

ARCH CAPITAL GROUP LTD.  
Form 10-Q  
May 08, 2015  
Table of Contents

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

FORM 10-Q

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

For the period ended March 31, 2015

Or

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

Commission file number: 001-26456

ARCH CAPITAL GROUP LTD.  
(Exact name of registrant as specified in its charter)

Bermuda  
(State or other jurisdiction of incorporation or organization)

Not Applicable  
(I.R.S. Employer Identification No.)

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

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

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

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

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, or a smaller reporting company. See the definitions of "large accelerated filer," "accelerated filer" and "smaller reporting

company” in Rule 12b-2 of the Exchange Act.

Large accelerated Filer  Accelerated Filer  Non-accelerated Filer  Smaller reporting company

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

Yes  No

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

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Table of Contents

ARCH CAPITAL GROUP LTD.

INDEX

	Page No.
PART I. Financial Information	
Item 1 — Consolidated Financial Statements	
<u>Report of Independent Registered Public Accounting Firm</u>	<u>2</u>
<u>Consolidated Balance Sheets</u> March 31, 2015 (unaudited) and December 31, 2014	<u>3</u>
<u>Consolidated Statements of Income</u> For the three month periods ended March 31, 2015 and 2014 (unaudited)	<u>4</u>
<u>Consolidated Statements of Comprehensive Income</u> For the three month periods ended March 31, 2015 and 2014 (unaudited)	<u>5</u>
<u>Consolidated Statements of Changes in Shareholders' Equity</u> For the three month periods ended March 31, 2015 and 2014 (unaudited)	<u>6</u>
<u>Consolidated Statements of Cash Flows</u> For the three month periods ended March 31, 2015 and 2014 (unaudited)	<u>7</u>
<u>Notes to Consolidated Financial Statements (unaudited)</u>	<u>8</u>
<u>Item 2 — Management's Discussion and Analysis of Financial Condition and Results of Operations</u>	<u>35</u>
<u>Item 3 — Quantitative and Qualitative Disclosures About Market Risk</u>	<u>69</u>
<u>Item 4 — Controls and Procedures</u>	<u>69</u>
<u>PART II. Other Information</u>	
<u>Item 1 — Legal Proceedings</u>	<u>69</u>
<u>Item 2 — Unregistered Sales of Equity Securities and Use of Proceeds</u>	<u>70</u>
<u>Item 5 — Other Information</u>	<u>70</u>
<u>Item 6 — Exhibits</u>	<u>70</u>

Table of Contents

Report of Independent Registered Public Accounting Firm

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

We have reviewed the accompanying consolidated balance sheet of Arch Capital Group Ltd. and its subsidiaries (the “Company”) as of March 31, 2015, and the related consolidated statements of income and comprehensive income for the three-month periods ended March 31, 2015 and March 31, 2014, and the consolidated statements of changes in shareholders’ equity and cash flows for the three-month periods ended March 31, 2015 and March 31, 2014. These interim financial statements are the responsibility of the Company’s management.

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

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

We previously audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the consolidated balance sheet as of December 31, 2014, and the related consolidated statements of income, comprehensive income, changes in shareholders’ equity, and cash flows for the year then ended (not presented herein), and in our report dated February 27, 2015, we expressed an unqualified opinion on those consolidated financial statements. In our opinion, the information set forth in the accompanying consolidated balance sheet information as of December 31, 2014, is fairly stated in all material respects in relation to the consolidated balance sheet from which it has been derived.

/s/ PricewaterhouseCoopers LLP

New York, New York  
May 8, 2015

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

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

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

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

See Notes to Consolidated Financial Statements

3

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Table of Contents

## ARCH CAPITAL GROUP LTD. AND SUBSIDIARIES

## CONSOLIDATED STATEMENTS OF INCOME

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

	(Unaudited)	
	Three Months Ended	
	March 31,	
	2015	2014
Revenues		
Net premiums written	\$ 1,066,995	\$ 1,064,990
Change in unearned premiums	(156,731 )	(205,210 )
Net premiums earned	910,264	859,780
Net investment income	78,994	66,994
Net realized gains (losses)	83,348	19,697
Other-than-temporary impairment losses	(7,247 )	(2,971 )
Less investment impairments recognized in other comprehensive income, before taxes	1,448	—
Net impairment losses recognized in earnings	(5,799 )	(2,971 )
Other underwriting income	11,536	1,582
Equity in net income of investment funds accounted for using the equity method	5,889	3,253
Other income (loss)	(1,888 )	(2,104 )
Total revenues	1,082,344	946,231
Expenses		
Losses and loss adjustment expenses	493,716	436,240
Acquisition expenses	163,076	160,342
Other operating expenses	157,882	145,799
Interest expense	12,736	14,404
Net foreign exchange (gains) losses	(66,501 )	6,563
Total expenses	760,909	763,348
Income before income taxes	321,435	182,883
Income tax expense	(12,678 )	(3,738 )
Net income	\$ 308,757	\$ 179,145
Amounts attributable to noncontrolling interests	(25,421 )	3,355
Net income available to Arch	283,336	182,500
Preferred dividends	(5,484 )	(5,484 )
Net income available to Arch common shareholders	\$ 277,852	\$ 177,016
Net income per common share		
Basic	\$ 2.24	\$ 1.34
Diluted	\$ 2.16	\$ 1.30
Weighted average common shares and common share equivalents outstanding		
Basic	124,209,276	131,857,910
Diluted	128,451,054	136,562,717

