ARCH CAPITAL GROUP LTD.
Form 10-Q
November 07, 2014
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UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549

FORM 10-Q

(Mark One)

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

For the period ended September 30, 2014

Or

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

Commission file number: 001-26456

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

Bermuda
(State or other jurisdiction of incorporation or organization)

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

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

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

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

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

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

Large accelerated filer x	Accelerated filer o
Non-accelerated filer o	Smaller reporting company o

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

The number of the registrant's common shares (par value, $0.0033 per share) outstanding as of October 31, 2014 was 129,110,352.

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Report of Independent Registered Public Accounting Firm

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

We have reviewed the accompanying condensed consolidated balance sheet of Arch Capital Group Ltd. and its subsidiaries (the “Company”) as of September 30, 2014, and the related condensed consolidated statements of income and comprehensive income for the three-month and nine-month periods ended September 30, 2014 and September 30, 2013, and the condensed consolidated statements of changes in shareholders’ equity and cash flows for the nine-month periods ended September 30, 2014 and September 30, 2013. These interim financial statements are the responsibility of the Company’s management.

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

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

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

/s/ PricewaterhouseCoopers LLP

New York, New York
November 7, 2014

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

	(Unaudited) September 30, 2014	December 31, 2013
Assets		
Investments:		
Fixed maturities available for sale, at fair value (amortized cost: $10,699,615 and $9,564,634)	$10,733,382	$9,571,776
Short-term investments available for sale, at fair value (amortized cost: $754,641 and $1,477,584)	748,659	1,478,367
Investment of funds received under securities lending, at fair value (amortized cost: $100,680 and $97,943)	104,252	100,584
Equity securities available for sale, at fair value (cost: $513,196 and $433,275)	582,075	496,824
Other investments available for sale, at fair value (cost: $398,719 and $488,687)	431,833	498,310
Investments accounted for using the fair value option	2,202,995	1,221,534
Investments accounted for using the equity method	307,252	244,339
Total investments	15,110,448	13,611,734
Cash	663,726	434,057
Accrued investment income	65,042	66,848
Investment in joint venture (cost: $100,000)	97,313	104,856
Fixed maturities and short-term investments pledged under securities lending, at fair value	107,547	105,081
Premiums receivable	1,027,204	753,924
Reinsurance recoverable on unpaid and paid losses and loss adjustment expenses	1,814,190	1,804,330
Contractholder receivables	1,286,799	1,064,246
Prepaid reinsurance premiums	404,661	328,343
Deferred acquisition costs, net	409,174	342,314
Receivable for securities sold	672,259	50,555
Goodwill and intangible assets	111,528	27,319
Other assets	840,794	872,487
Total assets	$22,610,685	$19,566,094
Liabilities		
Reserve for losses and loss adjustment expenses	$8,958,734	$8,824,696
Unearned premiums	2,303,247	1,896,365
Reinsurance balances payable	244,379	196,167
Contractholder payables	1,286,799	1,064,246
Deposit accounting liabilities	349,850	421,297
Senior notes	800,000	800,000
Revolving credit agreement borrowings	100,000	100,000
Securities lending payable	110,736	107,999
Payable for securities purchased	740,953	51,318
Other liabilities	633,502	456,510
Total liabilities	15,528,200	13,918,598
Commitments and Contingencies		

Redeemable noncontrolling interests (1)	219,419	—
Shareholders' Equity		
Non-cumulative preferred shares	325,000	325,000
Common shares ($0.0033 par, shares issued: 171,380,760 and 169,560,591)	571	565
Additional paid-in capital	366,408	299,517
Retained earnings	6,644,892	6,042,154
Accumulated other comprehensive income, net of deferred income tax	102,186	74,964
Common shares held in treasury, at cost (shares: 40,680,141 and 35,885,707)	(1,358,011)	(1,094,704)
Total shareholders' equity available to Arch	6,081,046	5,647,496
Non-redeemable noncontrolling interests (1)	782,020	—
Total shareholders' equity	6,863,066	5,647,496
Total liabilities, noncontrolling interests and shareholders' equity	$22,610,685	$19,566,094

(1) See Note 4.

See Notes to Consolidated Financial Statements

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

	(Unaudited) Three Months Ended September 30,		(Unaudited) Nine Months Ended September 30,	
	2014	2013	2014	2013
Revenues				
Net premiums written	$959,539	$839,135	$2,996,457	$2,602,446
Change in unearned premiums	(55,888)	(44,135)	(325,874)	(295,860)
Net premiums earned	903,651	795,000	2,670,583	2,306,586
Net investment income	80,105	66,083	220,089	200,124
Net realized gains (losses)	18,515	(6,022)	92,356	64,970
Other-than-temporary impairment losses	(8,593)	(901)	(26,313)	(3,873)
Less investment impairments recognized in other comprehensive income, before taxes	—	173	—	175
Net impairment losses recognized in earnings	(8,593)	(728)	(26,313)	(3,698)
Other underwriting income	1,702	526	5,317	1,966
Equity in net income of investment funds accounted for using the equity method	4,966	5,665	17,459	30,429
Other income (loss)	(7,815)	624	(5,069)	2,702
Total revenues	992,531	861,148	2,974,422	2,603,079
Expenses				
Losses and loss adjustment expenses	501,673	427,045	1,423,431	1,245,101
Acquisition expenses	163,547	147,313	482,047	406,582
Other operating expenses	149,480	118,070	451,629	365,661
Interest expense	4,152	5,937	32,890	17,687
Net foreign exchange (gains) losses	(56,031)	40,562	(47,174)	2,487
Total expenses	762,821	738,927	2,342,823	2,037,518
Income before income taxes	229,710	122,221	631,599	565,561
Income tax expense	(6,446)	(7,396)	(17,473)	(17,320)
Net income	$223,264	$114,825	$614,126	$548,241
Amounts attributable to noncontrolling interests (1)	5,411	—	5,065	—
Net income available to Arch	228,675	114,825	619,191	548,241
Preferred dividends	(5,484)	(5,484)	(16,453)	(16,453)
Net income available to Arch common shareholders	$223,191	$109,341	$602,738	$531,788
Net income per common share				
Basic	$1.69	$0.83	$4.56	$4.05
Diluted	$1.64	$0.80	$4.42	$3.92
Weighted average common shares and common share equivalents outstanding				
Basic	131,945,962	131,495,296	132,151,824	131,262,309
Diluted	135,876,605	136,034,413	136,354,172	135,680,829

(1) See Note 4.

See Notes to Consolidated Financial Statements

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

	(Unaudited) Three Months Ended September 30,		(Unaudited) Nine Months Ended September 30,	
	2014	2013	2014	2013
Comprehensive Income				
Net income	$223,264	$114,825	$614,126	$548,241
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	(90,619)	41,226	89,162	(208,865)
Portion of other-than-temporary impairment losses recognized in other comprehensive income, net of deferred income tax	—	(173)	—	(175)
Reclassification of net realized (gains) losses, net of income taxes, included in net income	(17,483)	20,701	(47,017)	(31,916)
Foreign currency translation adjustments	(23,595)	29,523	(14,923)	(4,106)
Comprehensive income	91,567	206,102	641,348	303,179
Amounts attributable to noncontrolling interests (1)	5,411	—	5,065	—
Comprehensive income available to Arch	$96,978	$206,102	$646,413	$303,179

(1) See Note 4.

See Notes to Consolidated Financial Statements

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

	(Unaudited) Nine Months Ended September 30,	
	2014	2013
Non-cumulative preferred shares		
Balance at beginning and end of period	$325,000	$325,000
Common shares		
Balance at beginning of year	565	561
Common shares issued, net	6	4
Balance at end of period	571	565
Additional paid-in capital		
Balance at beginning of year	299,517	227,778
Common shares issued, net	6,401	5,583
Exercise of stock options	14,891	7,438
Amortization of share-based compensation	45,118	40,305
Other	481	2,345
Balance at end of period	366,408	283,449
Retained earnings		
Balance at beginning of year	6,042,154	5,354,361
Net income	614,126	548,241
Amounts attributable to noncontrolling interests (1)	5,065	—
Preferred share dividends	(16,453)	(16,453)
Balance at end of period	6,644,892	5,886,149
Accumulated other comprehensive income		
Balance at beginning of year	74,964	287,017
Unrealized appreciation in value of available-for-sale investments, net of deferred income tax:		
Balance at beginning of year	80,692	289,956
Unrealized holding gains (losses) arising during period, net of reclassification adjustment	42,145	(240,781)
Portion of other-than-temporary impairment losses recognized in other comprehensive income, net of deferred income tax	—	(175)
Balance at end of period	122,837	49,000
Foreign currency translation adjustments:		
Balance at beginning of year	(5,728)	(2,939)
Foreign currency translation adjustments	(14,923)	(4,106)
Balance at end of period	(20,651)	(7,045)
Balance at end of period	102,186	41,955
Common shares held in treasury, at cost		
Balance at beginning of year	(1,094,704)	(1,025,839)
Shares repurchased for treasury	(263,307)	(67,994)

Balance at end of period	(1,358,011)	(1,093,833)
Total shareholders' equity available to Arch	6,081,046	5,443,285
Non-redeemable noncontrolling interests (1)	782,020	—
Total shareholders' equity	$6,863,066	$5,443,285

(1) See Note 4.

