-K, as filed with the SEC on June 5, 2013, and incorporated by reference.

\*\* This exhibit will not be deemed "filed" for the purposes of Section 18 of the Securities Exchange Act of 1934 (15 U.S.C. 78r) , or otherwise subject to the liability of that section. Such exhibit will not be deemed to be incorporated by reference into any filing under the Securities Act or Securities Exchange Act, except to the extent that Arch Capital Group Ltd. specifically incorporates it by reference.

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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: November 8, 2013

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

Date: November 8, 2013

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

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