See Notes to Consolidated Financial Statements

4

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Table of Contents

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

	(Unaudited)	
	Three Months Ended	
	March 31,	
	2015	2014
Comprehensive Income		
Net income	\$308,757	\$179,145
Other comprehensive income (loss), net of deferred income tax		
Unrealized appreciation (decline) in value of available-for-sale investments:		
Unrealized holding gains (losses) arising during period	84,304	71,353
Portion of other-than-temporary impairment losses recognized in other comprehensive income, net of deferred income tax	(1,448	) —
Reclassification of net realized (gains) losses, net of income taxes, included in net income	(30,932	) (21,249 )
Foreign currency translation adjustments	(22,757	) (1,349 )
Comprehensive income	337,924	227,900
Amounts attributable to noncontrolling interests	(25,421	) 3,355
Comprehensive income available to Arch	\$312,503	\$231,255

See Notes to Consolidated Financial Statements

Table of Contents

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

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

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

See Notes to Consolidated Financial Statements

6

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Table of Contents

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

	(Unaudited)	
	Three Months Ended	
	March 31,	
	2015	2014
Operating Activities		
Net income	\$308,757	\$179,145
Adjustments to reconcile net income to net cash provided by operating activities:		
Net realized gains	(87,907	) (22,367
Net impairment losses recognized in earnings	5,799	2,971
Equity in net income or loss of investment funds accounted for using the equity method and other income or loss	(1,970	) 9,559
Share-based compensation	13,238	14,175
Changes in:		
Reserve for losses and loss adjustment expenses, net of unpaid losses and loss adjustment expenses recoverable	54,327	10,326
Unearned premiums, net of prepaid reinsurance premiums	156,731	205,210
Premiums receivable	(192,247	) (242,616
Deferred acquisition costs, net	(36,304	) (41,988
Reinsurance balances payable	(16,022	) 5,428
Other liabilities	(48,856	) 59,285
Other items	(70,085	) 19,041
Net Cash Provided By Operating Activities	85,461	198,169
Investing Activities		
Purchases of fixed maturity investments	(7,030,731	) (7,131,071
Purchases of equity securities	(125,863	) (89,227
Purchases of other investments	(685,497	) (304,454
Proceeds from sales of fixed maturity investments	6,857,459	7,014,281
Proceeds from sales of equity securities	125,906	49,614
Proceeds from sales, redemptions and maturities of other investments	605,263	331,176
Proceeds from redemptions and maturities of fixed maturity investments	272,657	168,484
Net sales (purchases) of short-term investments	66,283	156,262
Change in cash collateral related to securities lending	(5,529	) 4,669
Purchase of business, net of cash acquired	(2,432	) (235,578
Purchases of furniture, equipment and other assets	(32,897	) (5,382
Net Cash Provided By (Used For) Investing Activities	44,619	(41,226
Financing Activities		
Purchases of common shares under share repurchase program	(162,898	) —
Proceeds from common shares issued, net	(412	) 3,021
Change in cash collateral related to securities lending	5,529	(4,669
Third party investment in non-redeemable noncontrolling interests	—	796,903
Third party investment in redeemable noncontrolling interests	—	186,893
Dividends paid to redeemable noncontrolling interests	(4,816	) —
Other	29,779	1,700
Preferred dividends paid	(5,484	) (5,484

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

See Notes to Consolidated Financial Statements

7

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Table of Contents

ARCH CAPITAL GROUP LTD. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)

1. General

Arch Capital Group Ltd. (“ACGL”) is a Bermuda public limited liability company which provides insurance and reinsurance on a worldwide basis through its subsidiaries (together with ACGL, the “Company”). The Company’s consolidated financial statements include the results of Watford Holdings Ltd., the parent of Watford Re Ltd. (see Note 3).

The interim consolidated financial statements have been prepared in conformity with accounting principles generally accepted in the United States of America (“GAAP”). All significant intercompany transactions and balances have been eliminated in consolidation. The preparation of financial statements in conformity with GAAP requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates and assumptions. In the opinion of management, the accompanying unaudited interim consolidated financial statements reflect all adjustments (consisting of normally recurring accruals) necessary for a fair statement of results on an interim basis. The results of any interim period are not necessarily indicative of the results for a full year or any future periods.