See Notes to Consolidated Financial Statements

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

	(Unaudited) Nine Months Ended September 30,	
	2014	2013
Operating Activities		
Net income	$614,126	$548,241
Adjustments to reconcile net income to net cash provided by operating activities:		
Net realized gains	(113,033)	(66,957)
Net impairment losses recognized in earnings	26,313	3,698
Equity in net income or loss of investment funds accounted for using the equity method and other income or loss	3,784	35,634
Share-based compensation	45,118	40,305
Changes in:		
Reserve for losses and loss adjustment expenses, net of unpaid losses and loss adjustment expenses recoverable	94,255	(24,305)
Unearned premiums, net of prepaid reinsurance premiums	325,874	295,860
Premiums receivable	(279,766)	(160,091)
Deferred acquisition costs, net	(72,120)	(73,793)
Reinsurance balances payable	49,621	2,573
Other liabilities	117,889	(15,893)
Other items	(12,402)	41,776
Net Cash Provided By Operating Activities	799,659	627,048
Investing Activities		
Purchases of:		
Fixed maturity investments	(22,030,862)	(12,436,587)
Equity securities	(366,578)	(438,255)
Other investments	(1,596,691)	(992,935)
Proceeds from the sales of:		
Fixed maturity investments	20,284,869	11,877,419
Equity securities	305,034	373,000
Other investments	1,030,901	813,596
Proceeds from redemptions and maturities of fixed maturity investments	636,729	595,503
Net sales (purchases) of short-term investments	678,388	(268,968)
Change in investment of securities lending collateral	(2,737)	2,508
Purchase of business, net of cash acquired (1)	(235,578)	—
Purchases of furniture, equipment and other assets	(14,575)	(10,953)
Net Cash Used For Investing Activities	(1,311,100)	(485,672)
Financing Activities		
Purchases of common shares under share repurchase program	(251,919)	(57,796)
Proceeds from common shares issued, net	3,248	(425)
Change in securities lending collateral	2,737	(2,508)
Third party investment in non-redeemable noncontrolling interests (2)	796,903	—
Third party investment in redeemable noncontrolling interests (2)	219,233	—
Dividends paid to redeemable noncontrolling interests (2)	(9,632)	—

Other	6,559	5,679
Preferred dividends paid	(16,453)	(16,453)
Net Cash Provided By (Used For) Financing Activities	750,676	(71,503)
Effects of exchange rate changes on foreign currency cash	(9,566)	(4,773)
Increase in cash	229,669	65,100
Cash beginning of year	434,057	371,041
Cash end of period	$663,726	$436,141

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

See Notes to Consolidated Financial Statements

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").

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

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

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

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

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

2. Business Acquired

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

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

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

At closing, the Company paid aggregate consideration of $160.6 million (80% of the actual closing date book value of the CMG Entities) under the SPA and $84.6 million under the APA. Additionally, the SPA contains provisions for contingent consideration payments, subject to an overall maximum payment of 150% of closing book value of the pre-closing portfolio of the CMG Entities as re-calculated over an earn-out period and payable at the third, fifth and sixth anniversaries after closing (subject to a one time extension period of one to three years at the sellers' discretion). The maximum amount of contingent consideration payments is $136.9 million. To the extent that the adjusted book value of the CMG Entities drops below the cumulative amount paid by the Company, no additional payments would be due. To determine the fair value of the contingent consideration liability, the Company estimated future payments using a weighted average cost of capital approach at a rate of return of 15% which reflects the industry-weighted average rate of return on debt and equity as required by market participants. The fair value of the contingent consideration liability was $41.8 million at closing. The contingent consideration liability, which is included in 'other liabilities' in the consolidated balance sheets, is remeasured at fair value at each balance sheet date ($58.7 million at September 30, 2014) until the contingency is resolved with changes in fair value recognized in 'net realized gains (losses).'

The following table summarizes the fair value of net assets acquired and allocation of purchase price, measured as of the acquisition date:

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

Net assets acquired (b)	$273,067
Goodwill (a)-(b)	$13,852

From the acquisition date to September 30, 2014, the Company recorded amortization expense of $15.0 million related to net intangible assets acquired. The Company recognized goodwill of $13.9 million that is primarily attributed to PMI's assembled workforce, access to the mortgage insurance market and additional synergies to be realized in the future. Under U.S. tax principles, which differentiate between taxable and non-taxable business combinations, the Company estimates that $48.0 million of goodwill is expected to be deductible for tax purposes.

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

3. Significant Accounting Policies

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

(b) Premium Revenues and Related Expenses

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

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

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

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

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

The Company also writes certain reinsurance business that is intended to provide insurers with risk management solutions that complement traditional reinsurance. Under these contracts, the Company assumes a measured amount of insurance risk in exchange for an anticipated margin, which is typically lower than on traditional reinsurance contracts. The terms and conditions of these contracts may include additional or return premiums based on loss experience, loss corridors, sublimits and caps. Examples of such business include aggregate stop-loss coverages, financial quota share coverages and multi- year retrospectively rated excess of loss coverages. If these contracts are deemed to transfer risk, they are accounted for as reinsurance.

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

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

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

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

(i) Reserves for Losses and Loss Adjustment Expenses

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

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

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

(p) 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. The Company is currently assessing the impact the implementation of this standard will have on its consolidated financial statements.

(q) Goodwill and Intangible Assets

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

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

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

4. Variable Interest Entity and Noncontrolling Interests

Variable interest entity

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

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

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

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

Non-redeemable noncontrolling interests

The Company accounts for the portion of Watford's common equity attributable to third party investors in the shareholders' equity section of its consolidated balance sheets. The noncontrolling ownership in Watford's common shares was approximately 89% at September 30, 2014. The portion of Watford'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 September 30, 2014	Nine Months Ended September 30, 2014
Balance, beginning of period	$792,340	$—
Sale of shares to noncontrolling interests	—	796,903
Amounts attributable to noncontrolling interests	(10,320)	(14,883)
Balance, end of period	$782,020	$782,020

Redeemable noncontrolling interests

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

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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, 2014	Three Months Ended September 30, 2013	Nine Months Ended September 30, 2014	Nine Months Ended September 30, 2013
Numerator:				
Net income	$223,264	$114,825	$614,126	$548,241
Amounts attributable to noncontrolling interests	5,411	—	5,065	—
Net income available to Arch	228,675	114,825	619,191	548,241
Preferred dividends	(5,484)	(5,484)	(16,453)	(16,453)
Net income available to Arch common shareholders	$223,191	$109,341	$602,738	$531,788
Denominator:				
Weighted average common shares outstanding — basic	131,945,962	131,495,296	132,151,824	131,262,309
Effect of dilutive common share equivalents:				
Nonvested restricted shares	1,156,790	1,124,644	1,134,481	1,094,327
Stock options (1)	2,773,853	3,414,473	3,067,867	3,324,193
Weighted average common shares and common share equivalents outstanding — diluted	135,876,605	136,034,413	136,354,172	135,680,829
Earnings per common share:				
Basic	$1.69	$0.83	$4.56	$4.05
Diluted	$1.64	$0.80	$4.42	$3.92

(1) Certain stock options were not included in the computation of diluted earnings per share where the exercise price of the stock options exceeded the average market price and would have been anti-dilutive or where, when applying the treasury stock method to in-the-money options, the sum of the proceeds, including unrecognized compensation, exceeded the average market price and would have been anti-dilutive. For the 2014 third quarter and 2013 third quarter, the number of stock options excluded were 1,355,087 and 387,249, respectively. For the nine months ended September 30, 2014 and 2013, the number of stock options excluded were 1,378,249 and 1,735,995, respectively.

6. Segment Information

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

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

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

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

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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, 2014					
	Insurance	Reinsurance	Mortgage	Sub-Total	Other	Total
Gross premiums written (1)	$726,683	$345,747	$66,389	$1,138,392	$103,483	$1,159,907
Premiums ceded	(187,689)	(83,502)	(7,904)	(278,668)	(3,668)	(200,368)
Net premiums written	538,994	262,245	58,485	859,724	99,815	959,539
Change in unearned premiums	(19,607)	34,303	(5,539)	9,157	(65,045)	(55,888)
Net premiums earned	519,387	296,548	52,946	868,881	34,770	903,651
Other underwriting income	499	215	988	1,702	—	1,702
Losses and loss adjustment expenses	(338,319)	(123,784)	(15,987)	(478,090)	(23,583)	(501,673)
Acquisition expenses, net	(81,775)	(60,205)	(11,958)	(153,938)	(9,609)	(163,547)
Other operating expenses	(83,138)	(36,337)	(17,913)	(137,388)	(1,658)	(139,046)
Underwriting income (loss)	$16,654	$76,437	$8,076	101,167	(80)	101,087
Net investment income				72,239	7,866	80,105
Net realized gains (losses)				31,411	(12,896)	18,515
Net impairment losses recognized in earnings				(8,593)	—	(8,593)
Equity in net income of investment funds accounted for using the equity method				4,966	—	4,966
Other income (loss)				(7,815)	—	(7,815)
Other expenses				(10,434)	—	(10,434)
Interest expense				(4,152)	—	(4,152)
Net foreign exchange gains (losses)				57,611	(1,580)	56,031
Income before income taxes				236,400	(6,690)	229,710
Income tax expense				(6,446)	—	(6,446)
Net income				229,954	(6,690)	223,264
Dividends attributable to redeemable noncontrolling interests				—	(4,909)	(4,909)
Amounts attributable to noncontrolling interests				—	10,320	10,320
Net income available to Arch				229,954	(1,279)	228,675
Preferred dividends				(5,484)	—	(5,484)
Net income available to Arch common shareholders				$224,470	$(1,279)	$223,191
Underwriting Ratios						
Loss ratio	65.1 %	41.7 %	30.2 %	55.0 %	67.8 %	55.5 %
Acquisition expense ratio	15.7 %	20.3 %	22.6 %	17.7 %	27.6 %	18.1 %

Other operating expense ratio	16.0 %	12.3 %	33.8 %	15.8 %	4.8 %	15.4 %
Combined ratio	96.8 %	74.3 %	86.6 %	88.5 %	100.2 %	89.0 %
Goodwill and intangible assets	$24,024	$3,939	$83,565	$111,528	$—	$111,528
Total investable assets				$14,584,727	$1,124,048	$15,708,775
Total assets				21,207,667	1,403,018	22,610,685
Total liabilities				15,223,488	304,712	15,528,200

(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.

ARCH CAPITAL GROUP LTD. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)

	Three Months Ended September 30, 2013					
	Insurance	Reinsurance	Mortgage	Sub-Total	Other	Total
Gross premiums written (1)	$682,839	$330,458	$24,633	$1,036,987	$—	$1,036,987
Premiums ceded	(180,868)	(17,927)	—	(197,852)	—	(197,852)
Net premiums written	501,971	312,531	24,633	839,135	—	839,135
Change in unearned premiums	(22,842)	(9,433)	(11,860)	(44,135)	—	(44,135)
Net premiums earned	479,129	303,098	12,773	795,000	—	795,000
Other underwriting income	545	(19)	—	526	—	526
Losses and loss adjustment expenses	(305,921)	(119,107)	(2,017)	(427,045)	—	(427,045)
Acquisition expenses, net	(82,799)	(61,063)	(3,451)	(147,313)	—	(147,313)
Other operating expenses	(75,734)	(32,108)	(2,334)	(110,176)	—	(110,176)
Underwriting income	$15,220	$90,801	$4,971	110,992	—	110,992
Net investment income				66,083	—	66,083
Net realized losses				(6,022)	—	(6,022)
Net impairment losses recognized in earnings				(728)	—	(728)
Equity in net income of investment funds accounted for using the equity method				5,665	—	5,665
Other income (loss)				624	—	624
Other expenses				(7,894)	—	(7,894)
Interest expense				(5,937)	—	(5,937)
Net foreign exchange losses				(40,562)	—	(40,562)
Income before income taxes				122,221	—	122,221
Income tax expense				(7,396)	—	(7,396)
Net income				114,825	—	114,825
Dividends attributable to redeemable noncontrolling interests				—	—	—
Amounts attributable to noncontrolling interests				—	—	—
Net income available to Arch				114,825	—	114,825
Preferred dividends				(5,484)	—	(5,484)
Net income available to Arch common shareholders				$109,341	$—	$109,341
Underwriting Ratios						
Loss ratio	63.8%	39.3%	15.8%	53.7%	—%	53.7%
Acquisition expense ratio	17.3%	20.1%	27.0%	18.5%	—%	18.5%
Other operating expense ratio	15.8%	10.6%	18.3%	13.9%	—%	13.9%
Combined ratio	96.9%	70.0%	61.1%	86.1%	—%	86.1%
Goodwill and intangible assets	$20,653	$8,307	$—	$28,960	$—	$28,960

Total investable assets	$13,282,560	$—	$13,282,560
Total assets	18,930,823	—	18,930,823
Total liabilities	13,487,538	—	13,487,538

(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.