Certain information and footnote disclosures normally included in financial statements prepared in accordance with GAAP have been condensed or omitted; however, management believes that the disclosures are adequate to make the information presented not misleading. This report should be read in conjunction with the Company’s Annual Report on Form 10-K for the year ended December 31, 2014 (“2014 Form 10-K”), including the Company’s audited consolidated financial statements and related notes.

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

2. Recent Accounting Pronouncements

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

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

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

Table of Contents

## ARCH CAPITAL GROUP LTD. AND SUBSIDIARIES

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)

## 3. Variable Interest Entity and Noncontrolling Interests

## Variable interest entity

On March 20, 2014, the Company invested \$100.0 million and acquired approximately 11% of Watford Holdings Ltd.'s common equity and a warrant to purchase additional common equity. Watford Holdings Ltd. is the parent of Watford Re Ltd., a multi-line Bermuda reinsurance company (together with Watford Holdings Ltd., "Watford Re"). Watford Re is considered a variable interest entity ("VIE") and the Company concluded that it is the primary beneficiary of Watford Re. As such, the results of Watford Re are included in the Company's consolidated financial statements.

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

Because Watford Re is an independent company, the assets of Watford Re can be used only to settle obligations of Watford Re and Watford Re is solely responsible for its own liabilities and commitments. The Company's financial exposure to Watford Re is limited to its investment in Watford Re's common shares and counterparty credit risk (mitigated by collateral) arising from the reinsurance transactions.

## Non-redeemable noncontrolling interests

The Company accounts for the portion of Watford Re's common equity attributable to third party investors in the shareholders' equity section of its consolidated balance sheets. The noncontrolling ownership in Watford Re's common shares was approximately 89% at March 31, 2015. The portion of Watford Re's income or loss attributable to third party investors is recorded in the consolidated statements of income in 'amounts attributable to noncontrolling interests.' The following table sets forth activity in the non-redeemable noncontrolling interests:

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

## Redeemable noncontrolling interests

The Company accounts for redeemable noncontrolling interests in the mezzanine section of its consolidated balance sheets in accordance with applicable accounting guidance. Such redeemable noncontrolling interests represent the 9,065,200 cumulative redeemable preference shares ("Watford Preference Shares") issued in late March 2014 with a par value of \$0.01 per share and a liquidation preference of \$25.00 per share. Third party investors own 100% of the Watford Preference Shares at March 31, 2015. Preferred dividends, including the accretion of the discount and issuance costs, are included in 'amounts attributable to noncontrolling interests' in the Company's consolidated statements of income.



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

Table of Contents

## ARCH CAPITAL GROUP LTD. AND SUBSIDIARIES

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)

## 4. Earnings Per Common Share

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

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

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Certain stock options were not included in the computation of diluted earnings per share where the exercise price of the stock options exceeded the average market price and would have been anti-dilutive or where, when applying (1) the treasury stock method to in-the-money options, the sum of the proceeds, including unrecognized compensation, exceeded the average market price and would have been anti-dilutive. For the 2015 first quarter and 2014 first quarter, the number of stock options excluded were 703,853 and 759,172, respectively.

Table of Contents

ARCH CAPITAL GROUP LTD. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)

5. Segment Information

The Company classifies its businesses into three underwriting segments — insurance, reinsurance and mortgage — and two other operating segments — ‘other’ and corporate (non-underwriting). The Company determined its reportable segments using the management approach described in accounting guidance regarding disclosures about segments of an enterprise and related information. The accounting policies of the segments are the same as those used for the preparation of the Company’s consolidated financial statements. Intersegment business is allocated to the segment accountable for the underwriting results.

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

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

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

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

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

The ‘other’ segment includes the results of Watford Re (see Note 3). Watford Re has its own management and board of directors that is responsible for the overall profitability of the ‘other’ segment. For the ‘other’ segment, performance is measured based on net income or loss.



Table of Contents

## ARCH CAPITAL GROUP LTD. AND SUBSIDIARIES

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)

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

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

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

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

Table of Contents

## ARCH CAPITAL GROUP LTD. AND SUBSIDIARIES

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)