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)

Nine Months Ended September 30, 2014	Insurance	Reinsurance	Mortgage	Sub-Total	Other	Total
Gross premiums written (1)	$2,309,560	$1,212,641	$169,772	$3,690,462	$190,239	$3,726,804
Premiums ceded	(646,082)	(215,623)	(17,622)	(877,816)	(6,428)	(730,347)
Net premiums written	1,663,478	997,018	152,150	2,812,646	183,811	2,996,457
Change in unearned premiums	(158,878)	(23,495)	(9,606)	(191,979)	(133,895)	(325,874)
Net premiums earned	1,504,600	973,523	142,544	2,620,667	49,916	2,670,583
Other underwriting income	1,513	834	2,970	5,317	—	5,317
Losses and loss adjustment expenses	(936,615)	(413,745)	(39,938)	(1,390,298)	(33,133)	(1,423,431)
Acquisition expenses, net	(235,156)	(199,673)	(32,593)	(467,422)	(14,625)	(482,047)
Other operating expenses	(250,111)	(110,198)	(48,077)	(408,386)	(4,402)	(412,788)
Underwriting income (loss)	$84,231	$250,741	$24,906	359,878	(2,244)	357,634
Net investment income				211,690	8,399	220,089
Net realized gains (losses)				102,074	(9,718)	92,356
Net impairment losses recognized in earnings				(26,313)	—	(26,313)
Equity in net income of investment funds accounted for using the equity method				17,459	—	17,459
Other income (loss)				(5,069)	—	(5,069)
Other expenses				(36,512)	(2,329)	(38,841)
Interest expense				(32,890)	—	(32,890)
Net foreign exchange gains (losses)				48,191	(1,017)	47,174
Income before income taxes				638,508	(6,909)	631,599
Income tax expense				(17,473)	—	(17,473)
Net income (loss)				621,035	(6,909)	614,126
Dividends attributable to redeemable noncontrolling interests				—	(9,818)	(9,818)
Amounts attributable to noncontrolling interests				—	14,883	14,883
Net income available to Arch				621,035	(1,844)	619,191
Preferred dividends				(16,453)	—	(16,453)
Net income available to Arch common shareholders				$604,582	$(1,844)	$602,738
Underwriting Ratios						
Loss ratio	62.3%	42.5%	28.0%	53.1%	66.4%	53.3%
Acquisition expense ratio	15.6%	20.5%	22.9%	17.8%	29.3%	18.1%
Other operating expense ratio	16.6%	11.3%	33.7%	15.6%	8.8%	15.5%
Combined ratio	94.5%	74.3%	84.6%	86.5%	104.5%	86.9%

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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.

ARCH CAPITAL GROUP LTD. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)

	Nine Months Ended September 30, 2013					
	Insurance	Reinsurance	Mortgage	Sub-Total	Other	Total
Gross premiums written (1)	$2,075,560	$1,099,803	$69,135	$3,241,424	$—	$3,241,424
Premiums ceded	(567,471)	(74,581)	—	(638,978)	—	(638,978)
Net premiums written	1,508,089	1,025,222	69,135	2,602,446	—	2,602,446
Change in unearned premiums	(125,339)	(138,479)	(32,042)	(295,860)	—	(295,860)
Net premiums earned	1,382,750	886,743	37,093	2,306,586	—	2,306,586
Other underwriting income	1,599	367	—	1,966	—	1,966
Losses and loss adjustment expenses	(880,580)	(358,247)	(6,274)	(1,245,101)	—	(1,245,101)
Acquisition expenses, net	(227,806)	(167,497)	(11,279)	(406,582)	—	(406,582)
Other operating expenses	(232,216)	(96,207)	(5,027)	(333,450)	—	(333,450)
Underwriting income	$43,747	$265,159	$14,513	323,419	—	323,419
Net investment income				200,124	—	200,124
Net realized gains				64,970	—	64,970
Net impairment losses recognized in earnings				(3,698)	—	(3,698)
Equity in net income of investment funds accounted for using the equity method				30,429	—	30,429
Other income (loss)				2,702	—	2,702
Other expenses				(32,211)	—	(32,211)
Interest expense				(17,687)	—	(17,687)
Net foreign exchange losses				(2,487)	—	(2,487)
Income before income taxes				565,561	—	565,561
Income tax expense				(17,320)	—	(17,320)
Net income				548,241	—	548,241
Dividends attributable to redeemable noncontrolling interests				—	—	—
Amounts attributable to noncontrolling interests				—	—	—
Net income available to Arch				548,241	—	548,241
Preferred dividends				(16,453)	—	(16,453)
Net income available to Arch common shareholders				$531,788	$—	$531,788
Underwriting Ratios						
Loss ratio	63.7%	40.4%	16.9%	54.0%	—%	54.0%
Acquisition expense ratio	16.5%	18.9%	30.4%	17.6%	—%	17.6%
Other operating expense ratio	16.8%	10.8%	13.6%	14.5%	—%	14.5%
Combined ratio	97.0%	70.1%	60.9%	86.1%	—%	86.1%

(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.

7. Investment Information

At September 30, 2014, total investable assets of $15.71 billion included $14.58 billion managed by the Company and $1.12 billion attributable to Watford.

Available For Sale Investments

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

	Fair Value	Gross Unrealized Gains	Gross Unrealized Losses	Cost or Amortized Cost	OTTI Unrealized Losses (2)
September 30, 2014					
Fixed maturities and fixed maturities pledged under securities lending agreements (1):					
Corporate bonds	$3,070,353	$29,747	$(30,089)	$3,070,695	$—
Mortgage backed securities	966,848	18,567	(8,349)	956,630	(3,600)
Municipal bonds	1,293,455	31,860	(971)	1,262,566	—
Commercial mortgage backed securities	1,232,092	9,355	(5,976)	1,228,713	—
U.S. government and government agencies	1,551,583	6,433	(2,533)	1,547,683	—
Non-U.S. government securities	1,001,947	11,808	(27,117)	1,017,256	—
Asset backed securities	1,724,651	6,707	(7,175)	1,725,119	(22)
Total	10,840,929	114,477	(82,210)	10,808,662	(3,622)
Equity securities	582,075	78,988	(10,109)	513,196	—
Other investments	431,833	33,114	—	398,719	—
Short-term investments	748,659	407	(6,387)	754,639	—
Total	$12,603,496	$226,986	$(98,706)	$12,475,216	$(3,622)
December 31, 2013					
Fixed maturities and fixed maturities pledged under securities lending agreements (1):					
Corporate bonds	$2,267,263	$35,289	$(35,537)	$2,267,511	$(16)
Mortgage backed securities	1,133,095	16,270	(22,209)	1,139,034	(9,269)
Municipal bonds	1,481,738	29,378	(9,730)	1,462,090	(17)
Commercial mortgage backed securities	1,074,497	13,972	(15,224)	1,075,749	(199)
U.S. government and government agencies	1,301,809	3,779	(11,242)	1,309,272	(19)
Non-U.S. government securities	1,085,861	14,729	(19,363)	1,090,495	—
Asset backed securities	1,332,594	20,033	(13,795)	1,326,356	(3,422)
Total	9,676,857	133,450	(127,100)	9,670,507	(12,942)
Equity securities	496,824	69,487	(5,938)	433,275	—
Other investments	498,310	28,082	(18,459)	488,687	—

Short-term investments	1,478,367	1,654	(871)	1,477,584	—
Total	$12,150,358	$232,673	$(152,368)	$12,070,053	$(12,942)

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

(2) Represents the total other-than-temporary impairments ("OTTI") recognized in accumulated other comprehensive income ("AOCI"). It does not include the change in fair value subsequent to the impairment measurement date. At September 30, 2014, the net unrealized gain related to securities for which a non-credit OTTI was recognized in AOCI was $2.1 million, compared to a net unrealized gain of $6.0 million at December 31, 2013.

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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, 2014						
Fixed maturities and fixed maturities pledged under securities lending agreements (1):						
Corporate bonds	$1,549,643	$(22,058)	$193,803	$(8,031)	$1,743,446	$(30,089)
Mortgage backed securities	360,510	(2,809)	124,796	(5,540)	485,306	(8,349)
Municipal bonds	108,444	(470)	21,390	(501)	129,834	(971)
Commercial mortgage backed securities	508,131	(2,769)	94,948	(3,207)	603,079	(5,976)
U.S. government and government agencies	576,459	(2,385)	3,430	(148)	579,889	(2,533)
Non-U.S. government securities	538,957	(22,925)	49,200	(4,192)	588,157	(27,117)
Asset backed securities	802,765	(3,253)	222,099	(3,922)	1,024,864	(7,175)
Total	4,444,909	(56,669)	709,666	(25,541)	5,154,575	(82,210)
Equity securities	187,003	(10,087)	269	(22)	187,272	(10,109)
Other investments	—	—	—	—	—	—
Short-term investments	141,056	(6,387)	—	—	141,056	(6,387)
Total	$4,772,968	$(73,143)	$709,935	$(25,563)	$5,482,903	$(98,706)
December 31, 2013						
Fixed maturities and fixed maturities pledged under securities lending agreements (1):						
Corporate bonds	$1,183,625	$(32,837)	$46,673	$(2,700)	$1,230,298	$(35,537)
Mortgage backed securities	778,693	(20,253)	43,634	(1,956)	822,327	(22,209)
Municipal bonds	589,009	(9,422)	6,092	(308)	595,101	(9,730)
Commercial mortgage backed securities	677,617	(15,110)	1,612	(114)	679,229	(15,224)
U.S. government and government agencies	1,144,809	(11,242)	—	—	1,144,809	(11,242)
Non-U.S. government securities	821,506	(15,776)	24,334	(3,587)	845,840	(19,363)
Asset backed securities	692,362	(10,431)	88,629	(3,364)	780,991	(13,795)
Total	5,887,621	(115,071)	210,974	(12,029)	6,098,595	(127,100)
Equity securities	76,563	(5,938)	—	—	76,563	(5,938)
Other investments	165,891	(15,775)	47,316	(2,684)	213,207	(18,459)

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

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

At September 30, 2014, on a lot level basis, approximately 2,090 security lots out of a total of approximately 4,920 security lots were in an unrealized loss position and the largest single unrealized loss from a single lot in the Company's fixed maturity portfolio was $2.9 million. At December 31, 2013, on a lot level basis, approximately 2,080 security lots out of a total of approximately 4,400 security lots were in an unrealized loss position and the largest single unrealized loss from a single lot in the Company's fixed maturity portfolio was $3.5 million.

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.

	September 30, 2014		December 31, 2013	
Maturity	Fair Value	Amortized Cost	Fair Value	Amortized Cost
Due in one year or less	$253,946	$250,917	$235,330	$232,652
Due after one year through five years	4,184,904	4,178,652	3,738,500	3,718,920
Due after five years through 10 years	2,213,584	2,207,108	1,966,536	1,979,510
Due after 10 years	264,904	261,523	196,305	198,286
	6,917,338	6,898,200	6,136,671	6,129,368
Mortgage backed securities	966,848	956,630	1,133,095	1,139,034
Commercial mortgage backed securities	1,232,092	1,228,713	1,074,497	1,075,749
Asset backed securities	1,724,651	1,725,119	1,332,594	1,326,356
Total	$10,840,929	$10,808,662	$9,676,857	$9,670,507

Securities Lending Agreements

The Company operates a securities lending program under which certain of its fixed income portfolio securities are loaned to third parties, primarily major brokerage firms, for short periods of time through a lending agent. The fair value and amortized cost of fixed maturities and short-term investments pledged under securities lending agreements were $107.5 million and $109.0 million, respectively, at September 30, 2014, compared to $105.1 million and $105.9 million, respectively, at December 31, 2013. The fair value of the portfolio of collateral backing the Company’s securities lending program was $104.3 million at September 30, 2014, compared to $100.6 million at December 31, 2013. Such amounts included approximately $5.7 million of sub-prime securities at September 30, 2014, compared to $6.3 million at December 31, 2013. The Company maintains legal control over the securities it lends, retains the earnings and cash flows associated with the loaned securities and receives a fee from the borrower for the temporary use of the securities. An indemnification agreement with the lending agent protects the Company in the event a borrower becomes insolvent or fails to return any of the securities on loan to the Company.

Other Investments

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

	September 30, 2014	December 31, 2013
Available for sale:		
Asian and emerging markets	$ 275,191	$ 331,984
Investment grade fixed income	156,642	159,115
Other	—	7,211
Total available for sale	431,833	498,310
Fair value option:		
Term loan investments (par value: $1,013,196 and $494,502)	1,001,771	512,076
Asian and emerging markets	25,249	14,054
Investment grade fixed income	76,606	75,062
Other (1)	327,899	172,088

Total fair value option	1,431,525	773,280
Total	$ 1,863,358	$ 1,271,590

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

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

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

Fair Value Option

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

	September 30, 2014	December 31, 2013
Fixed maturities	$ 565,754	$ 448,254
Other investments	1,431,525	773,280
Short-term investments	205,716	—
Investments accounted for using the fair value option	$ 2,202,995	$ 1,221,534

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,	
	2014	2013	2014	2013
Fixed maturities	$66,052	$62,447	$194,370	$186,457
Term loan investments	14,065	5,296	26,642	15,539
Equity securities (dividends)	2,779	2,241	8,971	6,828
Short-term investments	905	417	1,417	1,173
Other (1)	7,914	3,753	21,733	14,786
Gross investment income	91,715	74,154	253,133	224,783
Investment expenses	(11,610)	(8,071)	(33,044)	(24,659)
Net investment income	$80,105	$66,083	$220,089	$200,124

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

Net Realized Gains (Losses)

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

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2014	2013	2014	2013
Available for sale securities:				
Gross gains on investment sales	$62,727	$47,433	$185,541	$183,306
Gross losses on investment sales	(35,012)	(69,256)	(108,053)	(149,095)
Change in fair value of assets and liabilities accounted for using the fair value option:				
Fixed maturities	(9,023)	5,599	318	3,955
Other investments	(1,085)	8,221	27,676	8,670
Equity securities	—	—	—	704
Short-term investments	638	—	638	—
Derivative instruments (1)	7,449	1,574	7,083	16,842
Other (2)	(7,179)	407	(20,847)	588
Net realized gains (losses)	$18,515	$(6,022)	$92,356	$64,970

(1) See Note 9 for information on the Company's derivative instruments.
(2) Includes accretion of contingent consideration liability amounts related to the acquisition of the CMG Entities (see Note 2 for further details).

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,	
	2014	2013	2014	2013
Fixed maturities:				
Mortgage backed securities	$(2)	$(280)	$(2)	$(295)
Corporate bonds	(147)	(88)	(811)	(88)
Asset backed securities	(29)	(20)	(40)	(40)
Total	(185)	(388)	(860)	(423)
Equity securities	(95)	(340)	(373)	(3,275)
Other investments	(8,313)	—	(25,080)	—
Net impairment losses recognized in earnings	$(8,593)	$(728)	$(26,313)	$(3,698)

A description of the methodology and significant inputs used to measure the amount of net impairment losses recognized in earnings in the 2014 periods is as follows:

- Other investments — the Company utilized information received from fund managers and positive and negative evidence on the fund investment, including the business prospects, recent events, industry and market data and other factors. Net impairment losses for the 2014 third quarter primarily related to a reduction in the carrying value of a fund investment as the Company decided to redeem its holding in early October 2014. Net impairment losses for the nine months ended September 30, 2014 primarily related to the same fund investment which was in an unrealized loss position and where the Company determined that it did not intend to hold such investment for a reasonable period of time by which the fair value of the fund would increase and the Company would recover its cost. The cost basis of such fund was adjusted down accordingly to its then current fair value based on an analysis performed each quarter;

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

- 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.

The Company believes that the $3.6 million of OTTI included in accumulated other comprehensive income at September 30, 2014 on the securities which were considered by the Company to be impaired was due to market and sector-related factors (i.e., not credit losses). At September 30, 2014, the Company did not intend to sell these securities, or any other securities which were in an unrealized loss position, and determined that it is more likely than not that the Company will not be required to sell such securities before recovery of their cost basis.

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

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2014	2013	2014	2013
Balance at start of period	$21,441	$61,449	$60,062	$62,001
Credit loss impairments recognized on securities not previously impaired	—	369	—	402
Credit loss impairments recognized on securities previously impaired	151	19	162	21
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	(217)	—	(38,849)	(587)
Balance at end of period	$21,375	$61,837	$21,375	$61,837

Restricted Assets

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

	September 30, 2014	December 31, 2013
Assets used for collateral or guarantees:		
Affiliated transactions	$ 4,159,480	$ 4,060,533
Third party agreements	941,372	856,890
Deposits with U.S. regulatory authorities	353,091	302,809

Deposits with non-U.S. regulatory authorities	—	6,546
Trust funds	76,110	75,264
Total restricted assets	$ 5,530,053	$ 5,302,042

8. Fair Value

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

The levels in the hierarchy are defined as follows:

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

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

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

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

The Company determines the existence of an active market based on its judgment as to whether transactions for the financial instrument occur in such market with sufficient frequency and volume to provide reliable pricing information. The independent pricing sources obtain market quotations and actual transaction prices for securities that have quoted prices in active markets. The Company uses quoted values and other data provided by nationally recognized independent pricing sources as inputs into its process for determining fair values of its fixed maturity investments. To validate the techniques or models used by pricing sources, the Company's review process includes, but is not limited to: (i) quantitative analysis (e.g., comparing the quarterly return for each managed portfolio to its target benchmark, with significant differences identified and investigated); (ii) a review of the average number of prices obtained in the pricing process and the range of resulting fair values; (iii) initial and ongoing evaluation of methodologies used by outside parties to calculate fair value including a review of deep dive reports on selected securities which indicate the use of observable inputs in the pricing process; (iv) comparing the fair value estimates to its knowledge of the current market; (v) a comparison of the pricing services' fair values to other pricing services' fair values for the same investments; and (vi) back-testing, which includes randomly selecting purchased or sold securities and comparing the executed prices to the fair value estimates from the pricing service. For a majority of investments, the Company obtained multiple quotes. A price source hierarchy was maintained in order to determine which price source would be used (i.e., a price obtained from a pricing service with more seniority in the hierarchy will be used over a less senior one in all cases). The hierarchy prioritizes pricing services based on availability and reliability and assigns the highest priority to index providers. Based on the above review, the Company will challenge any prices for a security or portfolio which are considered not to be representative of fair value. The Company did not adjust any of the prices obtained from the pricing services at September 30, 2014.

The independent pricing sources obtain market quotations and actual transaction prices for securities that have quoted prices in active markets. Each source has its own proprietary method for determining the fair value of securities that are not actively traded. In general, these methods involve the use of "matrix pricing" in which the independent pricing source uses observable market inputs including, but not limited to, investment yields, credit risks and spreads, benchmarking of like securities, broker-dealer quotes, reported trades and sector groupings to determine a reasonable fair value. In addition, pricing vendors use model processes, such as an Option Adjusted Spread model, to develop prepayment and interest rate scenarios. The Option Adjusted Spread model is commonly used to estimate fair value for securities such as mortgage backed and asset backed securities. In certain circumstances, when fair values are unavailable from these independent pricing sources, quotes are obtained directly from broker-dealers who are active in the corresponding markets. Such quotes are subject to the validation procedures noted above. Of the $14.87 billion of financial assets and liabilities measured at fair value at September 30, 2014, approximately $420.4 million, or 2.8%, were priced using non-binding broker-dealer quotes. Of the $13.37 billion of financial assets and liabilities measured at fair value at December 31, 2013, approximately $601.9 million, or 4.5%, were priced using non-binding broker-dealer quotes.