	Three Months Ended March 31, 2014						
	Insurance	Reinsurance	Mortgage	Sub-Total	Other	Total	
Gross premiums written (1)	\$730,646	\$517,053	\$47,907	\$1,295,136	\$32,194	\$1,295,136	
Premiums ceded	(185,044 )	(73,127 )	(4,639 )	(262,340 )	—	(230,146 )	
Net premiums written	545,602	443,926	43,268	1,032,796	32,194	1,064,990	
Change in unearned premiums	(68,101 )	(102,578 )	(4,503 )	(175,182 )	(30,028 )	(205,210 )	
Net premiums earned	477,501	341,348	38,765	857,614	2,166	859,780	
Other underwriting income	500	316	766	1,582	—	1,582	
Losses and loss adjustment expenses	(286,770 )	(139,636 )	(8,478 )	(434,884 )	(1,356 )	(436,240 )	
Acquisition expenses, net	(76,932 )	(73,433 )	(9,154 )	(159,519 )	(823 )	(160,342 )	
Other operating expenses	(81,144 )	(36,195 )	(13,876 )	(131,215 )	(1,109 )	(132,324 )	
Underwriting income	\$33,155	\$92,400	\$8,023	133,578	(1,122 )	132,456	
Net investment income				66,993	1	66,994	
Net realized gains				19,697	—	19,697	
Net impairment losses recognized in earnings				(2,971 )	—	(2,971 )	
Equity in net income of investment funds accounted for using the equity method				3,253	—	3,253	
Other income (loss)				(2,104 )	—	(2,104 )	
Other expenses				(10,799 )	(2,676 )	(13,475 )	
Interest expense				(14,404 )	—	(14,404 )	
Net foreign exchange losses				(6,656 )	93	(6,563 )	
Income before income taxes				186,587	(3,704 )	182,883	
Income tax expense				(3,738 )	—	(3,738 )	
Net income				182,849	(3,704 )	179,145	
Dividends attributable to redeemable noncontrolling interests				—	(52 )	(52 )	
Amounts attributable to noncontrolling interests				—	3,407	3,407	
Net income available to Arch Preferred dividends				182,849	(349 )	182,500	
Net income available to Arch common shareholders				(5,484 )	—	(5,484 )	
				\$177,365	\$(349 )	\$177,016	
Underwriting Ratios							
Loss ratio	60.1	% 40.9	% 21.9	% 50.7	% 62.6	% 50.7	%
Acquisition expense ratio	16.1	% 21.5	% 23.6	% 18.6	% 38.0	% 18.6	%
Other operating expense ratio	17.0	% 10.6	% 35.8	% 15.3	% 51.2	% 15.4	%
Combined ratio	93.2	% 73.0	% 81.3	% 84.6	% 151.8	% 84.7	%
Goodwill and intangible assets	\$20,184	\$5,803	\$94,888	\$120,875	\$—	\$120,875	

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

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



Table of Contents

## ARCH CAPITAL GROUP LTD. AND SUBSIDIARIES

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)

## 6. Investment Information

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

## Available For Sale Investments

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

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

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

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

(2) Represents the total other-than-temporary impairments (“OTTI”) recognized in accumulated other comprehensive income (“AOCI”). It does not include the change in fair value subsequent to the impairment measurement date. At March 31, 2015, the net unrealized loss related to securities for which a non-credit OTTI was recognized in AOCI was \$0.3 million, compared to a net unrealized gain of \$0.9 million at December 31, 2014.

Table of Contents

## ARCH CAPITAL GROUP LTD. AND SUBSIDIARIES

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)

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

	Less than 12 Months		12 Months or More		Total	
	Estimated Fair Value	Gross Unrealized Losses	Estimated Fair Value	Gross Unrealized Losses	Estimated Fair Value	Gross Unrealized Losses
March 31, 2015						
Fixed maturities and fixed maturities pledged under securities lending agreements (1):						
Corporate bonds	\$810,064	\$(40,337)	\$60,249	\$(6,645)	\$870,313	\$(46,982)
Mortgage backed securities	142,833	(1,333)	29,939	(732)	172,772	(2,065)
Municipal bonds	241,211	(1,494)	13,573	(519)	254,784	(2,013)
Commercial mortgage backed securities	194,085	(2,375)	30,774	(122)	224,859	(2,497)
U.S. government and government agencies	148,004	(776)	—	—	148,004	(776)
Non-U.S. government securities	376,737	(43,321)	38,091	(9,364)	414,828	(52,685)
Asset backed securities	331,543	(2,072)	157,748	(1,491)	489,291	(3,563)
Total	2,244,477	(91,708)	330,374	(18,873)	2,574,851	(110,581)
Equity securities	226,711	(12,467)	—	—	226,711	(12,467)
Other investments	128,867	(574)	—	—	128,867	(574)
Short-term investments	55,615	(4,151)	—	—	55,615	(4,151)
Total	\$2,655,670	\$(108,900)	\$330,374	\$(18,873)	\$2,986,044	\$(127,773)
December 31, 2014						
Fixed maturities and fixed maturities pledged under securities lending agreements (1):						
Corporate bonds	\$1,309,637	\$(32,903)	\$148,963	\$(6,071)	\$1,458,600	\$(38,974)
Mortgage backed securities	293,624	(1,476)	59,107	(2,366)	352,731	(3,842)
Municipal bonds	210,614					