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

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

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

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

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

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

Contingent consideration liability. The contingent consideration liability (included in 'other liabilities' in the consolidated balance sheets) resulted from the acquisition of the CMG Entities and is remeasured at fair value at each balance sheet date. Changes in fair value are recognized in 'net realized gains (losses).' To determine the fair value of the contingent consideration liability, the Company estimates future payments using an income approach based on modeled inputs which include a weighted average cost of capital. The Company determined that the contingent consideration liability would be included in Level 3 of the valuation hierarchy.

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The following table presents the Company’s financial assets and liabilities measured at fair value by level at September 30, 2014:

	Fair Value	Fair Value Measurement Using: Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
Assets measured at fair value:				
Available for sale securities:				
Fixed maturities and fixed maturities pledged under securities lending agreements (1):				
Corporate bonds	$3,070,353	$—	$3,070,353	$—
Mortgage backed securities	966,848	—	966,848	—
Municipal bonds	1,293,455	—	1,293,455	—
Commercial mortgage backed securities	1,232,092	—	1,232,092	—
U.S. government and government agencies	1,551,583	1,551,583	—	—
Non-U.S. government securities	1,001,947	—	1,001,947	—
Asset backed securities	1,724,651	—	1,724,651	—
Total	10,840,929	1,551,583	9,289,346	—
Equity securities	582,075	582,075	—	—
Other investments	431,833	—	328,750	103,083
Short-term investments	748,659	723,698	24,961	—
Fair value option:				
Corporate bonds	452,275	—	452,275	—
Non-U.S. government bonds	70,494	—	70,494	—
Mortgage backed securities	17,919	—	17,919	—
Asset backed securities	25,066	—	25,066	—
Other investments	1,431,525	—	1,008,531	422,994
Short-term investments	205,716	198,077	7,639	—
Total	2,202,995	198,077	1,581,924	422,994
Total assets measured at fair value	$14,806,491	$3,055,433	$11,224,981	$526,077
Liabilities measured at fair value:				
Contingent consideration liability	$58,661	$—	$—	$58,661
Total liabilities measured at fair value	$58,661	$—	$—	$58,661

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

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

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

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

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

	Fair Value Measurements Using: Significant Unobservable Inputs (Level 3)				
	Assets				Liabilities
s	Available-For-Sale		Fair Value Option		
	Corporate Bonds	Other Investments	Other Investments	Total	Contingent Consideration Liability
Three Months Ended September 30, 2014					
Balance at beginning of period	$—	$103,213	$451,036	$554,249	$ 53,099
Total gains or (losses) (realized/unrealized)					
Included in earnings (1)	—	(262)	(3,224)	(3,486)	5,562
Included in other comprehensive income	—	132	—	132	—
Purchases, issuances, sales and settlements					
Purchases	—	—	18,058	18,058	—
Issuances	—	—	—	—	—
Sales	—	—	—	—	—
Settlements	—	—	(42,876)	(42,876)	—
Transfers in and/or out of Level 3	—	—	—	—	—
Balance at end of period	$—	$103,083	$422,994	$526,077	$ 58,661
Three Months Ended September 30, 2013					
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	$ —

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

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	Fair Value Measurements Using: Significant Unobservable Inputs (Level 3)				
	Assets				Liabilities
s	Available-For-Sale		Fair Value Option		
	Corporate Bonds	Other Investments	Other Investments	Total	Contingent Consideration Liability
Nine Months Ended September 30, 2014					
Balance at beginning of period	$2,045	$170,420	$377,525	$549,990	$ —
Total gains or (losses) (realized/unrealized)					
Included in earnings (1)	—	291	19,222	19,513	16,899
Included in other comprehensive income	—	(1,464)	932	(532)	—
Purchases, issuances, sales and settlements					
Purchases	—	—	124,783	124,783	—
Issuances	—	—	—	—	41,762
Sales	(2,045)	(66,164)	—	(68,209)	—
Settlements	—	—	(99,468)	(99,468)	—
Transfers in and/or out of Level 3	—	—	—	—	—
Balance at end of period	$—	$103,083	$422,994	$526,077	$ 58,661
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	$ —

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

The amount of total losses for the 2014 third quarter included in earnings attributable to the change in unrealized gains or losses relating to assets still held at September 30, 2014 was $3.5 million, while the amount of total gains for the nine months ended September 30, 2014 included in earnings attributable to the change in unrealized gains or losses relating to assets still held at September 30, 2014 was $14.3 million. 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.

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, 2014, due to their respective short maturities. As these financial instruments are not actively traded, their respective fair values are classified within Level 2.

At September 30, 2014, the senior notes of ACGL were carried at their cost of $300.0 million and had a fair value of $414.8 million while the senior notes of Arch-U.S. were carried at their cost of $500.0 million and had a fair value of $543.1 million. The fair values of the senior notes were obtained from a third party pricing service and are based on observable market inputs. As such, the fair value of the senior notes is classified within Level 2.

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, 2014 or December 31, 2013.

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

	Asset Derivatives Fair Value	Liability Derivatives Fair Value	Net Derivatives Fair Value	Notional Value (1)
September 30, 2014				
Futures contracts	$437	$(1,797)	$(1,360)	$1,333,987
Foreign currency forward contracts	6,297	(1,783)	4,514	350,938
TBAs	397,193	(407,954)	(10,761)	776,558
Other	3,763	(2,719)	1,044	758,581
Total	$407,690	$(414,253)	$(6,563)	
December 31, 2013				
Futures contracts	$461	$(110)	$351	$475,967
Foreign currency forward contracts	5,023	(3,090)	1,933	330,746
TBAs	33,455	(21,731)	11,724	56,160
Other	920	(1,541)	(621)	347,916
Total	$39,859	$(26,472)	$13,387	

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

The Company's derivative instruments are generally traded under master netting agreements, which establish terms that apply to all derivative transactions with a counterparty. In the event of a bankruptcy or other stipulated event of default, such agreements provide that the non-defaulting party may elect to terminate all outstanding derivative transactions, in which case all individual derivative positions (loss or gain) with a counterparty are closed out and netted and replaced with a single amount, usually referred to as the termination amount, which is expressed in a single currency. The resulting single net amount, where positive, is payable to the party “in-the-money” regardless of whether or not it is the defaulting party, unless the parties have agreed that only the non-defaulting party is entitled to receive a termination payment where the net amount is positive and is in its favor. Effectively, contractual close-out netting reduces derivatives credit exposure from gross to net exposure. At September 30, 2014, asset derivatives and liability derivatives of $203.9 million and $343.7 million, respectively, were subject to a master netting agreement, compared to $28.0 million and $14.6 million, respectively, at December 31, 2013. The remaining derivatives included in the table above were not subject to a master netting agreement.

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

Derivatives not designated as hedging instruments	Three Months Ended September 30, 2014	2013	Nine Months Ended September 30, 2014	2013
Futures contracts	$(354)	$(2,804)	$4,969	$6,990
Foreign currency forward contracts	6,558	1,344	2,490	8,224
TBAs	660	2,511	353	(699)
Other	585	523	(729)	2,327
Total	$7,449	$1,574	$7,083	$16,842

10. Commitments and Contingencies

Letter of Credit and Revolving Credit Facilities

As of September 30, 2014, the Company had a $300 million unsecured revolving loan and letter of credit facility and a $500 million secured letter of credit facility (the "Credit Agreement"). The Credit Agreement expires on June 30, 2019. In addition, the Company had access to secured letter of credit facilities of approximately $192.5 million as of September 30, 2014, which are available on a limited basis and for limited purposes (together with the secured portion of the Credit Agreement and these letter of credit facilities, the "LOC Facilities"). At September 30, 2014, the Company had $421.4 million in outstanding letters of credit under the LOC Facilities, which were secured by investments with a fair value of $480.9 million, and had $100.0 million of borrowings outstanding under the Credit Agreement which are due on June 30, 2019. The Company was in compliance with all covenants contained in the LOC Facilities at September 30, 2014. As of September 30, 2014, Watford had a $200 million line of credit facility that expires on May 19, 2015. At September 30, 2014, Watford had $3.4 million in outstanding letters of credit under that credit facility. Watford was in compliance with all covenants contained in its credit facility at September 30, 2014.

Investment Commitments

The Company's investment commitments, which are primarily related to agreements entered into by the Company to invest in funds and separately managed accounts when called upon, were approximately $941.9 million at September 30, 2014.

11. Share Transactions

Share Repurchases

The board of directors of ACGL has authorized the investment in ACGL's common shares through a share repurchase program. Since the inception of the share repurchase program, ACGL has repurchased approximately 114.5 million common shares for an aggregate purchase price of $3.04 billion. For the 2014 third quarter and nine months ended September 30, 2014, ACGL repurchased 4,593,726 common shares for an aggregate purchase price of $251.9 million. During the 2013 third quarter and nine months ended September 30, 2013, ACGL repurchased 26,300 and 1,264,718 common shares, respectively, for an aggregate purchase price of $1.3 million and $57.8 million, respectively. At September 30, 2014, $460.2 million of share repurchases were available under the program. The timing and amount of the repurchase transactions under this program will depend on a variety of factors, including market conditions and corporate and regulatory considerations. See Note 16.

12. Income Taxes

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

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

The Company's income tax provision on income before income taxes resulted in an expense of 2.8% for the nine months ended September 30, 2014, compared to an expense of 3.1% for the 2013 period. These rates include the tax effect of unusual or infrequent items representing 0.1% and 0.2% of the Company's effective tax rate for the nine months ended September 30, 2014 and the 2013 period, respectively. 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 $155.8 million at September 30, 2014, compared to $128.6 million at December 31, 2013. In addition, the Company paid $13.3 million in income taxes for the nine months ended September 30, 2014, while the Company paid $7.6 million for the 2013 period.

13. Other Comprehensive Income (Loss)

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

		Amounts Reclassed from AOCI			
	Consolidated Statement of Income	Three Months Ended		Nine Months Ended	
Details About	Line Item That Includes	September 30,		September 30,	
AOCI Components	Reclassification	2014	2013	2014	2013
Unrealized appreciation on available-for-sale investments					
	Net realized gains (losses)	$27,715	$(21,825)	$77,488	$37,176
	Other-than-temporary impairment losses	(8,593)	(901)	(26,313)	(3,873)
	Total before tax	19,122	(22,726)	51,175	33,303
	Income tax (expense) benefit	(1,639)	2,025	(4,158)	(1,387)
	Net of tax	$17,483	$(20,701)	$47,017	$31,916

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

	Before Tax Amount	Tax Expense (Benefit)	Net of Tax Amount
Three Months Ended September 30, 2014			
Unrealized appreciation (decline) in value of investments:			
Unrealized holding gains (losses) arising during period	$(90,276)	$343	$(90,619)
Portion of other-than-temporary impairment losses recognized in other comprehensive income (loss)	—	—	—
Less reclassification of net realized gains included in net income	19,122	1,639	17,483
Foreign currency translation adjustments	(23,595)	—	(23,595)
Other comprehensive income (loss)	$(132,993)	$(1,296)	$(131,697)
Three Months Ended September 30, 2013			
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 (losses) 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
Nine Months Ended September 30, 2014			
Unrealized appreciation (decline) in value of investments:			
Unrealized holding gains (losses) arising during period	$100,274	$11,112	$89,162
Portion of other-than-temporary impairment losses recognized in other comprehensive income (loss)	—	—	—
Less reclassification of net realized gains included in net income	51,175	4,158	47,017
Foreign currency translation adjustments	(14,923)	—	(14,923)
Other comprehensive income (loss)	$34,176	$6,954	$27,222
Nine Months Ended September 30, 2013			
Unrealized appreciation (decline) in value of investments:			
Unrealized holding gains (losses) arising during period	$(229,919)	$(21,054)	$(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	(4,106)	—	(4,106)
Other comprehensive income (loss)	$(267,503)	$(22,441)	$(245,062)

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14. Guarantor Financial Information

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

	September 30, 2014				
Condensed Consolidating Balance Sheet	ACGL (Parent Guarantor)	Arch-U.S. (Subsidiary Issuer)	Other ACGL Subsidiaries	Consolidating Adjustments and Eliminations	ACGL Consolidated
Assets					
Total investments	$134	$78,741	$15,031,573	$—	$15,110,448
Cash	5,969	15,710	642,047	—	663,726
Investments in subsidiaries	6,487,180	1,641,236	—	(8,128,416)	—
Due from subsidiaries and affiliates	34	—	405,714	(405,748)	—
Premiums receivable	—	—	1,410,961	(383,757)	1,027,204
Reinsurance recoverable on unpaid and paid losses and loss adjustment expenses	—	—	5,572,303	(3,758,113)	1,814,190
Contractholder receivables	—	—	1,286,799	—	1,286,799
Prepaid reinsurance premiums	—	—	1,430,149	(1,025,488)	404,661
Deferred acquisition costs, net	—	—	409,174	—	409,174
Other assets	7,412	63,507	2,264,246	(440,682)	1,894,483
Total assets	$6,500,729	$1,799,194	$28,452,966	$(14,142,204)	$22,610,685
Liabilities					
Reserve for losses and loss adjustment expenses	$—	$—	$12,701,382	$(3,742,648)	$8,958,734
Unearned premiums	—	—	3,328,735	(1,025,488)	2,303,247
Reinsurance balances payable	—	—	615,237	(370,858)	244,379
Contractholder payables	—	—	1,286,799	—	1,286,799
Deposit accounting liabilities	—	—	628,383	(278,533)	349,850
Senior notes	300,000	500,000	—	—	800,000
Revolving credit agreement borrowings	100,000	—	—	—	100,000
Due to subsidiaries and affiliates	5	—	405,743	(405,748)	—
Other liabilities	19,678	58,139	1,597,887	(190,513)	1,485,191
Total liabilities	419,683	558,139	20,564,166	(6,013,788)	15,528,200
Redeemable noncontrolling interests (1)	—	—	219,419	—	219,419
Shareholders' Equity					
Total shareholders' equity available to Arch	6,081,046	1,241,055	6,887,361	(8,128,416)	6,081,046
Non-redeemable noncontrolling interests (1)	—	—	782,020	—	782,020
Total shareholders' equity	6,081,046	1,241,055	7,669,381	(8,128,416)	6,863,066
Total liabilities, noncontrolling interests and shareholders' equity	$6,500,729	$1,799,194	$28,452,966	$(14,142,204)	$22,610,685

(1) See Note 4.

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

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)

	Three Months Ended September 30, 2014				
Condensed Consolidating Statement of Income and Comprehensive Income	ACGL (Parent Guarantor)	Arch-U.S. (Subsidiary Issuer)	Other ACGL Subsidiaries	Consolidating Adjustments and Eliminations	ACGL Consolidated
Revenues					
Net premiums earned	$—	$—	$903,651	$—	$903,651
Net investment income	—	—	79,936	169	80,105
Net realized gains	—	—	18,515	—	18,515
Net impairment losses recognized in earnings	—	—	(8,593)	—	(8,593)
Other underwriting income	—	—	1,702	—	1,702
Equity in net income of investment funds accounted for using the equity method	—	—	4,966	—	4,966
Other income (loss)	—	—	(7,815)	—	(7,815)
Total revenues	—	—	992,362	169	992,531
Expenses					
Losses and loss adjustment expenses	—	—	501,673	—	501,673
Acquisition expenses	—	—	163,547	—	163,547
Other operating expenses	10,056	810	138,614	—	149,480
Interest expense	5,858	6,433	(8,308)	169	4,152
Net foreign exchange gains	—	—	(35,244)	(20,787)	(56,031)
Total expenses	15,914	7,243	760,282	(20,618)	762,821
Income (loss) before income taxes	(15,914)	(7,243)	232,080	20,787	229,710
Income tax benefit (expense)	—	2,097	(8,543)	—	(6,446)
Income (loss) before equity in net income of subsidiaries	(15,914)	(5,146)	223,537	20,787	223,264
Equity in net income of subsidiaries	244,589	10,459	—	(255,048)	—
Net income	228,675	5,313	223,537	(234,261)	223,264
Amounts attributable to noncontrolling interests (1)	—	—	5,411	—	5,411
Net income available to Arch	228,675	5,313	228,948	(234,261)	228,675
Preferred dividends	(5,484)	—	—	—	(5,484)
Net income available to Arch common shareholders	$223,191	$5,313	$228,948	$(234,261)	$223,191
Comprehensive income available to Arch	$96,978	$(10,614)	$104,501	$(93,887)	$96,978

(1) See Note 4.

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ARCH CAPITAL GROUP LTD. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)

	Three Months Ended September 30, 2013				
Condensed Consolidating Statement of Income and Comprehensive Income	ACGL (Parent Guarantor)	Arch-U.S. (Subsidiary Issuer)	Other ACGL Subsidiaries	Consolidating Adjustments and Eliminations	ACGL Consolidated
Revenues					
Net premiums earned	$—	$—	$795,000	$—	$795,000
Net investment income	—	—	72,772	(6,689)	66,083
Net realized losses	—	—	(6,022)	—	(6,022)
Net impairment losses recognized in earnings	—	—	(728)	—	(728)
Other underwriting income	—	—	526	—	526
Equity in net income of investment funds accounted for using the equity method	—	—	5,665	—	5,665
Other income (loss)	—	—	624	—	624
Total revenues	—	—	867,837	(6,689)	861,148
Expenses					
Losses and loss adjustment expenses	—	—	427,045	—	427,045
Acquisition expenses	—	—	147,313	—	147,313
Other operating expenses	6,975	397	110,698	—	118,070
Interest expense	5,793	7	6,826	(6,689)	5,937
Net foreign exchange losses	—	—	26,815	13,747	40,562
Total expenses	12,768	404	718,697	7,058	738,927
Income (loss) before income taxes	(12,768)	(404)	149,140	(13,747)	122,221
Income tax expense	—	(1,356)	(6,040)	—	(7,396)
Income (loss) before equity in net income of subsidiaries	(12,768)	(1,760)	143,100	(13,747)	114,825
Equity in net income of subsidiaries	127,593	6,839	—	(134,432)	—
Net income	114,825	5,079	143,100	(148,179)	114,825
Amounts attributable to noncontrolling interests	—	—	—	—	—
Net income available to Arch	114,825	5,079	143,100	(148,179)	114,825
Preferred dividends	(5,484)	—	—	—	(5,484)
Net income available to Arch common shareholders	$109,341	$5,079	$143,100	$(148,179)	$109,341
Comprehensive income available to Arch	$206,102	$18,444	$220,630	$(239,074)	$206,102

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ARCH CAPITAL GROUP LTD. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)

	Nine Months Ended September 30, 2014				
Condensed Consolidating Statement of Income and Comprehensive Income	ACGL (Parent Guarantor)	Arch-U.S. (Subsidiary Issuer)	Other ACGL Subsidiaries	Consolidating Adjustments and Eliminations	ACGL Consolidated
Revenues					
Net premiums earned	$—	$—	$2,670,583	$—	$2,670,583
Net investment income	—	—	237,317	(17,228)	220,089
Net realized gains	—	—	92,356	—	92,356
Net impairment losses recognized in earnings	—	—	(26,313)	—	(26,313)
Other underwriting income	—	—	5,317	—	5,317
Equity in net income of investment funds accounted for using the equity method	—	—	17,459	—	17,459
Other income (loss)	—	—	(5,069)	—	(5,069)
Total revenues	—	—	2,991,650	(17,228)	2,974,422
Expenses					
Losses and loss adjustment expenses	—	—	1,423,431	—	1,423,431
Acquisition expenses	—	—	482,047	—	482,047
Other operating expenses	35,613	2,281	413,735	—	451,629
Interest expense	17,565	19,395	13,158	(17,228)	32,890
Net foreign exchange gains	—	—	(28,449)	(18,725)	(47,174)
Total expenses	53,178	21,676	2,303,922	(35,953)	2,342,823
Income (loss) before income taxes	(53,178)	(21,676)	687,728	18,725	631,599
Income tax benefit (expense)	—	8,179	(25,652)	—	(17,473)
Income (loss) before equity in net income of subsidiaries	(53,178)	(13,497)	662,076	18,725	614,126
Equity in net income of subsidiaries	672,369	41,945	—	(714,314)	—
Net income	619,191	28,448	662,076	(695,589)	614,126
Amounts attributable to noncontrolling interests (1)	—	—	5,065	—	5,065
Net income available to Arch	619,191	28,448	667,141	(695,589)	619,191
Preferred dividends	(16,453)	—	—	—	(16,453)
Net income available to Arch common shareholders	$602,738	$28,448	$667,141	$(695,589)	$602,738
Comprehensive income available to Arch	$646,413	$29,792	$691,968	$(721,760)	$646,413

(1) See Note 4.

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ARCH CAPITAL GROUP LTD. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)

Condensed Consolidating Statement of Income and Comprehensive Income	Nine Months Ended September 30, 2013 ACGL (Parent Guarantor)	Arch-U.S. (Subsidiary Issuer)	Other ACGL Subsidiaries	Consolidating Adjustments and Eliminations	ACGL Consolidated
Revenues					
Net premiums earned	$—	$—	$2,306,586	$—	$2,306,586
Net investment income	—	—	220,074	(19,950)	200,124
Net realized gains	—	—	64,970	—	64,970
Net impairment losses recognized in earnings	—	—	(3,698)	—	(3,698)
Other underwriting income	—	—	1,966	—	1,966
Equity in net income of investment funds accounted for using the equity method	—	—	30,429	—	30,429
Other income (loss)	—	—	2,702	—	2,702
Total revenues	—	—	2,623,029	(19,950)	2,603,079
Expenses					
Losses and loss adjustment expenses	—	—	1,245,101	—	1,245,101
Acquisition expenses	—	—	406,582	—	406,582
Other operating expenses	30,608	1,947	333,106	—	365,661
Interest expense	17,456	15	20,166	(19,950)	17,687
Net foreign exchange (gains) losses	—	—	(1,839)	4,326	2,487
Total expenses	48,064	1,962	2,003,116	(15,624)	2,037,518
Income (loss) before income taxes	(48,064)	(1,962)	619,913	(4,326)	565,561
Income tax benefit (expense)	—	1,629	(18,949)	—	(17,320)
Income (loss) before equity in net income of subsidiaries	(48,064)	(333)	600,964	(4,326)	548,241
Equity in net income of subsidiaries	596,305	36,024	—	(632,329)	—
Net income	548,241	35,691	600,964	(636,655)	548,241
Amounts attributable to noncontrolling interests	—	—	—	—	—
Net income available to Arch	548,241	35,691	600,964	(636,655)	548,241
Preferred dividends	(16,453)	—	—	—	(16,453)
Net income available to Arch common shareholders	$531,788	$35,691	$600,964	$(636,655)	$531,788
Comprehensive income available to Arch	$303,179	$(4,385)	$351,576	$(347,191)	$303,179

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ARCH CAPITAL GROUP LTD. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)

	Nine Months Ended September 30, 2014				
Condensed Consolidating Statement of Cash Flows	ACGL (Parent Guarantor)	Arch-U.S. (Subsidiary Issuer)	Other ACGL Subsidiaries	Consolidating Adjustments and Eliminations	ACGL Consolidated
Operating Activities					
Net Cash Provided By Operating Activities	$265,694	$8,407	$822,558	$(297,000)	$799,659
Investing Activities					
Purchases of fixed maturity investments	—	(78,509)	(21,952,353)	—	(22,030,862)
Purchases of equity securities	—	—	(366,578)	—	(366,578)
Purchases of other investments	—	—	(1,596,691)	—	(1,596,691)
Proceeds from the sales of fixed maturity investments	—	—	20,284,869	—	20,284,869
Proceeds from the sales of equity securities	—	—	305,034	—	305,034
Proceeds from the sales of other investments	—	—	1,030,901	—	1,030,901
Proceeds from redemptions and maturities of fixed maturity investments	—	—	636,729	—	636,729
Net sales of short-term investments	2,396	408,760	267,232	—	678,388
Change in investment of securities lending collateral	—	—	(2,737)	—	(2,737)
Contributions to subsidiaries	—	(313,207)	(100,000)	413,207	—
Intercompany loans issued	—	—	10,250	(10,250)	—
Purchase of business, net of cash acquired	—	—	(235,578)	—	(235,578)
Purchases of furniture, equipment and other assets	(220)	—	(14,355)	—	(14,575)
Net Cash Provided By (Used For) Investing Activities	2,176	17,044	(1,733,277)	402,957	(1,311,100)
Financing Activities					
Purchases of common shares under share repurchase program	(251,919)	—	—	—	(251,919)
Proceeds from common shares issued, net	3,248	—	413,207	(413,207)	3,248
Repayments of intercompany borrowings	—	(10,250)	—	10,250	—
Change in securities lending collateral	—	—	2,737	—	2,737
Third party investment in non-redeemable noncontrolling interests (1)	—	—	796,903	—	796,903
Third party investment in redeemable noncontrolling interests (1)	—	—	219,233	—	219,233
Dividends paid to redeemable noncontrolling interests (1)	—	—	(9,632)	—	(9,632)
Dividends paid to parent	—	—	(297,000)	297,000	—
Other	—	—	6,559	—	6,559

Preferred dividends paid	(16,453)	—	—	—	(16,453)
Net Cash Provided By (Used For) Financing Activities	(265,124)	(10,250)	1,132,007	(105,957)	750,676
Effects of exchange rates changes on foreign currency cash	—	—	(9,566)	—	(9,566)
Increase in cash	2,746	15,201	211,722	—	229,669
Cash beginning of year	3,223	509	430,325	—	434,057
Cash end of period	$5,969	$15,710	$642,047	$—	$663,726

(1) See Note 4.

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ARCH CAPITAL GROUP LTD. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)

	Nine Months Ended September 30, 2013				
Condensed Consolidating Statement of Cash Flows	ACGL (Parent Guarantor)	Arch-U.S. (Subsidiary Issuer)	Other ACGL Subsidiaries	Consolidating Adjustments and Eliminations	ACGL Consolidated
Operating Activities					
Net Cash Provided By (Used For) Operating Activities	$62,400	$(653)	$659,301	$(94,000)	$627,048
Investing Activities					
Purchases of fixed maturity investments	—	—	(12,436,587)	—	(12,436,587)
Purchases of equity securities	—	—	(438,255)	—	(438,255)
Purchases of other investments	—	—	(992,935)	—	(992,935)
Proceeds from the sales of fixed maturity investments	—	—	11,877,419	—	11,877,419
Proceeds from the sales of equity securities	—	—	373,000	—	373,000
Proceeds from the sales of other investments	—	—	813,596	—	813,596
Proceeds from redemptions and maturities of fixed maturity investments	—	—	595,503	—	595,503
Net (purchases) sales of short-term investments	7,789	2,996	(279,753)	—	(268,968)
Change in investment of securities lending collateral	—	—	2,508	—	2,508
Contributions to subsidiaries	(160)	(11,850)	(250)	12,260	—
Intercompany loans issued	—	—	(10,250)	10,250	—
Purchases of furniture, equipment and other assets	(402)	—	(10,551)	—	(10,953)
Net Cash Provided By (Used For) Investing Activities	7,227	(8,854)	(506,555)	22,510	(485,672)
Financing Activities					
Purchases of common shares under share repurchase program	(57,796)	—	—	—	(57,796)
Proceeds from common shares issued, net	(425)	—	12,260	(12,260)	(425)
Proceeds from intercompany borrowings	—	10,250	—	(10,250)	—
Change in securities lending collateral	—	—	(2,508)	—	(2,508)
Dividends paid to parent	—	—	(94,000)	94,000	—
Other	—	—	5,679	—	5,679
Preferred dividends paid	(16,453)	—	—	—	(16,453)
Net Cash Provided By (Used For) Financing Activities	(74,674)	10,250	(78,569)	71,490	(71,503)
Effects of exchange rates changes on foreign currency cash	—	—	(4,773)	—	(4,773)
Increase (decrease) in cash	(5,047)	743	69,404	—	65,100
Cash beginning of year	6,417	612	364,012	—	371,041
Cash end of period	$1,370	$1,355	$433,416	$—	$436,141

15. 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, 2014, 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.

16. Subsequent Events

At September 30, 2014, $460.2 million of share repurchases were available under ACGL's share repurchase program. From October 1 through October 29, 2014, the Company repurchased 1.6 million common shares for an aggregate purchase price of $89.2 million. On November 6, 2014, the board of directors of ACGL increased the aggregate purchase amount authorized under the share repurchase program to $1.0 billion. Repurchases under this authorization may be effected from time to time in open market or privately negotiated transactions through December 31, 2016. The timing and amount of the repurchase transactions under this authorization will depend on a variety of factors, including market conditions and corporate and regulatory considerations.

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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, 2013 ("2013 Form 10-K"). In addition, readers should review "Risk Factors" set forth in Item 1A of Part I of our 2013 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 $6.98 billion in capital at September 30, 2014 and, through operations in Bermuda, the United States, Europe and Canada, writes specialty lines of property and casualty insurance and reinsurance, as well as mortgage insurance and reinsurance, on a worldwide basis.

Current Outlook

Our insurance group continued to obtain rate increases above loss cost trends in the primary insurance markets during the 2014 third quarter, slightly below the levels observed in the 2014 second quarter. Our insurance group continues to see its best opportunities in some sectors of the excess and surplus market and in its binding authority and program business. Competitive conditions have negatively affected primary property rates resulting in lower premium volume. In our reinsurance business, we see a continued softening of terms and conditions with property catastrophe business remaining under pressure due to the alternative capacity in the market. Also, cedents continue to request additional ceding commissions on quota share contracts and reinsurance buyers continue to shift business to excess of loss treaties. Our underwriting teams continue to execute a disciplined strategy by emphasizing small and medium-sized accounts over large accounts.

On January 30, 2014, the Company acquired CMG Mortgage Insurance Company and its affiliated mortgage insurance companies (together, "CMG Entities") and the mortgage insurance platform and related assets from PMI Mortgage Insurance Co. ("PMI"). CMG Mortgage Insurance Company (subsequently renamed Arch Mortgage Insurance Company), is the leading provider of mortgage insurance products and services to credit unions in the U.S. Prior to the acquisition, CMG Mortgage Insurance Company had been approved as an eligible mortgage insurer by Federal National Mortgage Association and Federal Home Loan Mortgage Corporation (each a government sponsored enterprise or "GSE") solely for credit union customers. As part of the transaction, Arch Mortgage Insurance Company ("Arch MI U.S.") has been approved as an eligible mortgage insurer by the GSEs. Arch MI U.S. will continue to serve its existing credit union customers and, at the same time, has made substantial progress in building out its sales force to serve banks and other mortgage originators.

In late March 2014, Watford Re Ltd., a newly-formed multi-line Bermuda reinsurance company, was launched with over $1.1 billion of initial capital. We invested $100.0 million in Watford Holdings Ltd., Watford Re Ltd.'s parent (combined with Watford Re Ltd., "Watford") to acquire approximately 11% of Watford Holdings Ltd.'s common equity and a warrant to purchase additional common equity. Arch Underwriters Ltd., our subsidiary, acts as Watford's reinsurance manager, and Highbridge Principal Strategies, LLC, a subsidiary of JPMorgan Chase & Co., manages Watford's investment assets, each under a long term services agreement. John Rathgeber, previously Vice Chairman of Arch Worldwide Reinsurance Group, was named CEO of Watford. In addition, Marc Grandisson, Chairman and CEO of Arch Worldwide Reinsurance and Mortgage Groups, and Nicolas Papadopoulo, CEO Reinsurance Group, were appointed to the board of directors of Watford.

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.

Deterioration in economic conditions could have a material impact on the frequency and severity of claims and, therefore, could negatively impact our underwriting returns. In addition, volatility in the financial markets could 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 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 available to Arch. We reserve the right to change this threshold at any time. Based on in-force exposure estimated as of October 1, 2014, our modeled peak zone catastrophe exposure was a windstorm affecting the Northeastern U.S., with a net probable maximum pre-tax loss of $658 million, followed by windstorms affecting the Gulf of Mexico and Florida Tri-County with net probable maximum pre-tax losses of $608 million and $451 million, respectively. Based on in-force exposure estimated as of July 1, 2014, our modeled peak zone exposure was a windstorm affecting the Northeastern U.S., with a net probable maximum pre-tax loss of $674 million, followed by windstorms affecting the Gulf of Mexico and Florida Tri-County with net probable maximum pre-tax losses of $623 million and $426 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, 2014, our modeled peak zone earthquake exposure (Los Angeles earthquake) represented approximately 51% of our peak zone catastrophe exposure, and our modeled peak zone international exposure (Japan earthquake) was substantially less than both our peak zone windstorm and earthquake exposures. Net probable maximum pre-tax loss estimates are net of expected reinsurance recoveries, before income tax and before excess reinsurance reinstatement premiums. Loss estimates are reflective of the zone indicated and not the entire portfolio. Since hurricanes and windstorms can affect more than one zone and make multiple landfalls, our loss estimates include clash estimates from other zones.

The loss estimates shown above do not represent our maximum exposures and it is highly likely that our actual incurred losses would vary materially from the modeled estimates. There can be no assurances that we will not suffer a net loss greater than 25% of total shareholders' equity available to Arch from one or more catastrophic events due to several factors, including the inherent uncertainties in estimating the frequency and severity of such events and the margin of error in making such determinations resulting from potential inaccuracies and inadequacies in the data provided by clients and brokers, the modeling techniques and the application of such techniques or as a result of a decision to change the percentage of shareholders' equity exposed to a single catastrophic event. Actual losses may also increase if our reinsurers fail to meet their obligations to us or the reinsurance protections purchased by us are exhausted or are otherwise unavailable. See "Risk Factors—Risk Relating to Our Industry" and "Management's Discussion and Analysis of Financial Condition and Results of Operations—Natural and Man-Made Catastrophic Events" in our 2013 Form 10-K.

Financial Measures

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

Book Value per Common Share

Book value per common share represents total common shareholders' equity available to Arch divided by the number of common shares outstanding. Management uses growth in book value per common share as a key measure of the value generated for our common shareholders each period and believes that book value per common share is the key driver of ACGL's share price over time. Book value per common share is impacted by, among other factors, our underwriting results, investment returns and share repurchase activity, which has an accretive or dilutive impact on book value per common share depending on the purchase price. Book value per common share was $44.04 at September 30, 2014, compared to $43.73 at June 30, 2014 and $38.34 at September 30, 2013. The 0.7% increase in the 2014 third quarter was driven by underwriting returns, offset by the impact of foreign exchange and investment returns, while the 14.9% increase for the trailing twelve months was driven by underwriting and investment returns.

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Operating Return on Average Common Equity

Operating return on average common equity ("Operating ROAE") represents annualized after-tax operating income available to Arch common shareholders divided by the average of beginning and ending common shareholders' equity available to Arch during the period. After-tax operating income available to Arch common shareholders, a "non-GAAP measure" as defined in the SEC rules, represents net income available to Arch common shareholders, excluding net realized gains or losses, net impairment losses recognized in earnings, equity in net income or loss of investment funds accounted for using the equity method and net foreign exchange gains or losses, net of income taxes. Management uses Operating ROAE as a key measure of the return generated to common shareholders and has set an objective to achieve an average Operating ROAE of 15% or greater over the insurance cycle, which it believes to be an attractive return to common shareholders given the risks we assume. See "Comment on Non-GAAP Financial Measures." Our Operating ROAE was 9.7% for the 2014 third quarter, compared to 11.9% for the 2013 third quarter, and 11.2% for the nine months ended September 30, 2014, compared to 11.9% for the 2013 period. The lower level of Operating ROAE for the 2014 third quarter primarily resulted from a lower level of underwriting income, reflecting an increase in attritional large losses and changes in mix of business, partially offset by a lower level of catastrophic activity. Operating ROAE for the 2014 periods also reflected a higher level of average common shareholders' equity compared to the 2013 periods. Our Operating ROAE also reflects the impact of new initiatives, such as our U.S. mortgage business, which required an upfront capital commitment but will take time to contribute significantly to our returns.

Total Return on Investments

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

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

At September 30, 2014, the benchmark return index had an average credit quality of "Aa2" by Moody's Investors Service ("Moody's"), an estimated duration of 3.49 years and included weightings to the following indices:

	Weighting	
The Bank of America Merrill Lynch 1-10 Year AA U.S. Corporate & Yankees Index	21.250	%
The Bank of America Merrill Lynch 1-5 Year U.S. Treasury Index	13.000	
The Bank of America Merrill Lynch U.S. Mortgage Backed Securities Index	11.875	
Barclays Capital CMBS, AAA Index	10.000	
The Bank of America Merrill Lynch 1-10 Year U.S. Municipal Securities Index	7.125	
The Bank of America Merrill Lynch 1-10 Year Euro Government Bond Index	5.500	

The Bank of America Merrill Lynch US Bullet Agency Securities 1-10 Years Index	5.000	
The Bank of America Merrill Lynch 0-3 Month U.S. Treasury Bill Index	5.000	
MSCI World Free Index	5.000	
The Bank of America Merrill Lynch 5-10 Year U.S. Treasury Index	3.250	
The Bank of America Merrill Lynch 1-10 Year U.K. Gilt Index	3.000	
The Bank of America Merrill Lynch U.S. High Yield Constrained Index	2.750	
Barclays Capital U.S. High-Yield Corporate Loan Index	2.750	
The Bank of America Merrill Lynch 1-10 Year Australia Government Bond Index	2.500	
The Bank of America Merrill Lynch 1-5 Year Canada Government Bond Index	2.000	
Total	100.000	%

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

	Arch Portfolio	Benchmark Return
Pre-tax total return (before investment expenses):		
2014 third quarter	(0.51)%	(0.89)%
2013 third quarter	1.43%	1.36%
Nine Months Ended September 30, 2014	2.32%	2.17%
Nine Months Ended September 30, 2013	0.31%	0.38%

Total return for the 2014 third quarter reflected the impact of the U.S. Dollar strengthening against the Euro, British Pound Sterling and other major currencies on non-U.S. Dollar denominated investments. Excluding foreign exchange, total return was 0.21% for the 2014 third quarter, compared to 0.84% for the 2013 third quarter, and 2.89% for the nine months ended September 30, 2014, compared to 0.27% for the 2013 period.

Comment on Non-GAAP Financial Measures

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

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

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

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RESULTS OF OPERATIONS

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

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2014	2013	2014	2013
After-tax operating income available to Arch common shareholders	$142,055	$149,205	$467,128	$442,974
Net realized gains (losses), net of tax	27,476	(3,442)	96,016	65,260
Net impairment losses recognized in earnings, net of tax	(8,593)	(728)	(26,313)	(3,698)
Equity in net income of investment funds accounted for using the equity method, net of tax	4,765	5,665	16,983	30,429
Net foreign exchange gains (losses), net of tax	57,488	(41,359)	48,924	(3,177)
Net income available to Arch common shareholders	$223,191	$109,341	$602,738	$531,788

Segment Information

During the 2014 first quarter, to reflect activity during the period as described below, we changed our segment structure and added two new segments (mortgage and ‘other’). We now classify our businesses into three underwriting segments — insurance, reinsurance and mortgage — and two other operating segments — ‘other’ and corporate (non-underwriting). Our insurance, reinsurance and mortgage segments each have managers who are responsible for the overall profitability of their respective segments and who are directly accountable to our chief operating decision makers, the Chairman, President and Chief Executive Officer of ACGL and the Chief Financial Officer of ACGL. The chief operating decision makers do not assess performance, measure return on equity or make resource allocation decisions on a line of business basis. Management measures segment performance for our three underwriting segments based on underwriting income or loss. We do not manage our assets by underwriting segment, with the exception of goodwill and intangible assets, and, accordingly, investment income is not allocated to each underwriting segment.

We determined our reportable segments using the management approach described in accounting guidance regarding disclosures about segments of an enterprise and related information. The accounting policies of the segments are the same as those used for the preparation of our consolidated financial statements. Intersegment business is allocated to the segment accountable for the underwriting results. The corporate (non-underwriting) segment results include net investment income, other income (loss), other expenses incurred by us, interest expense, net realized gains or losses, net impairment losses included in earnings, equity in net income (loss) of investment funds accounted for using the equity method, net foreign exchange gains or losses, income taxes and items related to our non-cumulative preferred shares. Such amounts exclude the results of the ‘other’ segment.

The mortgage segment was formed in the 2014 first quarter and consists of our mortgage insurance and reinsurance business, including Arch MI U.S. The mortgage segment also provides reinsurance on both a proportional and non-proportional basis globally, direct mortgage insurance in Europe and various risk-sharing products to government sponsored entities and mortgage lenders.

The ‘other’ segment includes the results of Watford, which is a multi-line Bermuda reinsurance company launched in late March 2014. Watford has its own management and board of directors that is responsible for the overall profitability of its results. We are required to consolidate the results of Watford in our financial statements. The portion of Watford’s earnings attributable to third party investors is recorded in the consolidated statements of income as ‘amounts attributable to noncontrolling interests.’ For the ‘other’ segment, performance is measured based on net income or loss.

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Insurance Segment

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

	Three Months Ended September 30,			Nine Months Ended September 30,		
	2014	2013	% Change	2014	2013	% Change
Gross premiums written	$726,683	$682,839	6.4	$2,309,560	$2,075,560	11.3
Premiums ceded	(187,689)	(180,868)		(646,082)	(567,471)	
Net premiums written	538,994	501,971	7.4	1,663,478	1,508,089	10.3
Change in unearned premiums	(19,607)	(22,842)		(158,878)		